SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 20-F

☐ 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, 2002

OR

☐ Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____________ to _____________

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)

Takebashi Yasuda Bldg., 3-13, Kanda Nishiki-cho
Chiyoda-ku, Tokyo 101-0054 Japan

(Address of principal executive offices)

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

Title of Each Class	Name of Each Exchange On Which Registered
None	**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, 2002, 22,480 shares of common stock were outstanding, including an aggregate of 6,041 shares represented by an aggregate of 12,082,000 American Depository Shares.

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 X No __

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

Item 17 ____Item 18 X

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Cautionary Note Regarding Forward-looking Statements

This annual report contains forward-looking statements that are based on our current expectations, assumptions, estimates and projections about us and our industry. 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 promise 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 expectations are generally set forth in Item 3.D. and include, without limitation:

- that our large investment in Crosswave Communications Inc. may not yield the expected returns,
- that we may not continue to increase subscribers to our connectivity services, particularly subscribers at higher bandwidths, and
- that we may not generate significant revenues from our systems integration services or our Internet data center services.

PART I

Item 1. Identity of Directors, Senior Management and Advisors.

Not Applicable.

Item 2. Offer Statistics and Expected Timetable.

Not Applicable.

Item 3. Key Information.

A. Selected financial data.

The selected consolidated financial data below should be read together with our consolidated financial statements and the notes to the financial statements beginning on page F-1 and with Item 5., "Operating and Financial Review and Prospects". The statement of operations data below for the fiscal years ended March 31, 1998, 1999, 2000, 2001 and 2002 and the balance sheet data as of March 31, 1998, 1999, 2000, 2001 and 2002 are derived from our audited financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States, or U.S. GAAP, and audited by Deloitte Touche Tohmatsu, independent auditors.

	As of and for the year ended March 31,					
	1998	1999	2000	2001	2002	2002
	(millions of yen, except per share and ADS data)					(thousands of U.S. dollars, except per share and ADS data)
Statement of Operations Data:						
Connectivity and value-added services revenues:						
Dedicated access	¥ 6,756	¥ 7,798	¥ 9,999	¥ 12,779	¥ 13,542	$ 102,049
Dial-up access	4,474	4,101	4,496	4,423	3,644	27,461
Value-added	368	496	884	2,136	3,861	29,097
Other..	132	110	408	592	1,668	12,570
Total connectivity and value-added services revenue	11,730	12,505	15,787	19,930	22,715	171,177
Systems integration revenues, including related equipment sales	527	1,179	7,640	10,556	14,356	108,179
Other equipment sales revenues	66	1,085	1,875	1,390	2,834	21,357
Total revenues	12,323	14,769	25,302	31,876	39,905	300,713
Cost of connectivity and value-added services revenues	9,015	11,178	15,091	18,983	19,800	149,204
Cost of systems integration revenues, including related equipment sales	329	950	6,272	9,117	12,314	92,797
Cost of other equipment sales revenues	60	1,074	1,807	1,289	2,540	19,142
Total cost of revenues	9,404	13,202	23,170	29,389	34,654	261,143
Sales and marketing expenses	1,508	1,570	2,604	3,252	3,038	22,897
General and administrative expenses	939	1,065	1,234	1,618	1,840	13,862
Research and development expenses	152	243	364	287	319	2,407
Total cost and expenses	12,003	16,080	27,372	34,546	39,851	300,309
Operating income (loss)	320	(1,311)	(2,070)	(2,670)	54	404
Other income (expenses):						
Interest income	7	4	362	454	122	918
Interest expense	(216)	(219)	(277)	(643)	(659)	(4,967)
Other – net	(35)	16	(830)	1,088	(406)	(3,058)
Other income (expenses) – net	(244)	(199)	(745)	899	(943)	(7,107)
Income (loss) before income taxes	76	(1,510)	(2,815)	(1,771)	(889)	(6,703)
Income tax expense (benefit)	289	16	(1,280)	(926)	1,099	8,282
Minority interest in consolidated subsidiaries	(42)	123	(70)	160	24	184
Equity in net loss of equity method investees	(105)	(26)	(3,180)	(4,015)	(5,482)	(41,312)
Net loss	¥ (360)	¥ (1,429)	¥ (4,785)	¥ (4,700)	¥ (7,446)	$ (56,113)
Per Share and ADS Data:						
Basic and diluted net loss per share	¥ (23,565)	¥ (75,720)	¥(225,791)	¥(209,085)	¥(331,234)	$ (2,496)
Basis and diluted net loss per ADS equivalent	(11.78)	(37.86)	(112.89)	(104.54)	(165.62)	(1.2)
Weighted average number of shares	15,286	18,868	21,190	22,480	22,480	
Weighted average number of ADS equivalents (thousands)	30,572	37,736	42,380	44,960	44,960	
Balance Sheet Data:						
Cash	¥ 1,158	¥ 1,061	¥ 16,158	¥ 13,571	¥ 11,046	$ 83,240
Total assets	9,340	13,359	39,001	50,641	45,263	341,091
Short-term borrowings	2,440	6,679	13,690	5,620	3,820	28,789
Current portion of long-term borrowings, including capital lease obligations	1,142	1,855	2,255	1,644	3,374	25,424
Long-term borrowings, including capital lease obligations	2,929	2,151	2,300	5,479	6,262	47,186
Convertible notes [(1)]	—	—	—	15,000	15,000	113,037
Shareholder's equity	1,868	485	15,001	16,928	7,725	58,216

	As of and for the year ended March 31,					
	1998	1999	2000	2001	2002	2002
	(millions of yen, except per share and ADS data)					(thousands of U.S. dollars, except per share and ADS data)
Operating Data:						
Capital expenditures, including capitalized leases	¥ 1,696	¥1,929	¥ 3,465	¥ 3,963	¥ 3,773	$ 28,063
Adjusted EBITDA[(2)]	1,448	111	(37)	(72)	2,960	22,308
Operating margin[(3)]	2.6%	(8.9)%	(8.2)%	(8.4)%	0.1%	
Adjusted EBITDA margin[(2)(4)]	11.7%	0.7%	(0.1)%	(0.2)%	7.4%	
Net cash provided by (used in):						
Operating activities	¥ 292	¥ 400	¥ 1,199	¥ (271)	¥ 1,161	$ 8,751
Investing activities	(300)	(3,695)	(7,135)	(9,544)	(2,457)	(18,517)
Financing activities	785	3,186	22,192	6,428	(1,462)	(11,017)

(1) In April 2000, we issued 1.75 percent unsecured yen convertible notes due March 2005 in the aggregate principal amount of ¥15,000 million.
(2) Adjusted EBITDA represents operating income (loss) plus depreciation and amortization. Adjusted EBITDA is provided because it is a measure commonly used by investors to analyze and compare companies on the basis of operating performance. Adjusted EBITDA is not a measurement of financial performance under generally accepted accounting principles and should not be construed as a substitute for operating income, net income or cash flows from operating activities for purposes of analyzing our operating performance, financial position and cash flows. Our Adjusted EBITDA is not necessarily comparable with similarly titled measures for other companies.
(3) Operating income (loss) as a percentage of total revenues.
(4) Adjusted EBITDA as a percentage of total revenues.

Exchange rates

Fluctuations in exchange rates between the Japanese yen and U.S. dollar and other currencies will affect the U.S. dollar and other currency equivalent of the yen price of our shares and ADSs and the U.S. dollar amounts received on conversion of any cash dividends. 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 ¥132.70 per $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 29, 2002, the last business day prior to the date of our most recent annual financial statements. The noon buying rate on July 26, 2002 was ¥118.78 per $1.00. Translations do not imply that the yen amounts actually represent, or have been or could be converted into, equivalent amounts in U.S. dollars.

Fiscal year ended March 31,	High	Low	Average [(1)]	Period-end
1998	¥133.99	¥111.42	¥123.57	¥133.29
1999	147.14	108.83	128.10	118.43
2000	124.45	101.53	110.02	102.73
2001	125.54	104.19	111.65	125.54
2002	134.77	115.89	125.64	132.70
2003 (through July 26, 2002)	133.40	115.71	122.80	118.78
Calendar year 2002				
January	134.64	130.93		
February	134.77	132.26		
March	133.46	127.07		
April	133.40	128.13		
May	128.66	123.08		
June	125.64	119.38		
July (through July 26, 2002)	120.19	115.71		

(1) Calculated from the average of the exchange rates on the last day of each month during the period.

B. Capitalization and Indebtedness.

Not applicable.

C. Reasons for the Offer and Use of Proceeds.

Not applicable.

D. Risk Factors.

You should carefully consider the risks described below before making an investment decision. If any of the risks described below actually occurs, our business, financial condition or results of operations could be adversely affected. In that event, the trading price of our securities could decline, and you may lose all or part of your investment. Additional risks not currently known to us or that we now deem immaterial may also harm us and affect your investment.

We may not be able to maintain positive operating income

While we achieved positive operating income last year, we had operating losses for each of the three previous years, and our operating income may turn negative again due to a number of factors, including:

- Further deterioration or a lack of improvement in the Japanese economy could significantly curtail interest in our services in Japan, which, because of our dependence on the Japanese markets, could negatively impact our revenue;

- Our revenues may be adversely affected by price reductions or by failure to retain and/or attract customers;

- Our cost of revenues may adversely affect our financial results if we contract for more backbone capacity than we need or if we are unable to reduce our leased line costs as we intend;

- Increased expenses resulting from our leasing of additional equipment may adversely affect our overall cost structure;

- Revenues and margins from our growing systems integration business and Internet data center business, which is seasonally stronger in the second and the fourth quarters as companies in Japan typically make large investments in or around September and March before they close their semiannual and annual budgetary cycles, might not grow and/or be profitable as expected; and

- Because of strong competition in the retail Internet Service Provider, or ISP, market, we may lose our ISP customers.

Please see Item 5., "Operating and Financial Review and Prospects" for more detailed information concerning our losses and other operating results.

We had net losses for the past five fiscal years and we expect net losses will continue

We incurred a net loss of ¥7,446 million for the year ended March 31, 2002. Our accumulated deficit at March 31, 2002 was ¥18,208 million. We expect to incur net losses for the year ending March 31, 2003 and perhaps beyond. We believe our financial performance and therefore the magnitude of our losses and the extent to which they continue will be affected primarily by the financial performance of our affiliate Crosswave Communications Inc., which may continue to post operating losses and net losses for the year ending March 31, 2003 and perhaps beyond. As we own 37.9% of Crosswave, these losses will have a direct impact on our financial performance, as a portion of these losses will be included in our financial results under the equity method of accounting that we have used to account for our investment in Crosswave. If we believed all or any portion of our investment was not likely to be recovered, we would need to recognize an impairment of part or all of our investment in Crosswave. If we were to provide additional funds to Crosswave to fund any losses, our financial results would be further affected. For the year ended March 31, 2002, Crosswave had a net loss of ¥13,397 million. At March 31, 2002, Crosswave's accumulated deficit was ¥32,176 million. If Crosswave continues to post losses or our losses increase, our accumulated deficit would increase and we may need to seek additional borrowings or equity financing to fund the losses, and there is no guarantee that we will be able to obtain such funding on commercially reasonable terms or at all.

We may not realize the expected benefits of our large capital investment in Crosswave

We have made substantial investments in Crosswave. As of March 31, 2002, the carrying value of our investment in Crosswave was ¥7.6 billion. At March 31, 2002, Crosswave's accumulated deficit was ¥32,176 million and for the year ended March 31, 2002, Crosswave had a net loss of ¥13,397 million.

Crosswave is also a very important part of our business. In addition to being one of our group companies that provides total network solutions, we procure significant portions of our network backbone, rack space and other essential elements of our Internet data center services from Crosswave, and Crosswave is an important network component in many of our systems integration projects.

Specific risks relating to our investment in Crosswave include:

- Crosswave has a limited operating history and may not be able to successful implement its business plan;
- Crosswave may need additional cash to develop its network and fund its operations but may not be able to obtain it, or we may provide such additional financial support;
- Crosswave may not be able to compete effectively against established competitors, such as NTT Communications, PoweredCom, Japan Telecom and KDDI, which have greater financial and other resources; and
- Competition has lead to downward pricing pressure which may result in Crosswave generating less revenue than anticipated.

For additional discussion of risks relating to Crosswave, please refer to the most recent annual report on Form 20-F of Crosswave (commission file number 0-30868) and its other filings with the U.S. Securities and Exchange Commission.

If Crosswave does not become profitable in the future, we will not recover amounts invested in Crosswave and our business operations and financial condition may be negatively affected.

If Crosswave does not satisfy its bank loan repayment obligations, breaches conditions specified in its loan agreements or requires additional cash to further develop its network and fund its operations, it may be forced to limit its network development and we may be forced to modify or abandon some or all of our plans

In May 2002, Crosswave entered into loan agreements with Japanese commercial banks for up to a total amount of ¥20 billion. Crosswave will use these funds, among other things, to implement its network development plan, which includes increasing the coverage and redundancy of its nationwide network, additional equipment purchases or leasing in accordance with market demand and construction of data centers in Yokohama and Saitama. However, more investment may be needs and Crosswave may need additional funds, and there is no assurance that the additional funds will be available on commercially reasonable basis, or at all. In addition, to obtain funds agreed to in Crosswave's loan agreement, Crosswave will have to meet covenants or certain requirements for draw down. There is no assurance that it will continue to meet these requirements, and any inability to meet such requirements may prevent Crosswave from implementing its plans or may require it to modify or abandon some or all of its plans. Any such modifications may require us to modify our plans too, which may have an adverse effect on our operations.

In conjunction with Crosswave's loan agreements, we have agreed to provide cash deficiency support for the period of the loan facility and have deposited with an agent bank ¥5 billion that will be available for withdrawal in the event that Crosswave does not satisfy its loan repayment obligations or breaches conditions specified in its loan agreements. If Crosswave does not satisfy its loan repayment obligations or breaches conditions specified in its loan agreements, our financial condition could be directly and adversely affected.

Decisions by our competitors can strongly influence conditions in our markets and we may be vulnerable to decisions resulting in downward pricing pressure

Competition in the industry has caused significant downward pricing pressure including lower-priced Internet access services offered to small- and medium-sized companies and to larger corporations which are our primary target markets. To the extent that potential and existing customers make decisions based solely or primarily on price, we may be unable to retain existing or attract new customers or we may be forced to reduce our prices to keep existing customers.

We may not be able to compete effectively, especially against established competitors, which have greater financial, marketing and other resources

Our major competitors in the Internet access business and Internet data center business are major telecommunications carriers like NTT Communications, KDDI, Japan Telecom, PoweredCom and their affiliates. In the systems integration business, our major competitors are large hardware vendors such as IBM, NEC and Hitachi and systems integrators like NTT Data. These competitors have certain advantages over us including:

- substantially greater financial resources,
- more extensive and well-developed marketing and sales networks,
- higher brand recognition among consumers, and
- large customer bases.

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

- develop, market and sell their services,
- adapt more quickly to new and changing technologies, and
- more easily obtain new customers.

In addition, if telecommunications carriers replace their existing switches and equipment with more advanced switches and equipment, this may increase their ability to use their extensive networks for Internet and data transmission and could negatively affect our ability to compete.

New competitors may attract customers away from us

In the field of Internet access services, we may also compete with new Internet service providers, or ISPs, that emerge as the Internet market continues to grow. For example, many of the major cable television companies, mobile communications companies and ADSL companies are increasing the number of subscribers to their Internet access services. ADSL stands for Asymmetric Digital Subscriber Line, which is a high-speed method for transmitting data over existing copper wires. Although we provide backbone services to such companies including cable television Internet providers, it may also affect our customer base expansion in the retail market.

In the field of Internet data center services, competition from other data center operators may attract customers away from us. Various companies in the data center business such as NTT Communications, KDDI, PoweredCom and Japan Telecom may become strong competitors of ours, and if they are successful in the market we could lose customers or grow less rapidly.

We may not attract new customers for our Internet data centers planned for early 2003

We plan to open two large-scale Internet data centers in Saitama and Yokohama in early 2003 in conjunction with the opening of Crosswave's data center facilities. We intend to use these Internet data centers to provide total network solutions to our clients, which would provide us a competitive edge over our competitors. However, if we are unable to attract new customers or are unable to open these centers, we will not be able to realize our goals, which could have an adverse effect on our revenues and results of operations.

We depend on key personnel, and our business and relationship with customers and major shareholders may suffer if we cannot attract or retain qualified personnel or if we lose the services of our executive officers

If we fail to attract or retain qualified personnel, our business may be adversely affected. Because our network, services, products and technologies are complex, we depend on the continued service of our existing engineering and other personnel and will need to hire additional engineers and research and development personnel. Competition for qualified engineers, research and development personnel and employees in the telecommunications service industry in Japan is intense and there are a limited number of persons with the necessary knowledge and experience.

Our future success also depends on the continued service of our executive officers, particularly Mr. Koichi Suzuki, who is our President and CEO and also serves as the President of Crosswave and most of the other IIJ group companies. We rely on his expertise in the operation of our businesses and on his personal relationships with our shareholders and the shareholders of the IIJ group companies and with our business partners. None of our officers or key employees, including Mr. Suzuki, is bound by an employment or noncompetition agreement.

Conflicts of interest may arise between us and Crosswave which could be resolved in a manner unfavorable to us

Conflicts of interest could arise relating to the nature, quality and pricing of services provided by Crosswave to us or by us to Crosswave, the allocation of corporate opportunities and general issues relating to maintaining or increasing our profitability. Our President, Chief Executive Officer and Representative Director is also the President and Representative Director at Crosswave, and many of our key management and technical personnel, including two of Crosswave's directors, perform services for both us and Crosswave. Fifteen of our employees are seconded to Crosswave. We have not entered into any agreement with Crosswave regarding conflicts of interest. There could be potential conflicts of interest when these directors and officers are faced with decisions that could have different implications for our company and Crosswave. As a result, it is possible that these directors and executive officers could place the interest of Crosswave ahead of our interests when the two are incompatible.

Rapid 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 use 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.

Our business may be adversely affected if we fail to maintain the reliability and security of our network

The reliability of our network could be affected by damage from fire, earthquakes and other natural disasters, power loss, telecommunications failures and 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. Computer viruses and interruptions in service as a result of the accidental or intentional actions of Internet users and others may also prevent us from providing service to our customers. Any problems that cause interruptions in the services we provide could have a material adverse effect on 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 at our Internet data centers 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 IIJ Technology and IIJ Media Communications, 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, because of a lack of qualified engineers, or lack of task-management capabilities for software-development vendors or lack of management of customer's data at our Internet data centers. If we do not execute these services/projects as contracted, we may be sued by our counterparties, which could in turn have an impact on our reputation, results of operation and financial condition.

We do not have complete control over the operations of several affiliates upon whose performance we greatly depend

We conduct our business in part through our affiliates. While we have invested heavily in and exercise significant influence over these companies, we do not own a majority interest in our affiliates. There are risks associated with this group structure, including:

- Crosswave, one of our affiliates, may require significant additional funding to strengthen its network buildout and we may be requested to assist it with this financing, in addition to our current investment and financial guarantees;

- Crosswave's operations are an integral part of our business and we are substantially dependent on its fiber lines and data centers facilities;

- Our success is dependent on Crosswave's success to buildout its network and attract enough customers to become profitable to recover our significant capital investments in fixed assets;

- These affiliated companies' financial contributions to our results of operations are limited even though we offer our services and operate as a group; and

- We may not be able to exercise significant influence over these companies in the future, and our interests may diverge from one or more of these companies or their other shareholders.

There are risks associated with our continued international expansion

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. In addition, we have invested in two data center businesses in Korea and the Philippines. Our international expansion continues to require management attention and financial resources. We face significant exposure to risks in connection with our international operations. These risks include:

- 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, and
- political and economic instability.

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

We depend on 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 like Crosswave, KDDI, Japan Telecom and MCI Worldcom for a significant portion of our network backbone and regional NTT companies for local access lines for our customers. We are subject to potential disruptions in these telecommunications services and may have no means of replacing these services, on a timely basis or at all, in the event of any such disruption.

In the Asia-Pacific region and for the operation of the A-Bone by Asia Internet Holding, we depend on telecommunications carriers in various countries including lesser-developed countries whose quality of service may not be stable or who are more susceptible to economic or political instability where they conduct business.

We also depend on third-party suppliers of hardware components like routers that are used in our network. We acquire some components from only one or two sources, typically Cisco Systems and Lucent Technologies. 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, could delay our ability to increase the number of our POPs, where customers connect to our backbone, or to expand the capacity of our network.

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,
- changes in customer requirements, and
- evolving industry standards.

The introduction of services using new technologies, such as the transition from version four of Internet Protocol, or IP, to version 6 of IP, and the emergence of new industry standards could render our existing services obsolete.

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. 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.

Regulatory matters 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 Ministry of Public Management, Home Affairs, Posts and Telecommunications, or MPHPT. We operate pursuant to licenses and approvals that have been granted by the MPHPT. Our licenses are issued under the Telecommunications Business Law to provide telecommunications services through networks owned by other companies, such as Crosswave, which makes us a Type II Carrier. In contrast, Type I Carriers, such as NTT Communications or Crosswave, own or have long-term leases for the networks through which they offer telecommunication services.

Our Type II license has an unlimited duration. However, this license is subject to revocation by the MPHPT if we violate telecommunications laws and regulations in a manner that is deemed to impair 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 MPHPT. However, there can be no assurance that we will be able to do so.

Our 37.9% owned affiliate, Crosswave, faces similar regulatory risks. Crosswave was the first Type I Carrier to receive a license to provide services through a network the rights of which were obtained pursuant to a long-term lease. Previously Type I Carriers were required to own their networks. Any decisions or changes by the MPHPT in the areas of the grant, amendment or renewal of licenses based on the leasing of facilities could require Crosswave to substantially change its business model.

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. We cannot predict the future regulatory framework of our business. Any changes in laws, regulations or MPHPT 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 and certain of our officers have been named as defendants in a number of class action lawsuits which if decided against us could have an adverse impact on our business, financial condition and results of 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 Internet Initiative Japan Inc. ("IIJ"), Koichi Suzuki — our President, Chief Executive Officer and Representative Director, Yasuhiro Nishi — our Director, Chief Financial Officer and Chief Accounting Officer, and the Goldman Sachs Group Inc. and 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 IIJ 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. We believe these claims are without any merit, and intend to defend these actions vigorously. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. Any unfavorable outcome of this litigation could have an adverse impact on our business, financial condition and results of operations.

Foreign exchange fluctuations may negatively affect the yen equivalent value of our U.S. dollar monetary assets

Our reporting currency and most of our revenues are in Japanese yen and future fluctuations in currency exchange rates may adversely affect our financial results. We held approximately $26,082 thousand in dollar-denominated demand deposits as of March 31, 2002, primarily from the U.S. dollar proceeds of our August 1999 initial public offering. We recorded a ¥254,882 thousand foreign exchange gain for the year ended March 31, 2002 as a result of the depreciation of the yen against the dollar.

Item 4. Information on the Company.

A. Historical Background.

We are incorporated in Japan as a joint stock corporation under the name Internet Initiative Japan Inc. ("IIJ"). We were founded in December 1992 and operate under the laws of Japan. We began operations in July 1993, making us one of the first commercial Internet service providers in Japan offering Internet access. 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 ADSs on the Nasdaq National Market.

We may consider the possibility of entering into a merger, acquisition or other strategic arrangements if we believe the competitive situation warrants it. We, along with Crosswave, recently announced that we have had discussions with PoweredCom, Inc., a 32.06% owned affiliate of Tokyo Electric Power Company, Incorporated., regarding exploring the possibility of integrating the businesses. However, we have not yet entered into any memorandum of understanding and the proposed terms of any such memorandum of understanding or of any possible integration have not yet been determined.

Our head office is located at Takebashi Yasuda Bldg., 3-13, Kanda Nishiki-cho, Chiyoda-ku, Tokyo 101-0054, Japan, and our telephone number at that location is 81-3-5259-6500. Our agent in the United States is IIJ America, Inc., 399 Park Avenue, 23rd Floor, New York, New York 10022 and our telephone number at that location is 212-350-1300. 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.

For a discussion of capital expenditures for the past three years see "Capital Expenditures" in Item 4.B. For a discussion of current capital expenditures see Item 5.B., Liquidity and Capital Resources.

B. Business Overview.

We offer a comprehensive range of Internet access 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 a variety of services to our customers as part of our total network solutions. Our primary services are our Internet access services, systems integration services and Internet data center services. Our Internet access services range from low-cost dial-up access to high-speed access through dedicated lines for individual and corporate customers. Our systems integrations services are tailored to our customers' requirements, which include consulting/project planning, systems design, construction of network systems and systems outsourcing. Our Internet data center services provide a variety of data storage and management options for corporate customers.

Most of our revenues are generated in Japan. The table below provides a breakdown of the percentage of total revenues for our primary services over the past three years.

	For the year ended March 31,		
	2000	**2001**	**2002**
Connectivity services	57.3%	54.0%	43.0%
Systems integration services	30.2%	33.1%	36.0%
Internet data center services	1.8%	3.9%	5.5%

We also offer independently, or together with our group companies, a variety of other value-added services, including:

- security services, such as managed firewalls with VPN function ("Virtual private networks" provide private capacity transmission services), network intrusion detection and comprehensive network security services,
- mail server outsourcing services,
- Web hosting services,
- content development, distribution and Internet broadcasting services, and
- gateway services for remote user access and roaming.

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

We have created a high-quality network that extends throughout Japan. Our backbone is one of the highest capacity Internet backbones in Japan. Our backbone network is formed by leasing lines from telecommunications carriers. As of March 31, 2002, we operate 24 network operation centers, nine Internet data centers and 78 POPs, the main points at which our customers connect to our backbone, throughout Japan, which are connected to our network backbone by one STM-4c trunk line (equivalent to 622 Mbps), one STM-1 trunk line (equivalent to 155 Mbps) and other lines. Our backbone network also extends to the United States, with a total capacity of 2.25 Gbps (3 STM-1 trunk lines and 3 STM-4c trunk lines) as of June 30, 2002.

In addition to our network, we have significant interests in two other networks: the A-Bone and the Crosswave network. We currently own 26.7% of Asia Internet Holding, the company that owns the A-Bone. The A-Bone is an Internet network using leased lines that connects nine countries in the Asia-Pacific region, including Japan, China, South Korea, Singapore, Hong Kong, Malaysia, the Philippines, Indonesia and Thailand. Using our network and engineering expertise and pursuant to an agreement with Asia Internet Holding, we operate and manage the A-Bone.

We also own 37.9% of Crosswave, which operates one of the first high-speed telecommunications facilities and networks in Japan designed specifically for data communications. Through DWDM and SONET, advanced multiplexing and transmission technologies, we believe that Crosswave's network has the capacity to provide over 100 Gbps of bandwidth with multiplexing and transmission equipment upgrades.

Crosswave's network began operating in May 1999 and, as of March 31, 2002, had extended to all prefectures nationwide, except Shimane prefecture.

Crosswave provides its customers with access to dedicated lines nationwide in Japan. We are Crosswave's largest customer and use Crosswave's lines for a significant portion of our domestic backbone—currently we transmit more than 90% of our domestic Internet traffic over Crosswave's fiber optic lines. We will continue to use Crosswave's lines as we add new lines and upgrade existing lines. Crosswave's lines allow us to significantly expand our network by adding additional capacity to handle increasing traffic volume. We also utilize Crosswave's Japan-US fiber optic STM-4 trunk line (equivalent to 622 Mbps) as of June 30, 2002.

Services

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

Our total network solutions for business users is one of the primary focuses of our business. We consult with businesses and other customers to identify their particular situations and needs. We draw upon our extensive resources to address those needs.

Our Internet Access Services

Our Internet access services provide access to sites worldwide. We offer two categories of Internet access services: dedicated access services and dial-up access services. Dedicated access services are based on dedicated local-line connections provided by carriers between our backbone and customers. Dial-up access services require customers to connect to our POPs through the public-switched telephone network. The Internet access part of our total network solutions ranges from cost-effective, 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 the headquarters, data centers, branch offices and mobile personnel. Currently, large telecommunications carriers such as regional NTTs 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 access service to accommodate such developments.

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

	As of March 31,				
	1998	**1999**	**2000**	**2001**	**2002**
Dedicated access service contracts:					
IP Service					
64 kbps - 128 kbps	794	654	484	295	142
192 kbps - 768 kbps	169	171	155	80	42
1 Mbps – 2 Mbps	51	66	140	240	270
3 Mbps – 1.2 Gbps	34	57	71	111	156
Total IP Service	1,048	948	850	726	610
IIJ Fiber Access/F	—	—	—	—	73
IIJ Ethernet Standard	—	—	—	—	2
IIJ T1 Standard (1.5 Mbps)	—	—	146	575	667
IIJ DSL/F (F (Maximum 1.5 Mbps)	—	—	—	—	1,237
IIJ Economy (64 kbps - 128 kbps)	156	708	1,008	1,295	921
Total dedicated access service contracts	1,204	1,656	2,004	2,596	3,510
Dial-up access service contracts:					
IIJ4U	21,422	48,195	75,170	95,273	89,213
Others	14,534	10,508	54,970	66,857	171,363
Total dial-up access service contracts	35,956	58,703	130,140	162,130	260,576

As of June 30, 2002, we offered the following Internet access services:

Service Type	Summary Description	Pricing
Dedicated access services		
IP Service	Full-scale dedicated line service with high-speed access for businesses and other network operators with demanding throughput requirements.	Setup and monthly fees vary according to carrier, line speed, line type and distance involved.
IIJ Fiber Access/F	Service for dedicated line Internet access using optical lines at either 10 Mbps or 100 Mbps targeted primarily at small- and medium-sized enterprise requirements for high-capacity, high-speed transmissions. SLA (Service Level Agreement), a quality assurance program, is applicable.	Initial setup of ¥50,000. Monthly fees from ¥25,000 to ¥350,000 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 Ethernet Standard	Service for dedicated line Internet connectivity using ethernet-based access line at 10 Mbps.	Initial setup of ¥60,000. Monthly fee of ¥250,000. Monthly fee does not include ethernet-based access line charge which is paid directly by the customer to the access provider.
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. The monthly access fee of ¥117,000 for up to eight IP addresses and ¥167,000 for up to 16 IP addresses.
IIJ DSL/F Service	Service for dedicated-line Internet access using ADSL lines at speeds up to 8 Mbps targeted primarily at small- and medium-sized offices and home offices. SLA applicable.	Initial setup of ¥30,000. Monthly access fees from ¥9,800 to ¥49,800 depending on the number of allocated IP addresses. Monthly charges do not include ADSL charges which are to be paid directly by customer to ADSL service provider.

Service Type	Summary Description	Pricing
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 and ¥15,000 for an IP address application. Monthly access fees of ¥38,000 for 64 kbps service and ¥45,000 for 128 kbps service.
Dial-up access services		
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 businesses offering multiple dial-up accounts at a fixed monthly fee.	Initial setup fee of ¥20,000. Monthly basic fees 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 2 hours.
Dial-up E-rate Service	Service for educational institutions. Services include Internet access, e-mail and disk space for home pages.	Initial setup fee of ¥5,000. ¥30,000 per year.
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 fiber optic, ISDN and ADSL are available.	Initial setup fee of ¥1,900. Monthly service fee of ¥800 for the first 8 hours and charge of ¥5 per minute, with a ceiling of ¥4,900.
IIJ*mio* DSL/De Service	Service for individual users offering Internet connectivity over ADSL at up to 8 Mbps. The choice of ADSL access line is limited to eAccess, an ADSL provider.	Initial setup fee ranges from ¥6,800 to ¥26,600; monthly charge ranges from ¥3,973 to ¥6,233, depending on type of ADSL access line (data communications only or shared with telephone usage) and on router status (purchase or rental). Monthly charges include ADSL charges.

Service Type	Summary Description	Pricing
IIJ*mio* DSL/SF Service	Service for individual users offering Internet connectivity over ADSL at up to 8 Mbps. ADSL access is limited to "FLET's" lines provided by regional NTTs.	The service does not charge an initial setup fee. Monthly charge is ¥4,800. Monthly charges do not include ADSL charges which are to be paid directly by the customer to the regional NTTs.
IIJ*mio* FiberAccess/SF Service	Service for individual users offering Internet connectivity over optical fiber network at 10 Mbps or 100 Mbps. Optical fiber access is limited to "BFLET's" lines provided by regional NTTs.	The service does not charge an initial setup fee. Monthly charge ranges from ¥8,000 to ¥12,000, depending on the type of access line. Monthly charges do not include optical fiber access charges which are to be paid directly by the customer to the regional NTTs.

Dedicated Access Services

Our lineup of dedicated line access services includes: IIJ FiberAccess/F, IIJ Ethernet Standard, IIJ T1 Standard, IIJ DSL/F and IIJ Economy. We have recently added IIJ Ethernet Standard (December 2001) to accommodate new access lines. The total bandwidth allocated to our dedicated access services has increased approximately 270% to 9.4 Gbps as of March 31, 2002, from 3.5 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. This is the core service we offer. As of March 31, 2002, we had 610 customers for our IP Service compared to 726 for our IP Service as of March 31, 2001. The customer chooses the level of service it needs based upon its bandwidth requirements. As of March 31, 2002, we offered service at speeds from 64 kbps to 1.2 Gbps.

Our IP Service revenues (including revenues of IIJ T1 Standard, IIJ Fiber Access/F and IIJ Ethernet Standard) represented 30.5% of our total revenues for the year ended March 31, 2002 and 36.1% for the year ended March 31, 2001. We believe that as businesses continue to develop Internet capabilities, this service will continue to be the foundation of our total network solutions offering.

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. We collect this 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. 15.6% of our IP Service contracts as of the end of March 2002 are for at least three years.

We have introduced ATM (Asynchronous Transfer Mode) access, a high speed transmission technology, to our IP Service in several larger metropolitan areas including Tokyo and Osaka. A subscriber may now connect to our network using NTT's ATM MegaLink service or the equivalent service from other carriers. ATM service was available at speeds from 2 Mbps to 135 Mbps as of March 31, 2002 at rates comparable to our IP Service rates.

We also offer various IPv6-capable Internet access 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 as well since December 2001. IPv6 is the next generation Internet Protocol which allows IPv6 technology to overcome the problems of the protocol generally used, IPv4, which includes limited IP address availability, and which enables customers to hook-up a vast range of electronic appliances and equipment, including cellular phones, AV equipment, car navigation devices and home electronics. We are the first commercial 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 these services except IPv6/IPv4 Dual Stack 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 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 credit against the amount invoiced for the services if our service quality fails to meet the prescribed standards. In September 2001, we raised the benchmark for an average round trip time across our entire domestic backbone network by decreasing the time from 40 to 30 milliseconds.

Subscribers to our IP Service receive 24-hour-a-day, seven-day-a-week technical support.

IIJ Fiber Access/F Service. IIJ Fiber Access/F services is a dedicated Internet access service that uses "BFLET's" fiber optic access lines provided by regional NTT companies allowing service at 10 Mbps or 100 Mbps on a best-efforts basis. We began offering this service in August 2001. The service is available in four variations (Business, Basic, Family and Mansion) optimizing each customer's needs in speed and connection interface. Customers also can choose the number of allocated IP addresses from: 1, 4, 8 and 16. We support this service by providing guarantees of latency rates under service level agreements. As of March 31, 2002, we had 73 customers for IIJ Fiber Access/F Service.

IIJ Ethernet Standard. Our IIJ Ethernet Standard is an Internet connectivity service at 10 Mbps over dedicated ethernet-based access lines. We introduced this service in December 2001. Eight IP addresses are allocated per contract. This service is not subject to service level agreements. As of March 31, 2002, we had two customers for IIJ Ethernet Standard.

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 16 IP addresses. Last mile access must be through NTT's Digital Access 1500 or similar services from other carriers. As of March 31, 2002, we had 667 subscribers to IIJ T1 Standard compared to 575 customers as of March 31, 2001.

IIJ DSL/F Service. IIJ DSL/F Service provides dedicated line Internet connectivity via ADSL with speeds up to 8 Mbps. We began offering this service in May 2001. IIJ DSL/F Service is primarily targeted at small- and medium-sized offices and home offices that have access to ADSL lines provided by regional NTT companies under the name of "FLET's ADSL". We support this service by providing guarantees of latency rates under service agreements. As of March 31, 2002, we had 1,237 customers compared to 45 customers as of July 2001.

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 introduced IIJ Economy in November 1997. We currently guarantee latency rates under service level agreements for IIJ Economy. We had 921 customers for IIJ Economy as of March 31, 2002 compared to 1,295 customers as of March 31, 2001.

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. It is our dial-up services, for example, that allow frequent travelers to access our network or their own corporate networks through one of our POPs or through our roaming access points. Our dial-up access services are also an important option for our large corporate groups that will be linking many offices through our network. Although these corporate groups would use dedicated lines for the main offices and their larger regional and local offices, they would also likely use our dial-up access services for their smaller branch offices or as a remote-access tool for employees out of the office. We also offer traditional dial-up access service for individuals and OEM (where we provide services for other companies which sell those services under their own name) service for other network operators, such as Sharp, NTT East and NTT West.

Our main dial-up access services are our IIJ Dial-up Standard, Enterprise Dial-up IP Service, IIJ Dial-up Advanced, Dial-up E-rate Service, IIJ4U, IIJ*mio* DSL/De Service, IIJ*mio* DSL/SF Service and IIJ*mio* FiberAccess/SF Service, all as described in the table above. We also provide Network-type Dial-up IP Service, Terminal-type Dial-up IP Service and UUCP Service to customers, but we are no longer promoting these services.

We have expanded access to our network through roaming agreements that are an important part of our dial-up access services. We offer global Internet roaming service in 133 countries with over 15,900 access numbers as of June 30, 2002. Additionally, in the United States and Canada through IIJ America, we have roaming access through a toll-free number for areas where we don't already have local POPs through roaming agreements or otherwise.

Our Systems Integration Services

We offer systems integrations services tailored to our customers' requirements, which include consulting/project planning, systems design, construction of network systems and systems outsourcing. Our systems integration services mainly focus on Internet business systems and corporate information systems such as Intranet and Extranet. We have built a strong record in various business fields, including the following representative examples:

- Examples of corporate information systems include:
  - an Extranet enabling data conversion for a major printing company,
  - an Internet environment with a giga-class trunk network as well as a LAN system linking classrooms at a university,
  - Internet server systems for central government ministries and agencies, and
  - an Extranet for wholesale transactions by financial institutions.

- Examples of Internet business systems include:
  - online brokerage systems for investment banks and securities firms,
  - large-scale portal sites for PDA users,
  - “virtual campus” systems including both Internet connectivity and Intranet information services,
  - a B2B online distribution system for digital content, and
  - systems for Internet CATV (Cable tv) infrastructure.

The fee structure of our systems integration services is based upon the complexity and scale of the project required by the customer. 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.

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. The task of network systems construction usually incorporates many of our other access 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 IIJ group companies. Rather than simply looking after the customer’s content, we take on the customer’s entire computing environment and provide round-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-order systems integration services, which we refer to as iBPS, e-business solutions, consisting of consulting and supplying various shared components such as server equipment, settlement distribution systems, data storage systems, CRM (Customer Relations Management) systems, network monitoring and systems operation management that allow our customers to launch their own e-commerce businesses quickly and cost-effectively. In March 2002, we launched a new iBPS lineup called “iBPS Security Assessment Service,” a large-scale security assessment service performed not only on external networks but also on in-house LAN networks, which is offered as a part of the IIJ group’s Systems Integration business.

Our Value-added Services

Although our primary service to our customers has been Internet access, our customers are increasingly seeking additional network-related services. We provide our customers with a broad range of value-added services and products such as network security services, mail hosting services, and managed router services, which complement and enhance our Internet access services and systems integration 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 estimable average period of service 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 solutions***. As of March 31, 2002, we offered six main security services that protect customers' internal networks from unauthorized access and secure remote connections to internal networks: IIJ Security Standard, IIJ Security Premium, IIJ Security Scan Service, Network Intrusion Detection Service, IIJ Secure Remote Access and IIJ Global VPN Service. We were the first ISP in Japan to provide firewall services, which we first offered in 1994.

  IIJ Security Standard In October 1999, we began offering Security Standard Service pursuant to which we install and manage a round-the-clock operation of firewall systems. The initial setup fee is ¥120,000 and the monthly fee ranges from ¥60,000 to ¥120,000 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 a initial cost of ¥20,000 and a monthly fee of ¥10,000 per computer.

  IIJ Security Premium In July 2000, we began offering "IIJ 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.

  IIJ Security Scan Service In March 2002, we began IIJ Security Scan Service, a package of scan 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, 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 one IP address is between ¥9,000 and ¥25,000, depending upon the type of items to be scanned. For the spot scan service, the basic charge for scanning one IP address ranges from ¥12,000 to ¥30,000, again depending upon the type of items to be scanned.

  Network Intrusion Detection Service In April 2001, we began 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. Initial cost for the service is ¥300,000, and the monthly fee starts from ¥300,000 and depends on the customer's traffic volume.

  IIJ Secure Remote Access IIJ Secure Remote Access is a packaged service combining the new IIJ Dial-up Advanced Service 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 will ensure 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, such as connections from overseas via local ISPs.

IIJ Global VPN Service IIJ Global VPN Service is an Internet VPN service enabling Japan-based businesses and organizations to establish secure communication in 50 countries worldwide via the Internet. We started this service on a trial basis in September 2001 and launched the full-fledged service in April 2002. The service includes 24-hours-a-day, seven-days-a-week security monitoring and management, hardware and software maintenance, customer support, and incident response services ensuring secure, reliable global VPN communications. The service offers Japanese-language support in the U.S., as well as payment in yen for Japanese companies located internationally. The IIJ Global VPN Service is offered in partnership with Genuity Inc. The fee for the service depends upon the locations where VPN machines are installed.

- ***E-Mail related solutions.*** As of March 31, 2002, we offered six main e-mail related services enabling customers to outsource administrative tasks for e-mail server related functions: IIJ Post Office Service, IIJ Mail Box Service, IIJ Mail Gateway Service, Mail Operator Service, IIJ*mio* Prime Mail Service and IIJ*mio* Safety Mail Service.

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 on-line through our customer support Web interface.

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 on-line through our customer support Web interface.

IIJ Mail Gateway Service IIJ Mail Gateway is a gateway service for corporate mail servers to provide security management against e-mails that may contain viruses or information leaks. The service was launched in March 2002. IIJ Mail Gateway Service was developed for large corporate customers issuing more than 1,000 e-mail accounts and offers three options: e-mail Virus Protection, e-mail Auditing and E-mail Archive. Customers can select or combine any of these options to best meet their corporate needs. The service gateway servers are installed in our Internet data centers with around-the-clock operations. Initial charges for the Virus Protection and E-mail Audit options are ¥300,000 each, while monthly charges for each are ¥400,000, which covers at least 1,000 e-mail accounts for the selected options. The charge for the E-mail Archive option varies according to each customer's needs.

Mail Operator Service Mail Operator Service is an outsourcing service for e-mail magazine distribution launched in December 2001. The new service enables users to ease the burden of distribution tasks and prevent possible leaks of subscriber e-mail account information. The service charges ¥20,000 per operation, which includes content distribution to up to 100,000 e-mail accounts.

IIJmio Prime Mail Service IIJ*mio* Prime Mail Service is a deluxe e-mail account service for individuals, emphasizing security, stability and reliability. To achieve tighter security, we pioneered the use of POP/SMTP over SSL, together with SMTP authentication to ensure a higher level of encryption and authorization than currently available in general use. The service places no restrictions on the number of incoming mail items or on incoming mail size. It also offers e-mail backup storage for three months, along with forwarding functions, Authenticated Post Office Protocol (APOP) compatibility, and virus detection and elimination. Basic monthly charge for this service is ¥10,000. In June 2002, we introduced the SLA program to provide quality assurance for our subscribers. Under the SLA program, if the servers drop service for more than 15 minutes, we will give its subscribers a 10% credit against the amount invoiced for the following month's services. The SLA covers only the availability of servers and not value-added functions such as virus elimination.

IIJmio Safety Mail Service IIJ*mio* Safety Mail Service is a standard e-mail service with an anti-virus function for individual users launched in December 2001. The service employs the InterScan VirusWall developed by Trend Micro Co., Ltd., and features POP/SMTP over SSL, in addition to SMTP authentication, which ensures a higher level of encryption and authorization than what is currently available for general use. There is no initial charge and the monthly charge is ¥500.

- ***Value-added Hosting Solutions.*** As of March 31, 2002, we offered four value-added hosting solutions enabling customers to manage their web content: IIJ Hosting One, IIJ Web Standard, IIJ Download Site Service and IIJ*mio* Personal Domain Name Service.

IIJ Hosting One IIJ Hosting One is a hosting service providing users with web, e-mail and Domain Name System (DNS) administration functions in a single package with one gigabyte of disk space. It is mainly targeted at medium-sized enterprises. The hosting servers for this service are managed by us, with a highly reliable and robust data hosting environment with direct connections to our network, one of the largest Internet backbone networks in Japan. The monthly charge for the service is ¥30,000.

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, through careful traffic management of the storage space, a high-performance web-server environment for users is ensured. This service mainly targets small- and medium-sized enterprises.

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 300 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.

IIJmio Personal Domain Name Service IIJ*mio* Personal Domain Name Service is a service for individuals to build their own web sites of up to 100 megabytes and use e-mail addresses under their original domain names. The service was launched in March 2002. The initial charge is ¥5,000, and the basic monthly fee is ¥3,800.

- ***Our Disaster Recovery Solutions.*** As of March 31, 2002, we offered two disaster recovery solutions enabling customers to secure their digital data: Backup4U Enterprise and Backup4U option for IIJ4U users.

  <u>*Backup4U Enterprise*</u> Backup4U Enterprise is a data storage service which automatically backs up the hard disk and/or system data of designated computers at our data centers by use of the Internet. The initial charge is ¥30,000. Monthly charges range from ¥30,000 to ¥50,000, depending on the storage capacity and type of data.

  <u>*Backup4U option for IIJ4U users*</u> Backup4U option service is available for users of IIJ4U and functions like Backup4U Enterprise. Option charges are ¥900 for light use and ¥2,000 for full-fledged use.

- ***Our Streaming Solutions.*** We provide Internet streaming services for live broadcasts over the Internet, as well as streaming server hosting services with our Streaming-On-Demand Channel.

- ***Our Network Management Solutions (Omnibus).*** Omnibus, launched in February 2002, was developed specifically to enable corporate customers to integrate their various network systems by interconnecting them at our Internet data centers. The Omnibus service also integrates customers' security systems, including firewalls and intrusion detective systems. The initial charge is ¥300,000. Monthly charges depend on the number of ports to be used for the service, ranging from ¥180,000 (six ports) to ¥720,000 (24 ports).

- ***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.

- ***IIJ DNS Services.*** We offer domain name related services which consist of domain name administration services and domain name server outsourcing services. Domain names such as ".jp", ".com," ".net" and ".org" are available.

Our Internet Data Center Services

As part of our value-added services, we offer Internet data center services. Our Internet data center services comprise 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. Generally, the service period for all Internet data center services is one year and customers are billed monthly. We recognize revenues for these services on a monthly-billed 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 estimable average period of service to customers.

As of March 31, 2002, we had 138 Internet data center contracts, compared with 113 as of March 31, 2001. Contracted bandwidth for Internet data center connectivity service was 2.0 Gbps as of March 31, 2002.

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 Crosswave and the CRC Solutions Corp. and are equipped with robust security systems, 24-hour-a-day non-stop power supplies, fire extinguishing systems, 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. The initial cost of our Internet data center services is ¥250,000, plus ¥300,000 per rack per month.

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 in both directions are not the same – 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 down-stream transmissions, we offer either 10BASE-T Connectivity (10 Mbps) and 100BASE-T Connectivity (100 Mbps). For upstream transmissions, we offer bandwidths from 1 Mbps to 4 Mbps for 10BASE-T connectivity contracts, and 6 Mbps to 48 Mbps for 100BASE-T connectivity.

Generally, the service period for our connectivity services is one year and customers are billed monthly. We recognize revenues for these services on a monthly-billed 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.

We offer management and monitoring services which we tailor in accordance with our customers' requirements.

In addition to the above, we offer IPv6-capable data center services, which offer the same services using Internet Protocol Version 6 (IPv6).

Network

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

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

The primary components of our network consist of:

- our backbone, which includes leased lines and network equipment such as advanced Internet routers;
- POPs in major metropolitan areas in Japan;
- data centers; and
- a network operations center or NOC.

Backbone

Leased lines. Our network is anchored by our extensive Internet backbone in Japan and between Japan and the United States. As of June 30, 2002, we had a total capacity of 2.25 Gbps between Japan and the United States. 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, including Crosswave. As of March 31, 2002, we transmitted over 90% of our domestic backbone traffic over lines procured from Crosswave, since Crosswave's network including data center facilities has already been integrated with our network services as part of our total network solutions.

With respect to our leased lines to the United States, IIJ has contracts with Crosswave, KDDI, Cable & Wireless IDC, NTT Communications and AT&T. The table below shows our international backbone capacity and cost. Average total capacity is calculated by averaging the international capacity at the end of each month.

International Backbone Capacity and Cost

	For the year ended March 31,				
	1998	**1999**	**2000**	**2001**	**2002**
Backbone cost (thousand yen)	3,095,149	3,722,676	5,660,277	5,548,527	2,469,002
Average total capacity (Mbps)	204.58	282.08	620.00	1,162.50	1,778.33
Average cost per 1 Mbps (thousand yen)	15,129	13,197	9,129	4,773	1,388

In the United States, our network backbone connects to the following major interexchange (IX) points:

- MAE West in San Jose, California;
- MAE West ATM in San Jose, California;
- Equinix GigE Exchange in San Jose, California;
- PAIX (Palo Alto Internet Exchange) in Palo Alto, California;
- the Sprint Network Access Point in Pennsauken, New Jersey;
- NYIIX (New York International Internet Exchange) in New York;
- MAE East ATM in Ashburn, Virginia; and
- Equinix GigE Exchange in Ashburn, Virginia.

Through these IX points we connect to many other ISPs in the United States, including Sprint, Cable & Wireless (Internet MCI) and MCI WorldCom (UUNET).

In Asia, we have established a backbone connection through the A-Bone, the Internet backbone network covering the Asia-Pacific region. The A-Bone is operated by Asia Internet Holding, of which we own 26.7%. Asia Internet Holding commissioned us to design and build the A-Bone, and we currently manage it.

Expansion plans. We have placed a high priority on the continued expansion of the capacity and geographic reach of our networks. We will look first to expand our domestic network and our network between Japan and the United States. We will also look at expanding our network in the Asia-Pacific region, Europe and the United States as opportunities arise.

For domestic expansion under our broadband strategy called "IIJ CDN Platform", IIJ plans to connect various regional broadband networks to our nationwide backbones and redesign our existing backbone network connecting the nine IIJ Internet data centers with one another, setting in place the infrastructure needed for full-scale broadband transmission.

Between Japan and the United States, we will look primarily to increase our capacity by securing long-term committed capacity either directly or through Crosswave, who would then lease all or a substantial portion of the international capacity to us on a long-term basis.

We believe that our total expenditures for additional capacity in the near term will continue to decrease in absolute terms because we believe that the per-unit costs of the lines between Japan and the United States will continue to be significantly reduced due to the increase of available capacity between Japan and the United States. If trans-Pacific leased line costs do not decline as anticipated, we may not realize the cost savings we anticipate and/or we may choose not to add as much capacity as we currently plan.

Network equipment. We use advanced equipment in our network. Our primary routers for our dedicated lines are Cisco routers. Our primary dial-up routers are Lucent Technologies MAX 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.

POPs

Points of Presence, or POPs, are the main points at which our customers connect to our backbone. We provide Internet access from our POPs to commercial and residential customers through leased lines and dial-up connections over local exchange facilities. As of March 31, 2002, we had 24 primary POPs which allow for dedicated and dial-up access and include the main Internet backbone routers that form our network. As of the same date, we also had 78 POPs for dial-up access. We are also in a position to leverage Crosswave's nationwide network and access points and can easily add additional POPs for either dedicated or dial-up access as demand merits.

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, KDDI and Japan Telecom. We lease the physical space from these carriers or use such space under other arrangements with terms ranging from one to two years and which can usually be terminated by either party on three to six months' notice. We maintain our routers and other networking equipment at these POPs. The actual location of our POPs in, or in close proximity to, the same buildings in which the switches and routers of these carriers and ISPs are located offers us the ability to quickly and easily interconnect our equipment with theirs.

Internet Data Centers

In addition to existing Internet data centers in Yokohama and Tokyo, in fiscal 2000 and 2001, we set up seven new Internet data centers nationwide in Osaka, Sapporo, Sendai, Nagoya, Kyoto, Fukuoka and a second data center in Tokyo which we use to offer our value-added data center services. We now have nine Internet data centers throughout Japan available for services. Furthermore, Crosswave is expected to open two other large scale data centers in the suburbs of Tokyo, in Yokohama and in the Saitama Kawaguchi Intelligent Park complex in early 2003. These data centers are specifically designed for application hosting, co-location services and high capacity access to both Crosswave's and our networks.

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 of ¥97 million. Our other Internet data center venture, "AyalaPort Makati," with the Ayala Group in the Philippines launched in October 2001 with a floor space of approximately 1,800 square meters and a total investment of ¥209 million.

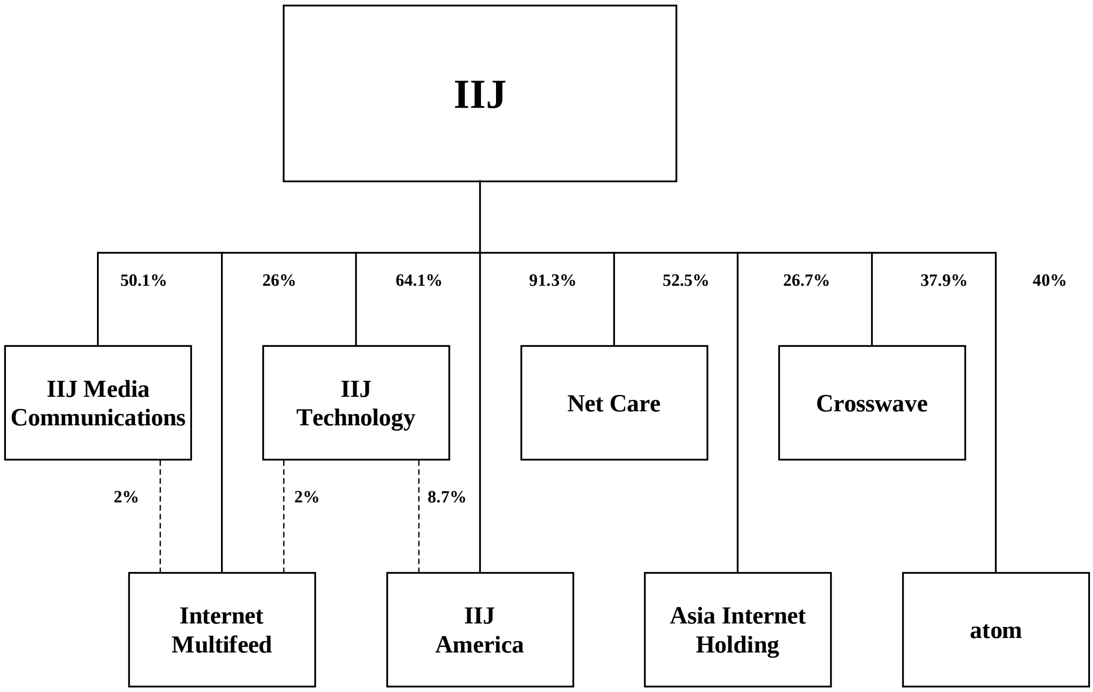
Network operations center and technical and customer support

Our network operations center, or NOC, in Tokyo operates 24-hours-a-day, 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 we 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 specialization of the group companies to offer total Internet solutions.

The chart below sets out our group companies, including our subsidiaries and principal equity method investees and our ownership of each of them as of June 30, 2002:



Crosswave Communications Inc.

Crosswave is a pioneer in the introduction of broadband data communications infrastructure and services to businesses and telecommunications carriers in Japan, including its high-speed backbone, wide-area Ethernet platform and data center services. Crosswave operates the first nationwide fiber optic network in Japan specifically designed for the high-speed transmission of data. Its network uses advanced optical technologies that allow it to deliver high-capacity, cost-effective and highly reliable data communication services, eliminating the burden of multiple layers of equipment employed in traditional telephony systems. Its extensive, flexible, and scalable network can be easily upgraded to increase capacity, support new services and incorporate new transmission technologies, as the market demands.

Crosswave was formed in October 1998 by IIJ, Sony and Toyota Motor and began offering services in May 1999. Crosswave is incorporated under the laws of Japan. In August 2000, Crosswave became a public company with an initial public offering on the Nasdaq National Market under ticker code of CWCI. As of March 31, 2002, IIJ, Sony and Toyota Motor owned 37.9%, 23.9% and 23.9%, respectively, of Crosswave.

As of March 31, 2002, Crosswave had 236 full-time employees, 15 of whom were seconded to Crosswave from us.

Crosswave is a Type I carrier, which allows it to provide telecommunications services through its own telecommunications circuit facilities.

For the year ended March 31, 2002, it had revenues of ¥9,488 million and a net loss of ¥13,397 million.

Crosswave's network. Crosswave's primary asset is its network. Crosswave's primary expenses are related to the development of its domestic network. For a discussion of Crosswave's expenses and the contract with KDDI, please see Item 5, "Operating and Financial Review and Prospects".

We have been primarily responsible for and have actively participated, as a third-party contractor or through our seconded employees, in the planning and design of the Crosswave network and services. We worked closely with Crosswave to ensure that its network is well suited, in terms of quality of technology and otherwise, to integrate with our network and the services we currently offer and will offer in the future. In addition, we assist Crosswave in the operation and maintenance of its optical fiber network as a third-party contractor.

In addition to its optical fiber network in Japan, Crosswave expanded its network internationally by securing international backbone capacity connecting Japan and the United States. Depending upon the rate of expansion, we would anticipate securing leases for a large amount of our international capacity from Crosswave. As with domestic leased lines that Crosswave offers, we expect that this international capacity would be available at significantly lower per-unit costs than we are currently paying.

Crosswave's primary services. Crosswave offers two main types of services, Network services and Data Center services. Network services include Wide-area Ethernet Platform Service, Wide-area IP Platform Service, High-speed backbone service, International backbone service, Metro Wave service and Dial-up port service.

- ***Wide-area Ethernet Platform Service***. Crosswave offers Wide-area Ethernet Platform Service targeted mainly at corporate customers, particularly those with multiple offices, buildings, factories, laboratories or shops. The service provides customers with a seamless LAN environment over a large geographic area. The service offers "multi-point-to-multi-point" architecture in which LAN networks connect to each other seamlessly through our high-speed network. This architecture, incorporating multi-point-to-multi-point Ethernet switching, allows a customer's headquarters and branch offices, which may be separated by long distances, to communicate with each other as if they were part of the same LAN without the need for any additional equipment, thereby realizing a seamless LAN environment over a wide area with higher reliability at lower costs. Crosswave provides either a 10 base-T or a faster 100 base-T interface depending on a customer's access speed and preference.

- ***Wide-area IP Platform Service***. This service is mainly targeted at corporate customers that have hundreds or thousands of locations scattered throughout Japan, including gas stations, franchise retail convenience stores and chain restaurants or shops. By utilizing Crosswave's existing nationwide backbone and the installed user authentication system, this service builds secure private broadband networks for corporate customers at relatively reasonable costs. This service provides solutions for customers with multiple locations who previously lacked sufficient bandwidth at certain local stations and suffered rising communications costs and operational difficulty due to a large number of nationwide sites. The Wide-area IP Platform Service is currently available in 11 cities and prefectures (Tokyo, Saitama, Chiba, Kanagawa, Hokkaido, Miyagi, Aichi, Osaka, Hyogo, Fukuoka and Shizuoka) and will be extended nationwide. Fees for this service consist of an initial setup charge and monthly fees.

- ***High-speed backbone service.*** Its high-speed backbone service targets telecommunications carriers, network operators such as ISPs and companies with large data transmission requirements such as cable television broadcasters and media organizations. This service currently offer speeds of up to 9.6 Gbps (gigabits per second) using DWDM, or Dense Wave-length Division Multiplexing, and SONET, or Synchronous Optical Network Technology, transmission technologies. Furthermore, Crosswave offers point-to-point dedicated backbone services with Ethernet interface of 10 Base-T, 100 Base-TX and 1000 Base-LX. Our 1000 Base L-X service, called Gigabit Ethernet Backbone Service, was launched in April 2002. Gigabit Ethernet Backbone Service and 9.6 Gbps items have initially been provided in the area between and peripheral to our data centers located in Tokyo, Osaka and Nagoya and we plan to gradually expand the service area depending on demand for these services. The pricing structure for these services is primarily based on bandwidth, not on distance.

- ***Metro Wave service.*** This is a new end-to-end broadband multi-interface service aimed at the Tokyo metropolitan area. Currently this service is offered at six points within the Chiyoda, Shinagawa, Chuo and Koto wards in Tokyo and will be progressively expanded to other areas in Tokyo, Yokohama and Saitama. Metro Wave Service is also used as the access lines for our High-speed Backbone Service and Wide-area Ethernet Platform Service.

- ***International backbone service.*** Crosswave's International backbone service conducts international telecommunications services for data transmission and leased circuits. Pricing is based on bandwidth and destination.

- ***Dial-up port service.*** Crosswave offers this service targeted mainly at value-added network operators such as ISPs. This service allows customers to offer nationwide dial-up access to their own networks via our network. This service is offered nationwide through Crosswave's access points located in 81 cities throughout Japan. Authorized users who want to access a network supported using this service call the telephone number of the closest access point using a telephone or ISDN line. The call is then transmitted over Crosswave's network to the remote access server of the customer's network located in Crosswave's data centers.

- ***Data center services.*** Crosswave currently has seven data centers in operation in major metropolitan areas in Japan – Tokyo, Osaka, Nagoya, Sapporo, Sendai, Fukuoka and Kyoto. Crosswave targets a wide variety of customers, including large companies and value-added network service providers, such as application and digital content service providers, and new entrants into the Japanese telecommunications market that require high-speed access to networks and resources, co-location and operational support for their systems. Crosswave personnel operate and manage each of the data centers, and outsource certain support and maintenance services to Net Care, an IIJ group company, and other third-party providers. At the data centers, Crosswave provides services that, together with services offered by IIJ, provide total network solutions to end users.

Crosswave's customers. Crosswave's sales and marketing is primarily done by Crosswave and us, although Crosswave also uses third-party agents throughout Japan. In addition, we market Crosswave's services as an agent and as part of the services offered by the IIJ group. As a Type I carrier, Crosswave is required to make its tariff-based services available on the same terms and conditions to all customers, without special treatment to its shareholders, including us.

Our synergy with Crosswave's services. We continue to benefit from Crosswave's network in primarily two ways. First, as broadband traffic increases over our domestic backbone we will continue to expand our domestic network which includes redesigning of our backbone network structure connecting IIJ Internet data centers to one another. Crosswave allows us to add significant capacity to our existing networks as well as enabling us to set in place the network infrastructure needed for full-scale content transmission. Second, we continue to perform joint service and product development with Crosswave to produce advanced and flexible network services which are designed primarily for us. Through this joint development, we continue to provide unique total network solutions services by integrating Crosswave's advanced network structure prior to the introduction of comparable services by our competitors.

Our contributions to Crosswave. In order to strengthen a nationwide network, Crosswave requires substantial investment. In accordance with the joint venture agreement, the three joint venture partners have contributed ¥20 billion of capital contributions on a pro rata basis. As of March 31, 2000, we had contributed ¥8 billion (our pro rata contribution based on our 40% interest at that time). Crosswave raised approximately ¥24 billion in proceeds after payment of underwriting commissions and expenses from its August 2000 initial public offering, at which time we purchased an additional 15,000 shares of Crosswave for ¥4.6 billion. Furthermore, we purchased an additional 3.0 million outstanding American Depositary Receipts ("ADRs") of Crosswave at fair market value in a privately negotiated transaction in December 2000. The three million ADRs are equivalent to 15,000 shares of Crosswave's common stock. As a result, our ownership in Crosswave decreased from 40.0% to approximately 37.9%. In May 2002, to assist Crosswave in securing loan financing, we have entered into a ¥5.0 billion Cash Deficiency Support Agreement with Crosswave and four Japanese commercial banks. In connection with this financing, Crosswave granted us and the bank consortium stock acquisition rights exercisable for a total of 30,000 shares of Crosswave's common stock, equivalent to 6,000,000 American Depositary Shares (ADSs). The exercise price of these stock acquisition rights was set at US $1.50 per ADS, which represents a 50% premium over the closing market price of the ADSs as of May 9, 2002. These stock acquisition rights will be exercisable from June 6, 2002 to May 31, 2009. For further information on the Cash Deficiency Support Agreement, see Item 5.B, "Cash Deficiency Support Agreement."

Our financial results will be affected by Crosswave's performance because we account for Crosswave using the equity method. However, we are not directly responsible for any of the expenses of Crosswave beyond our equity investment, aside from our previously mentioned Cash Deficiency Support Agreement with Crosswave. Crosswave's accumulated deficit as of March 31, 2002 was ¥32,176 million.

More detailed information on Crosswave can be found in its registration statement initially filed with the SEC on July 10, 2000, as amended, and its annual report on form 20-F filed with the SEC in July 2002.

Our most significant investment in our group companies continues to be in Crosswave.

IIJ Technology Inc.

IIJ Technology is becoming an increasingly important element in our providing total Internet solutions to our customers. IIJ Technology Inc. is incorporated under the laws of Japan. IIJ Technology provides comprehensive Internet network systems integration and consulting services, focusing on design, operation, and consulting for corporate networks (LANs, enterprise networks, Intranets) and their security systems. IIJ Technology 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 Technology can integrate an organization's multiple sites in different locations in Japan and different countries throughout the world.

As of March 31, 2002, we owned 64.1% of IIJ Technology.

IIJ Technology had sales of approximately ¥14,272 million for the year ended March 31, 2002. As of March 31, 2002, IIJ Technology had approximately 99 full-time employees, 21 of whom were seconded from us.

IIJ Media Communications Inc.

IIJ Media Communications provides expert services to help customers exploit the potential of the Internet as a new communications medium. IIJ Media Communications Inc. is incorporated under the laws of Japan. IIJ Media Communications' core business is providing various hosting and home page development services as well as Internet broadcasting services. For this purpose, IIJ Media Communications engages in research and development of the newest technologies for media communications, such as streaming technologies including multicast and portal service applications, and incorporates the technologies into various applications.

IIJ Media Communications also provides total support for customers' content and systems, particularly those customers who engage in e-commerce related activities. IIJ Media Communications provides consultation, planning, configuration (including selection of hardware and choices of applications), content production and ongoing support for its customers.

Other basic media services offered by IIJ Media Communications include information management services related to the Internet. IIJ Media Communications also offers servers to manage mailing lists, to provide simultaneous distribution services and to operate IIJ Net News services.

As of March 31, 2002, we owned 50.1% of IIJ Media Communications.

IIJ Media Communications had sales of approximately ¥766 million for the year ended March 31, 2002. As of March 31, 2002, IIJ Media Communications had approximately 32 full-time employees, 32 of whom were seconded from us.

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. Net Care, Inc. is incorporated under the laws of Japan.

As of March 31, 2002, we owned 52.5% of Net Care. Other major shareholders of Net Care include JGC Corporation and CRC Solutions Corp., each of which owns 12.5%. Itochu Corp., Sumitomo Corp, Toyota Motor and Intelligence each owns 4.5%. In September 2001, Net Care issued an additional 11,000 shares of its common stock in the amount of ¥825 million to strengthen our group's business in network and systems management services. Among the 11,000 shares, we purchased 6,000 shares and increased our equity stake in Net Care from 50.0% to 52.5%. As strategic shareholders, JGC Corporation and CRC Solutions Corp. also took new ownership positions, holding 12.5% each of Net Care's common stock.

Net Care had sales of approximately ¥1,314 million for the year ended March 31, 2002. As of March 31, 2002, Net Care had approximately 216 employees, nine of whom were seconded from us.

IIJ America, Inc.

IIJ America is a U.S.-based Internet access provider, catering mostly to U.S.-based operations of Japanese companies that use our services in Japan. IIJ America, Inc. is incorporated under the laws of the state of New York.

As of June 30, 2002, we owned 91.3% of IIJ America and IIJ Technology owned 8.7% as a result of the issuance of 30,000 new shares of IIJ America to us for a total of $3.0 million through three transactions from the period between April 2001 and June 2002.

IIJ America had revenues of $5,871 thousand for the year ended December 31, 2001. As of March 31, 2002, IIJ America had approximately ten employees, four of whom were seconded from us.

Asia Internet Holding Co., Ltd.

Asia Internet Holding was created to own and manage the A-Bone, which is a high-speed Internet backbone network that connects countries in the Asia-Pacific region to a common network infrastructure. Asia Internet Holding Co., Ltd. is incorporated under the laws of Japan.

Currently, the A-Bone ties into networks in Japan and eight other countries in the region: Singapore, Hong Kong, Malaysia, Indonesia, the Philippines, Thailand, South Korea and China (PRC). Asia Internet Holding has network operations centers in each of these countries. The A-Bone also connects to the United States through our network. Asia Internet Holding is considering establishing connections to Taiwan, Vietnam, India, and Australia in the near future.

The primary customers of Asia Internet Holding are telecom carriers and ISPs throughout Asia including Japan.

As of March 31, 2002, we own 26.7% of Asia Internet Holding. We operate and manage the A-Bone pursuant to an agreement with Asia Internet Holding for which we are paid ¥7 million per month. The agreement is a yearly contract that renews automatically although it may be terminated by either party upon two months prior notice in writing. We operate the A-Bone from our network operations center in Tokyo.

Asia Internet Holding had sales of approximately ¥1,568 million for the year ended March 31, 2002. As of March 31, 2002, Asia Internet Holding had approximately 14 employees, five of whom were seconded from us and three of whom worked part time. In August 2001, we increased our stake in Asia Internet Holding to 26.7% from 20.6% through an additional Investment of ¥295 million.

atom Co., Ltd.

atom is primarily a Web page design company that aims to define new forms of design work using digital technology in all network-based aspects, including from content production to graphic design. atom Co., Ltd. is incorporated under the laws of Japan. As of March 31, 2002, we owned 40% of atom, which had sales of approximately ¥946 million for the year ended March 31, 2002. As of March 31, 2002, atom had 52 employees, five of whom worked part time.

Internet Multifeed Co.

Internet Multifeed provides the location and facilities for directly connecting high-speed Internet backbones with content servers to make distribution on the Internet more efficient. Internet Multifeed Co. is incorporated under the laws of Japan. We developed their technology jointly with NTT. Internet

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.

Through its Multifeed connectivity and Multifeed housing services, Internet Multifeed has already connected major ISPs to its premises. Having such an environment, Internet Multifeed provides Multifeed housing services for content providers, which allows them to distribute content more efficiently by reducing the number of networks that data must travel through. Major news company customers include Asahi Shimbun, Nikkei, Mainichi and Yomiuri. Matsui Securities, one of Japan's largest Internet security companies, is also one of its customers.

As of March 31, 2002, we own 26% of Internet Multifeed and IIJ Technology and IIJ Media Communications each owns 2%. Internet Multifeed had sales of approximately ¥1,400 million for the year ended March 31, 2002. As of March 2002, Internet Multifeed had approximately 16 full-time employees, two of whom were seconded from us and two of whom worked part time.

Capital Expenditures

The table below represents our capital expenditures, including capitalized leases, for the last three years.

	For the year ended March 31,		
	2000	2001	2002
		(millions of yen)	
Capital expenditures, including capitalized leases	¥ 3,465	¥ 3,963	¥ 3,773

Our future capital expenditures are difficult to predict given the rapid changes and uncertainties in the Internet traffic. However, most of our capital expenditures relate to the expansion and improvement of our existing network, including the leasing of lines that form our network backbone and the installation of the routers and servers necessary to offer services on our network. Our current plans call for us to invest approximately ¥4.0 to ¥5.0 billion in each of the next few years to increase the access to our networks by adding more POPs and increasing our data center facilities. In addition, we will continue to add equipment to our network as we expand the capacity of our network.

We have not made any material divestitures in the past three fiscal years.

Seasonality

See Item 5.D, "Operating and Financial Review and Prospectus — Factors Affecting Our Future Financial Results — System Integration Revenues".

Sales and Marketing

Our sales headquarters is in Tokyo. We also have branches in Osaka, Nagoya, Sapporo, Sendai, 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, 2002, we had approximately 182 people working in sales and marketing.

We organize our sales personnel into four distinct, separate divisions: sales, sales planning, sales administration and new business promotion.

Personnel in our sales divisions are further separated into three sections:

- Two of the sections focus on our total network solutions and work with large corporate clients, including telecommunications carriers and ISPs, financial institutions, manufacturing, government institutions, and universities and other schools. In order to provide our total network solutions, personnel in our sales divisions work closely with other IIJ group companies such as IIJ Technology and Crosswave Communications.

- One of the sections focuses on sales outside of Tokyo.

In addition to the above, we have three divisions in our sales/marketing organization: marketing, strategic sales division and business planning and development division. The marketing division promotes marketing communications through advertisement activities as well as organizes conferences and seminars given for targeted customers in order to enhance awareness of our total network solutions. The strategic sales division includes our contact center, which promotes our various network services for small- and medium-size businesses by making calls to potential customers. This contact center works with our third party sales agents. We reduced the number of agent contracts to nine at the end of June 2002 from 50 at the end of June 2001 in order to streamline sales activities. The business planning and development division promotes new business development including CDN (Content Distribution Network) business.

Customers

We had approximately 6,000 business and other institutional customers and approximately 260,000 individual subscribers which includes individuals through OEM services as of March 31, 2002. Our main customers continue to be major corporations including ISPs. We were awarded "the best service provider of year 2001" title in a major annual survey conducted by Nikkei Communications, a leading telecom industry trade magazine. According to the survey, which encompassed responses from 926 corporations in Japan and was released on December 3, 2001, we were ranked number one in all-qualifying categories of dedicated access, dialup access and value-added services.

Research and Development

We have always focused on advancing the use of network including 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. We continue to strive to develop new services, applications and products. Our research and development efforts are a fundamental part of that effort.

Our research and development expenses are not particularly substantial, averaging less than 1.0% of total revenues for the past two consecutive years. For the years ended March 31, 2002, 2001, 2000 and 1999, our research and development expenses were ¥319 million, ¥287 million, ¥364 million and ¥243 million, respectively. 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. Rather, as noted above and as set forth in more detail below, we focus on monitoring the developments in the industry and in developing new and innovative services and applications using and modifying existing technologies and products.

As of March 31, 2002, we had approximately 97 people working in our research and development organization, all of whom also have additional responsibilities in the Technology Department. 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.

R&D Organization

We have organized our research and development staff to promptly and effectively address the rapidly changing technological environment in the Internet. Research and development on practical applications of new and developing technologies is the responsibility of the Technology Department, the Service Administrative Department and of the IIJ Research Lab.

Technology department. As of March 31, 2002, the Technology Department comprised the following divisions:

- Network Operations and Administrations Division, which operates IIJ backbones and Internet data centers;

- Network Engineering Division, which designs network infrastructures including Internet data centers and network-related products, such as network monitoring devices and routers, and software development aimed at enhancing network monitoring and traffic management;

- Applied Technology Division, which develops network security technology and applications such as firewalls;

- Media Technology Division, which develops multimedia distribution systems such as IP multicast and Internet broadcasting;

- Planning and Development Division, which manages technology implementation for various new services; and

- Project Promotion Division, which develops backoffice applications such as customer databases, billing systems and service management systems.

Service administrative department. As of March 31, 2002, the Service Administrative Department comprised the following divisions:

- Customer Support Division, which operates customer-related back-office tasks such as management of customer databases, billing flow, etc.; and

- Internet Technology Division, which is responsible for technological requirements of each IP services customer.

IIJ Research Lab. We established the IIJ Research Lab in April 1998 to engage in R&D of new basic network technologies. For example, through the IIJ Research Lab, we are participating in various research and development activities in a corporation with organizations from private and academic sectors to promote the deployment and implementation of IPv6. For example, 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.

R&D 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 new SEIL T1 router, routers we developed specifically to be integrated into IIJ'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/lP 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

We have acquired a license from Check Point Software Technologies which allows us to provide managed firewall services for high-end users using Check Point's Firewall-1 and Provider-1 products.

Since June 1999, we are also a licensee under an agreement with WatchGuard Technologies, Inc. for the right to use WatchGuard's managed firewall service products which provide the ability to manage, update and configure firewalls remotely.

We have acquired a license from Trend Micro Incorporated which will allow us to add the option of virus scanning to our e-mail hosting and e-mail services.

We are also a licensee under an agreement with RSA Security Inc. which enables us to provide advanced secure remote access service to our customers.

Furthermore, we have acquired a license from NCL Communications K.K. which enables us to provide to our customers a disaster-recovery service storing backup data in customers' computers located at our data center.

Additionally, we are a licensee under an agreement with NRI Secure Technologies, Ltd. which enables us to provide service to investigate and identify any security problems in our customers' networks.

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 June 30, 2002, there were six applications pending and 18 which have been granted.

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 November 2000, IIJ Media Communications was sued in Japan by K.K. Gavali Digital Entertainment, a company which planned to launch an Internet game based on the stock market. IIJ Media Communications was sub-contracted to construct web-servers and databases and to perform consulting and management functions. Gavali is suing us for breach of contract in the amount of ¥332 million. We do not believe there is any merit in their claims. The matter is pending at the Tokyo District Court. Gavali alleges, among other things, that we failed to secure users' personal information and that the simulated stock market did not close at the same time as the real market.

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 IIJ, Koichi Suzuki — our President, Chief Executive Officer and Representative Director, Yasuhiro Nishi — our Director, Chief Financial Officer and Chief Accounting Officer, and the Goldman Sachs Group Inc. and 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 IIJ 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. We believe these claims are without any merit, and intend to defend these actions vigorously. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation.

Regulation of the Telecommunications Industry in Japan

The MPHPT regulates the Japanese telecommunications industry. Type I Carriers and Type II Carriers, including us, are regulated by the MPHPT primarily under the Telecommunications Business Law.

The Telecommunications Business Law

The Telecommunications Business Law, which became effective in 1985, authorizes the MPHPT to regulate two types of telecommunications companies, Type I Carriers and Type II Carriers. Type I Carriers include NTT Communications, NTT East, NTT West, KDDI, Japan Telecom and other new common carriers, including Crosswave, as well as cellular or other mobile operators. Type I Carriers provide telecommunications services by establishing their own telecommunications circuit facilities. Type II Carriers are telecommunications carriers other than Type I Carriers. Type II Carriers may engage in the businesses of telecommunications circuit resale and the provision of Internet services. Type II Carriers provide telecommunications services to customers by using the telecommunications facilities of Type I Carriers, typically NTT East and NTT West.

Historically, the MPHPT required Type I Carriers to own the telecommunication circuit facilities they used to provide telecommunications services. As a result of deregulation, however, the MPHPT modified this requirement in 1997. Type I Carriers may now lease telecommunications circuit facilities on a long-term basis and under stable conditions from the owner of the facilities. The MPHPT refers to such a lease as an indefeasible right of use, or IRU. This modification in the regulations allowed Crosswave, by virtue of its IRU agreement with KDDI, to obtain a Type I Carrier license. In December 1999, the MPHPT released its “Guidelines for Network Establishment” according to which in order to qualify as an IRU the following requirements must be satisfied:

- the agreement may not be unilaterally terminable by the owner of the facilities;
- a reasonable usage fee for the whole term of the agreement must be determined;
- the owner may not grant any security interest in the facilities to any third-party; and
- the agreement must not be less than ten years.

The fourth requirement was further deregulated in September 2001. Now, instead of having a term of not less than ten years, a term of not less than one year may be the basis of an IRU if the term can be renewed automatically and the agreement cannot be terminated by the owner of the facilities without the consent of the lessee.

In June 2001, the Telecommunications Business Law was amended to allow Type I Carriers to engage in wholesale telecommunications services for other Type I Carriers and Type II Carriers with prior notification to the MPHPT. The amendment took effect on November 30, 2001. As a result of this amendment, Type I Carriers may construct a partial segment of their network by purchasing wholesale telecommunications services made available by other carriers.

Among Type I Carriers, a carrier which operates an essential local network for the enhancement of user benefits and the general and rational development of telecommunications, designated by the MPHPT as “Category I Designated Telecommunications Facilities”, and a carrier which operates a mobile telecommunications network exceeding the ratio criteria provided by the MPHPT and ensures adequate and smooth interconnection with telecommunications facilities of other carriers, designated by the MPHPT as a “Category II Designated Telecommunications Facilities”, are subject to special regulation by the MPHPT.

Type II Carriers are not allowed, in principle, to provide telecommunications services through their own telecommunication circuit facilities. Therefore, if a carrier wishes to provide telecommunications services through its own circuit facilities, the carrier must obtain a Type I license under the Telecommunications Business Law. A telecommunications carrier may simultaneously hold a Type I license and a Type II license if the services offered under each license are kept separate and distinct according to the requirements of the Telecommunications Business Law. Alternatively, a carrier of one type is permitted to own a carrier of the other type.

The following table summarizes some of the major regulatory requirements applicable to Type I and Type II Carriers:

	Type I Carriers	**Type II Carriers**	
		Special Type II	**General Type II**
Government Regulation:			
a. Start-up of services	Permission from MPHPT required	Registration with MPHPT required	Notification to MPHPT required
b. Rates and charges	Notification* to MPHPT required	Notification to MPHPT required	Unregulated
c. Share acquisition by foreign investors	Unregulated**	Unregulated	Unregulated

* Type I Carriers which operate Category I Designated Telecommunications Facilities are required to receive MPHPT 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 33.3% foreign ownership restriction is applicable only to NTT (which was changed from a 20% foreign ownership restriction on November 30, 2001).

Regulations of Special Type II Carriers

The following regulations apply to us as a Special Type II Carrier.

Registration. Special Type II Carriers must obtain registration from the MPHPT before commencing a Special Type II business. The applicant must specify the categories of services to be provided and the facilities to be used by the carrier. Our registration as a Special Type II Carrier is made under the service category of “data transmission.”

Terms and conditions for the provision of services. Special Type II Carriers must establish terms and conditions for the provision of telecommunications services that they offer. The terms and conditions may be established and changed simply by prior notification to the MPHPT and without any need for MPHPT approval. Special Type II Carriers are prohibited from providing telecommunications services other than pursuant to the terms and conditions notified to the MPHPT.

Revocation of registration. If a Special Type II Carrier has violated the provisions of the TBL or any orders or administrative decisions, and is determined to impair the public interest, its registration may be revoked by the MPHPT.

Technical standards for Special Type II Carriers. Special Type II Carriers must maintain their telecommunications facilities in conformity with the technical standards provided in the applicable ordinances of the MPHPT. If the MPHPT determines that the telecommunications facilities fail to meet the technical standards, the MPHPT may order the Carrier to improve, repair or limit the use of its telecommunications facilities. The technical standards are specified to avoid damage or failure of, or interference to, telecommunications facilities, to maintain the quality of the telecommunications service, to maintain secrecy of communications and to clarify the demarcation of responsibilities between the telecommunications facilities of telecommunications carriers.

In addition, Special Type II Carriers must establish their own administrative rules in accordance with MPHPT 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. Such administrative rules must be submitted to the MPHPT prior to the commencement of operations, and changes must be submitted to the MPHPT after they are implemented without delay.

A telecommunications carrier that provides universal service, that is basic telecommunications service, and is designated an Eligible Telecommunications Carrier, or ETC, must make an effort to provide its services fairly, equitably and in a stable manner on a nationwide and non-discriminatory basis. A carrier that provides universal service will be entitled to receive a subsidy as an ETC upon application to MPHPT. The subsidy will be provided to the ETC by the Universal Service Support Institution, which has been established for the purpose of ensuring provision of universal services through contributions. In order to support the Universal Service Support Institution, contributions are collected from other carriers which have entered into interconnection agreements with an ETC. We may be subject to the obligation of paying a certain amount as a contribution to the Universal Service Support Institution if we enter into an interconnection agreement with an ETC.

C. Organizational structure.

See the information contained in "—Our Group Companies" above.

D. Property, plants and equipment.

See the information contained in "—Network", "—Backbone", "—POPs", and "—Internet Data Centers" above.

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 our consolidated financial statements and the notes to those financial statements beginning on page F-1 in response to Item 8 and Item 18. This discussion and analysis contains forward-looking statements and you should read the risk factors relating to forward-looking statements appearing at the beginning of this annual report.

Overview

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

Our primary sources of revenues are Internet access and connectivity services, systems integration services, Internet data center services and other value-added services. We also generate revenues from sales of purchased equipment, which are components of our total network solutions. Substantially all of our revenues are from our customers in Japan.

We provide Internet access and related value-added services, such as Internet data center services, security services, and mail server outsourcing services. We also provide systems integration services, various applications services and systems operation and maintenance services, such as systems development and integration for business-to-business and business-to-consumer networks, Web design, content development and distribution, network monitoring and call center support. We are the main point of contact of customers for these various services. We draw upon our group companies to provide the resources necessary to provide total network solutions to our customers.

We provide our services directly or by working together with the subsidiaries and affiliates of the IIJ 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 have consolidated four of our group companies — IIJ Technology, IIJ Media Communications, IIJ America and Net Care. We account for our non-consolidated group companies, including Crosswave, by the equity method.

We categorize our Internet access services revenues into dedicated access services and dial-up access services; however, there is no reasonable means to, and accordingly we do not, allocate the leasing fees for leased lines, other than customers' local access lines, and the lease payments, depreciation and other charges for network equipment to each such category of our Internet access service revenues.

Results of Operations

As an aid to understanding our operating results, the following tables shows items from our statement of operations for the periods indicated in millions of yen amounts and as a percentage of total revenues.

	Year Ended March 31,						
	2000		2001		2002		
	(millions of yen except for percentage data)						(thousands of U.S. dollars)
Statement of Operations Data:							
Connectivity and value-added services revenues:							
Dedicated access:							
IP Service (including IIJ T1 Standard, IIJ FiberAccess/F)	¥ 9,099	36.0%	¥ 11,520	36.1%	¥ 12,179	30.5%	$ 91,779
IIJ Economy + IIJ DSL/F	900	3.5	1,259	4.0	1,363	3.4	10,270
Total dedicated access	9,999	39.5	12,779	40.1	13,542	33.9	102,049
Dial-up access	4,496	17.8	4,423	13.9	3,644	9.1	27,461
Value-added:							
Internet data center	347	1.8	1,237	3.9	2,209	5.5	16,650
Other	537	1.7	899	2.8	1,652	4.2	12,447
Total value-added	884	3.5	2,136	6.7	3,861	9.7	29,097
Other	408	1.6	592	1.8	1,668	4.2	12,570
Total connectivity and value-added services revenues	15,787	62.4	19,930	62.5	22,715	56.9	171,177
Systems integration revenues, including related equipment sales	7,640	30.2	10,556	33.1	14,356	36.0	108,179
Other equipment sales revenues	1,875	7.4	1,390	4.4	2,834	7.1	21,357
Total revenues	25,302	100.0	31,876	100.0	39,905	100.0	300,713
Cost of connectivity and value-added services revenues:							
International backbone cost	5,660	22.4	5,549	17.4	2,469	6.2	18,606
Domestic backbone cost	1,533	6.1	2,574	8.1	3,187	8.0	24,017
Local access line cost	2,090	8.3	3,142	9.9	3,872	9.7	29,179
Other connectivity cost	1,220	4.8	1,366	4.3	1,375	3.4	10,354
Depreciation and amortization	1,760	6.9	2,192	6.9	2,474	6.2	18,643
Other	2,828	11.2	4,160	13.0	6,423	16.1	48,405
Total cost of connectivity and value-added services	15,091	59.7	18,983	59.6	19,800	49.6	149,204
Cost of systems integration revenues, including related equipment sales:							
Cost of equipment sales related to systems integration	2,749	10.9	2,755	8.6	3,303	8.3	24,889
Other	3,523	13.9	6,362	20.0	9,011	22.6	67,908
Total cost of systems integration revenues	6,272	24.8	9,117	28.6	12,314	30.9	92,797
Cost of other equipment sales revenues	1,807	7.1	1,289	4.0	2,540	6.4	19,142
Total cost of revenues	23,170	91.6	29,389	92.2	34,654	86.9	261,143
Sales and marketing	2,604	10.3	3,252	10.2	3,038	7.6	22,897
General and administrative	1,234	4.9	1,618	5.1	1,840	4.6	13,862
Research and development	364	1.4	287	0.9	319	0.8	2,407
Total cost and expenses	27,372	108.2	34,546	108.4	39,851	99.9	300,309
Operating income (loss)	(2,070)	(8.2)	(2,670)	(8.4)	54	0.1	404
Other income (expenses):							
Interest income	362	1.4	454	1.4	122	0.3	918
Interest expense	(277)	(1.1)	(643)	(2.0)	(659)	(1.6)	(4,967)
Foreign exchange gains (losses)	(1,128)	(4.4)	1,132	3.6	255	0.6	1,921
Other–net	298	1.2	(44)	(0.2)	(661)	(1.6)	(4,979)
Other income (expenses) – net	(745)	(2.9)	899	2.8	(943)	(2.3)	(7,107)
Loss from consolidated operations before income tax expense (benefit)	(2,815)	(11.1)	(1,771)	(5.6)	(889)	(2.2)	(6,703)

	Year Ended March 31,						
	2000		2001		2002		
	(millions of yen except for percentage data)						(thousands of U.S. dollars)
Loss from consolidated operations before income tax expense (benefit)	¥ (2,815)	(11.1)%	¥ (1,771)	(5.6)%	¥ (889)	(2.2)%	$ (6,703)
Income tax expense (benefit)	(1,280)	(5.1)	(926)	(2.9)	1,099	2.8	8,282
Minority interests in consolidated subsidiaries	(70)	(0.3)	160	0.5	24	0.1	184
Equity in net loss of equity method investees	(3,180)	(12.6)	(4,015)	(12.6)	(5,482)	(13.8)	(41,312)
Net loss	¥ (4,785)	(18.9)%	¥ (4,700)	(14.8)%	¥ (7,446)	(18.7)%	$ (56,113)

Year ended March 31, 2002 compared to the year ended March 31, 2001

Total revenues.

Our total revenues increased 25.2% to ¥39.9 billion for the year ended March 31, 2002 from ¥31.9 billion for the previous fiscal year. The primary drivers of this growth were the increases in systems integration revenues and value added services revenues, in particular, Internet data center services and security related services.

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, increased 14.0% to ¥22.7 billion for the year ended March 31, 2002 from ¥19.9 billion for the previous fiscal year.

Dedicated access. Revenues from dedicated access services increased 6.0% to ¥13.5 billion for the year ended March 31, 2002 from ¥12.8 billion for the previous fiscal year. This increase was the result of (1) capturing broadband demand from CATV operators through our HSMN (High Speed Media Network) structure and (2) strong demand for low-cost, higher-bandwidth service by small- and medium-sized companies. Demand for IIJ T1 standard service and our new service, IIJ DSL/F, also increased. The increase in demand for IIJ DSL/F service offset decreased demand for IIJ economy service. Demand for full-service IP service decreased slightly, mainly as a result of a shift in demand to our Internet data center connectivity services.

Dial-up access. Revenues from dial-up access services decreased 17.6% to ¥3.6 billion for the year ended March 31, 2002 from ¥4.4 billion for the previous fiscal year. This decrease was the result of declining revenues from our conventional dial-up access services and IIJ4U services. This decrease in IIJ4U revenues was due not only to the decrease in the number of subscribers but also to a shift to the lower-end IIJ4U fixed price service by users of NTT's FLET's services. We also introduced our new high-quality service for individual users, IIJ*mio* service, to offset the decrease in IIJ4U revenues.

Value-added services. Our value-added services revenues increased 80.8% to ¥3.9 billion for the year ended March 31, 2002 from ¥2.1 billion for the previous fiscal year. This increase was due to the growth of Internet data center services and security-related services. Internet data center services, including our Internet data center connectivity service, increased 78.7% to ¥2.2 billion for the year ended March 31, 2002 from ¥1.2 billion for the previous fiscal year. Other revenues, which included rental router service, customer support service, set up fees of network equipment and resale of Wide area Ethernet services, increased 181.8% to ¥1.7 billion for the year ended March 31, 2002 from ¥0.6 billion for the previous fiscal year.

Systems integration revenues. Our revenues from systems integration, which include equipment sales related to systems integration, increased 36.0% to ¥14.3 billion for the year ended March 31, 2002 from ¥10.6 billion for the previous fiscal year. Systems integration revenues accounted for 36.0% of our total revenues during the period compared to 33.1% in the previous year. This growth in our systems integration business reflected the increase in large-scale contracts, from the financial sector in particular, and the increase in recurring fees from systems operation and monitoring services incurred by our developing network systems.

Other equipment sales revenues. Our other equipment sales revenues increased 103.8% to ¥2.8 billion for the year ended March 31, 2002 from ¥1.4 billion for the previous fiscal year, mainly as a result of the increase in sales of telecommunications equipment to Crosswave and in sales of our original router "SEIL" series, which is expected to serve as a core of the IIJ group's system management services.

Total cost of revenues.

Total cost of revenues increased 17.9% to ¥34.7 billion for the year ended March 31, 2002 from ¥29.4 billion for the previous fiscal year. The increase in total cost of revenues reflected primarily an increase in cost of systems integration revenues.

Cost of connectivity and value-added services revenues. Cost of connectivity and value-added services revenues increased 4.3% to ¥19.8 billion for the year ended March 31, 2002 from ¥19.0 billion for the previous fiscal year. The gross margin in connectivity and value-added services revenues substantially improved to 12.8% for the year ended March 31, 2002 from 4.8% for the previous fiscal year. This improvement is mainly a result of the significant decrease in international backbone cost, which decreased 55.5% to ¥2.5 billion for the year ended March 31, 2002 from ¥5.5 billion for the previous fiscal year. In addition, the yearly unit backbone cost declined by approximately 70.9%. Domestic backbone cost increased 23.8% to ¥3.2 billion for the year ended March 31, 2002 from ¥2.6 billion for the previous fiscal year, attributable to the expansion of our domestic backbone capacity, along with rising internet traffic in Japan. We also upgraded our U.S. domestic backbone network for enhanced service redundancy and stability. Local access line costs increased 23.2% to ¥3.9 billion for the year ended March 31, 2002 from ¥3.1 billion for the previous fiscal year as a result of an overall increase in the number of our dedicated access service subscribers.

Cost of systems integration revenues. Our cost of systems integration revenues, including related equipment sales, increased 35.1% to ¥12.3 billion for the year ended March 31, 2002 from ¥9.1 billion for the previous fiscal year. The gross margin in system integration revenues improved steadily to 14.2% for the year ended March 31, 2002 from 13.6% for the previous fiscal year. This steady increase was due to the increase in recurring fees in system operations, which is generally more profitable than systems development.

Cost of equipment sales revenues. Our cost of other equipment sales revenues increased 97.1% to ¥2.5 billion for the year ended March 31, 2002 from ¥1.3 billion for the previous fiscal year. The marginal ratio in equipment sales improved to 10.4% for the year ended March 31, 2002 from 7.3% for the previous fiscal year. The revenue increase in our original router "SEIL" contributed to the improvement in equipment sales' profitability.

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 15.4% to ¥39.9 billion for the year ended March 31, 2002 from ¥34.6 billion for the previous year. The increase in total costs and expenses was primarily a result of the increase in total revenues.

Sales and marketing. Sales and marketing expenses decreased 6.6% to ¥3.0 billion for the year ended March 31, 2002 from ¥3.3 billion for the previous fiscal year. This decrease was due to lower advertising costs, which decreased 47.2% to ¥0.4 billion from ¥0.8 billion, resulting from a cutback in the promotion of IIJ4U. Corresponding with a growth in client demand for network solution services, sales personnel expenses increased 12.9% in the year to year comparison.

General and administrative. General and administrative expenses increased 13.7% to ¥1.8 billion for the year ended March 31, 2002 from ¥1.6 billion for the previous fiscal year. The increase in expenses was due to an increase in our administrative staff as a result of the growth of our operations.

Research and development. Research and development expenses increased 11.3% to ¥0.32 billion for the year ended March 31, 2002 from ¥0.29 billion for the previous fiscal year. These expenses were mainly due to research and development on IPv6 and our proprietary router "SEIL".

Other income (expenses), net.

A loss of ¥943 million was recorded for other income (expenses)--net for the year ended March 31, 2002 compared to a gain of ¥899 million for the previous fiscal year.

Interest income. Interest income decreased to ¥0.1 billion for the year ended March 31, 2002 from ¥0.5 billion for the previous fiscal year, as our U.S. dollar-denominated monetary assets decreased due to payment in U.S. dollars made for the equity investment in our subsidiary company, IIJ America, and connectivity costs to IIJ America's network.

Interest expense. Interest expense increased to ¥0.7 billion for the year ended March 31, 2002 from ¥0.6 billion for the previous fiscal year, due to an increase in interest expenses incurred on our capitalized leases.

Foreign exchange gains. For the year ended March 31, 2002, we recorded a foreign exchange gain of ¥0.3 billion compared to a gain of ¥1.1 billion for the previous fiscal year. The gains are due to a foreign exchange gain on the U.S. dollar denominated monetary assets attributable to the depreciation of the Japanese yen against the U.S. dollar. The decrease in foreign exchange gain was due to a decrease in our U.S. dollar denominated monetary assets and lower levels of depreciation of the Japanese yen against the U.S. dollar compared to last year.

Other-net. Other expenses for the year ended March 31, 2002 included losses of ¥433 million on the write down of investments in equity securities to reflect the decline in value considered to be other than temporary.

Income tax expense (benefit).

Income tax expense was ¥1.1 billion for the year ended March 31, 2002 compared to a ¥0.9 billion income tax benefit for the previous fiscal year. This income tax expense was a result of an increase in the valuation allowance for deferred tax assets, attributable primarily to the income tax effect of unrealized gains which decreased in this period on certain available-for-sale securities.

Minority interests in consolidated subsidiaries.

Minority interests in consolidated subsidiaries amounted to income of ¥24 million for the year ended March 31, 2002 compared to income of ¥160 million for the previous fiscal year. This decrease was a result of the improvement in net income of IIJ Technology.

Equity in net loss of equity method investees.

Our equity in net loss of equity method investees increased substantially to ¥5.5 billion for the year ended March 31, 2002 from ¥4.0 billion for the previous fiscal year. This increase resulted primarily from our equity in the loss of Crosswave. Crosswave's losses related mainly to the cost of data communication services, including fees for the lease of dark fiber and maintenance relating thereto and related depreciation expenses.

Net Loss. Net loss for the year ended March 31, 2002 increased to ¥7,446 million from ¥4,700 million for the previous fiscal year. While operating income turned positive, the increase in net loss primarily reflects an increase in equity in net loss of equity method investees and the recording of a loss for other income (expenses), net.

Year ended March 31, 2001 compared to the year ended March 31, 2000

Total revenues.

Overall, our total revenues increased 26.0% to ¥31.9 billion for the year ended March 31, 2001 from ¥25.3 billion for the year ended March 31, 2000. The primary drivers of this growth were the increases in systems integration revenues and Internet data center services and the increases in services for higher bandwidths by our corporate customers.

Connectivity and value-added services revenues. Revenues from connectivity services and value-added services revenues increased 26.2% to ¥19.9 billion for the year ended March 31, 2001 from ¥15.8 billion for the previous fiscal year.

Dedicated access. Revenues from dedicated access services increased 27.8% to ¥12.8 billion for the previous fiscal year from ¥10.0 billion for the year ended March 31, 2000. The increase was the result of strong demand for higher bandwidth services from new customers and the migration of existing customers to higher bandwidth services. In particular, our IIJ T1 Standard service showed strong growth reflecting the strong demand for more capacity (i.e., higher bandwidth services) by small- and medium-sized companies. Overall, our IP Service revenues, which include IIJ T1 Standard, increased to ¥11.5 billion for the previous fiscal year from ¥9.1 billion for the year ended March 31, 2000. Revenues from IIJ Economy steadily increased 39.9% to ¥1.3 billion due to continuing growth in the number of subscribers to this service.

Dial-up access. Revenues from dial-up access services decreased 1.6% to ¥4.4 billion for the previous fiscal year from ¥4.5 billion for the year ended March 31, 2000. This marginal decrease was primarily a result of declining revenues from our older dial-up access services: network-type and terminal-type.

Value-added service. Our value-added services revenues increased 141.4% to ¥2.1 billion for the previous fiscal year from ¥0.9 billion for the year ended March 31, 2000. This significant increase was due to the strong growth of our Internet data center services, which increased by 256.5% to ¥1.2 billion, compared to only ¥0.3 billion in the prior year. Other revenues increased 45% to ¥0.6 billion for the previous fiscal year from ¥0.4 billion for the year ended March 31, 2000.

Systems integration revenues. Our revenues from systems integration, which include equipment sales related to systems integration, increased 38.2% to ¥10.6 billion for the previous fiscal year from ¥7.6 billion for the year ended March 31, 2000. Systems integration revenues, including related equipment sales, accounted for 33.1% of our total revenues during the period compared to 30.2% in the previous year. This increase was attributable to the growth of our systems integration business, particularly the growth of our iBPS systems integration services which appealed to small- and medium-sized businesses. Approximately 36% of systems integration revenues was related to equipment sales.

Other equipment sales revenues. Our other equipment sales revenues decreased to ¥1.4 billion for the previous fiscal year from ¥1.9 billion for the year ended March 31, 2000 as a result of the lower sales of telecommunications equipment to Crosswave as compared to the prior year.

Total cost of revenues.

Total cost of revenues increased 26.8% to ¥29.4 billion for the year ended March 31, 2001 from ¥23.2 billion for the year ended March 31, 2000.

Cost of connectivity and value-added services revenues. Cost of connectivity and value-added services revenues increased 25.8% to ¥19.0 billion for the previous fiscal year from ¥15.1 billion for the year ended March 31, 2000. The primary increases in cost of connectivity and value-added services revenues were related to a 67.9% increase in domestic backbone costs, a 50.4% increase in local access line costs, a 28.9% increase in depreciation and amortization and a 44.8% increase in other costs. The increases in domestic backbone costs were primarily attributable to the expansion of our trunk lines that form our domestic backbone, which underwent substantial upgrades in connection with our Internet data center services and our support of CATV services. Our increased costs were partially offset by a 2.0% decrease to ¥5.5 billion in international backbone costs despite the significant expansion of our international trunk lines between Japan and the United States. In addition, the international network per-unit cost of trunk lines decreased approximately 48%. The increase in local access line cost was due mainly to the revenue increase in dedicated access services. The increase in other costs was related to fees for leased data center facilities and an increased payroll cost in line with the increase in employees.

Our cost of connectivity and value-added services revenues as a percentage of the corresponding revenues was 95.3% for the year ended March 31, 2001, a slight decrease from 95.6% for the year ended March 31, 2000.

Cost of systems integration revenues. Our cost of systems integration revenues, including related equipment sales, increased 45.4% to ¥9.1 billion for the previous fiscal year from ¥6.3 billion for the year ended March 31, 2000. This significant increase in cost of systems integration was primarily a result of the significant growth of our systems integration businesses as well as pre-expenditures, principally amortization of software development cost relating to our iBPS systems integration services, which raised our costs of systems integration revenues to 86.4% of systems integration revenues from 82.1% in the prior period.

Cost of other equipment sales revenues. Our cost of other equipment sales revenues decreased 28.7% to ¥1.3 billion for the previous fiscal year from ¥1.8 billion for the year ended March 31, 2000. This decrease was primarily related to significant decreases in cost of equipment sold to Crosswave compared to the prior 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 to ¥34.6 billion for the year ended March 31, 2001 from ¥27.4 billion for the year ended March 31, 2000. The increase reflected the larger amount of total revenues.

Sales and marketing. Sales and marketing expenses increased 24.9% to ¥3.3 billion for the previous fiscal year from ¥2.6 billion for the year ended March 31, 2000. The increase reflected an increase in sales and marketing staff and higher advertising and other marketing expenses, particularly for the promotion of our IIJ4U and Internet data center services. Although in percentage terms the increase was significant, as a percentage of total revenues, sales and marketing costs actually declined marginally to 10.2% from 10.3%.

General and administrative. General and administrative expenses increased 31.1% to ¥1.6 billion for the previous fiscal year from ¥1.2 billion for the year ended March 31, 2000. The increase in expenses was due to increases in employees as a result of the growth of our operations and increases in recruiting expenses.

Research and development. Research and development expenses decreased 21.2% to ¥0.3 billion for the previous fiscal year from ¥0.4 billion for the year ended March 31, 2000. This decrease was related to the development of a proprietary router for 1.5 Mbps services known as a SEIL T1 in the prior period.

Other income expenses, net. We recorded a gain of ¥0.9 billion for the year ended March 31, 2001 as compared to a loss of ¥7.5 billion for the year ended March 31, 2000.

Interest income. Interest income increased to ¥0.5 billion for the previous fiscal year from ¥0.4 billion for the year ended March 31, 2000. Interest income is generated by U.S. dollar denominated monetary assets such as bonds and deposits. The increase was attributable to the overall appreciation of the U.S. dollar against the Japanese yen.

Interest expense. Interest expense increased to ¥0.6 billion for the previous fiscal year from ¥0.3 billion for the year ended March 31, 2000. This increase was primarily a result of the interest expense incurred on the unsecured convertible notes, 1.75 percent, due 2005, which were issued in April 2000.

Foreign exchange gains (losses). For the year ended March 31, 2001, we recorded a foreign exchange gain of ¥1.1 billion, mainly due to a foreign exchange gain on the U.S. dollar denominated monetary assets attributable to the depreciation of the Japanese yen against the U.S. dollar.

Other-net. Other expenses for the year ended March 31, 2001 included losses of ¥398 million on write down of investments in equity securities to reflect the decline in value considered to be other than temporary and cash dividend income of ¥433 million relating to an investment held in a limited partnership, which is accounted for by the cost method.

Income tax expense (benefit). Income tax benefit was ¥0.9 billion for the previous fiscal year compared to a ¥1.3 billion income tax benefit for the year ended March 31, 2000. This income tax benefit was a result of an increase of deferred tax assets due to operating loss incurred during the year ended March 31, 2001 and a decrease in the valuation allowance for deferred tax assets, attributable primarily to the income tax effect of unrealized gains on certain available-for-sale securities.

Minority interests in consolidated subsidiaries. Minority interests in consolidated subsidiaries amounted to income of ¥0.2 billion for the previous fiscal year which reflects the portion of losses of majority owned operations, principally IIJ Technology, which are applicable to the minority shareholders.

Equity in net loss of equity method investees. Our equity in net loss of affiliated companies increased substantially to ¥4.0 billion for the previous fiscal year from ¥3.2 billion for the year ended March 31, 2000. This increase resulted primarily from our equity in the loss of Crosswave. Crosswave's losses related mainly to the cost of data communication services, including fees for the lease of dark fiber and maintenance relating thereto and depreciation expenses.

Net loss. Net loss for the year ended March 31, 2001 decreased to ¥4.7 billion from ¥4.8 billion for the year ended March 31, 2000.

B. Liquidity and Capital Resources.

Our principal capital and liquidity needs historically have related to the development and expansion of our network infrastructure, our investments in our group companies, including Crosswave, sales and marketing activities and general working capital needs. We have met these capital needs primarily from cash flows from operations, the issuance of our common shares, capital lease arrangements and short-term and long-term borrowings.

Cash Flows

We had cash and cash equivalents of ¥11.0 billion at March 31, 2002. Pursuant to our CDS Agreement in respect of Crosswave's bank loan facility, ¥5 billion of cash is currently restricted.

The following table presents information about our cash flows during the years ended March 31, 2000, 2001 and 2002:

	Year ended March 31,		
	2000	2001	2002
	(Thousands of Yen)		
Net cash provided by (used in) operating activities	¥ 1,198,565	¥ (270,586)	¥ 1,161,213
Net cash used in investing activities	(7,135,174)	(9,544,214)	(2,457,198)
Net cash provided by (used in) financing activities	22,191,882	6,427,791	(1,461,901)
Effect of exchange rate changes on cash	(1,158,322)	799,277	233,098
Net (decrease) increase in cash and cash equivalents	15,096,951	(2,587,732)	(2,524,788)
Cash and cash equivalents at beginning of the year	1,061,488	16,158,439	13,570,707
Cash and cash equivalents at end of the year	¥ 16,158,439	¥ 13,570,707	¥ 11,045,919

Year ended March 31, 2002 as compared to the year ended March 31, 2001

Net cash provided by operating activities was ¥1.2 billion for the year ended March 31, 2002 compared to ¥0.3 billion used for the year ended March 31, 2001. The change was primarily a result of the improvement of operating income.

Net cash used in investing activities was ¥2.5 billion for the year ended March 31, 2002 and ¥9.5 billion for the year ended March 31, 2001. Cash used in investing activities for the years ended March 31, 2002 and 2001 included investments in and advances to equity method investees, mainly Crosswave, Asia Internet Holding and Net Care, respectively, purchases of short-term and other investments and purchases of property and equipment.

Net cash used in financing activities was ¥1.5 billion for the year ended March 31, 2002 as compared to ¥6.4 billion provided by financing activities for the year ended March 31, 2001. Cash used in financing activities for the year ended March 31, 2002 consisted primarily of payments under capital leases. In the year ended March 31, 2002, we converted ¥2.0 billion of short-term borrowings into long-term borrowings.

Year ended March 31, 2001 as compared to the year ended March 31, 2000

Net cash used in operating activities was ¥0.3 billion for the year ended March 31, 2001 compared to ¥1.2 billion provided by operating activities in the year ended March 31, 2000. Cash used in operating activities was primarily a result of a sizable net loss, an increase in accounts receivable and a deferred income tax benefit, which were substantially offset by a large amount of depreciation and amortization, a large amount of equity in net loss of affiliated companies and an increase in accounts payable.

Net cash used in investing activities was ¥9.5 billion for the year ended March 31, 2001 and ¥7.1 billion for the year ended March 31, 2000. Cash used in investing activities for the years ended March 31, 2001 and 2000 included investments in and advances to equity method investees, mainly Crosswave, and purchases of property and equipment.

Net cash provided by financing activities was ¥6.4 billion for the year ended March 31, 2001 and ¥22.2 billion for the year ended March 31, 2000. Cash provided by financing activities for the year ended March 31, 2001 consisted primarily of proceeds from the issuance of unsecured convertible notes in an aggregate amount of ¥15.0 billion, offset by a decrease in short-term borrowings.

Liquidity and Capital Requirements

Our principal capital and liquidity needs in recent years have been for investment in equity of affiliates, purchase of property and equipment, working capital expenditures, repayment of borrowings and payment of interest, and capital expenditures.

We have traditionally met our capital and liquidity requirements through cash flows from operating activities, long-term and short-term borrowings, and the proceeds from issuance of securities in connection with our initial public offering. We expect our net cash flow to turn positive in the near future and that cash from operating activities and our other sources of liquidity will be sufficient to meet our currently anticipated ongoing capital and liquidity requirements for our operations.

Investment in Equity Method Investees. See Item 4.B, "— Our Group Companies" for information on investment in equity of equity method investees.

Long-term and Short-term Debt. As of March 31, 2002, our short-term borrowings consisted primarily of unsecured notes payable to banks of ¥50 million and bank overdrafts of ¥3.8 billion. The weighted average interest rate of our short-term borrowings was 1.393%. We decreased our short-term borrowings by ¥1.8 billion in the year ended March 31, 2002 as a result of utilization of cash proceeds from unsecured long-term loans. Our bank overdraft agreements with certain Japanese banks allow for additional borrowings of up to ¥3.9 billion as of March 31, 2002.

As of March 31, 2002, we had ¥4.8 billion of outstanding long-term loans payable to banks which consisted of unsecured, fixed rate loans of ¥2.4 billion with a weighted average interest rate of 1.72 % and unsecured, variable rate loans of ¥2.4 billion with a weighted average interest rate of 0.95 %. These loans have maturity dates ranging from September 2002 to January 2007. On April 11, 2000 we issued ¥15.0 billion of 1.75% unsecured convertible notes due 2005. The notes are subject to conversion at ¥24,000 thousand per share at any time on or after July 3, 2000, and on or before March 15, 2005.

Annual maturities of long-term borrowings and convertible notes outstanding as of March 31, 2002, are as follows:

Year Ending March 31	Thousands of Yen
2003	¥ 1,400,000
2004	1,400,000
2005	16,400,000
2006	—
2007	600,000
Total	¥ 19,800,000

Substantially all of our short- and long-term borrowings contain conditions that would allow the banks to require us to provide collateral or guarantees with respect to the borrowings as is customary in Japan. However, we have never received a request to provide such collateral or guarantees to any bank. Our primary banking relationships are with Sumitomo Mitsui Banking Corporation, Fuji Bank and Sanwa Bank. The banks are also shareholders and customers of ours.

Working Capital. Our principle working capital requirements are for domestic and international backbone costs, local access line costs, personnel expenses and office rents.

Property and Equipment. See Item 4.D, "Information on the Company ─ Property, Plants and Equipment."

Lease Obligations

Operating Leases— We have operating lease agreements with telecommunications carriers and others, including Crosswave, for the use of connectivity lines, including local access lines that customers use to connect to IIJ's network. The leases for domestic backbone are generally either non-cancelable for a minimum one-year lease period or cancelable during a lease period principally of six years, with a significant penalty for cancellation (either 25 percent or 35 percent). The lease for domestic backbone with Crosswave is for a one-year period and non-cancelable. The leases for international backbone available as of March 31, 2002, are entered into with carriers for lease periods ranging from one to five years and 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 2005 and also leases network operation centers under non-cancelable operating leases.

Lease expenses related to backbone lines for the years ended March 31, 2000, 2001 and 2002, amounted to ¥7,192,864 thousand, ¥8,122,256 thousand and ¥5,656,116 thousand, respectively. Lease expenses for local access lines for the years ended March 31, 2000, 2001 and 2002, which are only attributable to dedicated access revenues, amounted to ¥2,089,791 thousand, ¥3,142,392 thousand and ¥3,872,101 thousand, respectively. Other lease expenses for the years ended March 31, 2000, 2001 and 2002, amounted to ¥1,288,271 thousand, ¥1,858,987 thousand and ¥2,764,026 thousand, respectively.

Capital Leases—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 ¥7,458,936 thousand and ¥3,221,325 thousand at March 31, 2001, and ¥8,493,003 thousand and ¥3,772,937 thousand at March 31, 2002, respectively.

Leases and Commitments

As of March 31, 2002, future lease payments under non-cancelable operating leases, including the aforementioned cancelable connectivity lease agreements (but excluding dedicated access lines which we charge outright to customers), and capital leases were as follows:

		Years to Maturity (Millions of yen)			
	Total contractual amount	**Less than 1 year**	**1 to 3 years**	**4 to 5 years**	**More than 5 years**
Connectivity line operating leases (1).......	¥ 1,300	¥ 990	¥ 192	¥ 118	¥ 0
Other operating leases (1)	1,725	1,119	427	37	142
Capital leases..	5,049	2,097	2,640	302	10
Total minimum lease payments	¥ 8,074	¥4,206	¥ 3,259	¥ 457	¥ 152

Notes:
(1) See Note 6 to the consolidated financial statements included in this annual report.

In addition to the above, we have contracted for connectivity lines with Crosswave as of March 31, 2002, that, on aggregate, require monthly payment of ¥266,503 thousand.

Purchase commitments for network system equipment outstanding at March 31, 2002, amounted to ¥150,476 thousand.

Capital Expenditures. For more information, see Item 4.B., "Information on the Company — Business Overview — Capital Expenditure".

Cash Deficiency Support Agreement

On May 21, 2002, in order to assist Crosswave in securing loan financing, we entered into a Cash Deficiency Support Agreement with Crosswave and four Japanese commercial banks. In accordance with the provisions of this CDS Agreement, we deposited ¥5 billion into a restricted account with a participating bank at the end of May 2002. Under the terms of the CDS Agreement, the deposited cash will be restricted over the period in which the Crosswave loans are outstanding and may only be used for debt service in the event Crosswave is otherwise unable to meet scheduled payments. We are not liable under the terms of the CDS Agreement for any amounts in addition to this amount of ¥5 billion. Any restricted cash withdrawn under the agreement will result in a corresponding unsecured funding to Crosswave by us that will be subordinate to the Crosswave loans outstanding under the agreement. The CDS Agreement provides that any such funding between us and Crosswave may be invested, based on the outcome of future negotiations as loans, bonds or equity of 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 of the notes to our 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 ¥7,755 million at March 31, 2002, comprising 17.1% 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 statement 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 years ended March 31, 2000, 2001 and 2002 were ¥2,012 million, ¥2,576 million and ¥2,906 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, 2002, were as follows:

Item	Useful Lives (years)
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 years ended March 31, 2000, 2001, and 2002 were ¥9 million, ¥24 million and ¥23 million, 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.

Impairment of long-lived assets

Long-lived assets consist primarily of property and equipment. 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; and
- other negative industry or economic trends.

When we determine that the carrying amount of a specific asset(s) 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 years ended March 31, 2000, 2001 and 2002.

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, 2001 and 2002, we maintained allowances for doubtful accounts of ¥139 million and ¥148 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.

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

The balance of our investments 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, 2002, we had investments in securities classified as noncurrent assets in the amount of ¥5,406 million. As at March 31, 2002, we also had investments in Crosswave, a publicly traded company, with a carrying value of ¥7,613 million, which we account for under the equity method. 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.

Losses on write-down of investments in marketable and nonmarketable securities for the years ended March 31, 2001 and 2002 amounted to ¥398 million and ¥433 million, respectively, and are included in other income (expense).

New Accounting Standards

On July 20, 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, “Business Combinations”, and SFAS No 142, “Goodwill and Other Intangible Assets”. The statements change the accounting for business combinations and goodwill in two significant ways. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Use of the pooling-of-interests method is prohibited. SFAS No. 142, “Goodwill and Other Intangible Assets”, changes the accounting for goodwill from an amortization method to an impairment – only approach. Thus, amortization of goodwill, including goodwill recorded in past business combinations and acquisitions, will cease upon adoption of that statement, which for the Company will be April 1, 2002. We expect that the adoption of SFAS No. 142 will reduce our annual amortization expenses by approximately ¥348 million ($2,622 thousand). Additionally, we do not expect to have significant goodwill impairment charges associated with the adoption of this statement.

On August 16, 2001, the FASB issued SFAS No. 143, “Accounting for Assets Retirement Obligation”, which is effective for fiscal years beginning after June 15, 2002. The pronouncement addresses the recognition and remeasurement of obligations associated with the retirement of tangible long-lived assets and the associated assets retirement costs. Management does not expect this pronouncement to have a material impact on our consolidated financial position or results of operations.

On October 3, 2001, the FASB issued SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets”, which is effective for fiscal years beginning after December 15, 2001. SFAS No. 144 applies to all long-lived assets (including discontinued operations) and it develops one accounting model for long-lived assets that are to be disposed of by sale. We do not expect this pronouncement to have a material impact on our consolidated financial position or results of operations.

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.

Revenues

We derive our revenues primarily from recurring monthly fees from our Internet access services and our value-added services, as well as one-time project fees and monthly operating fees from systems integration services. Our connectivity and value-added services revenues accounted for 56.9% of our revenues for the year ended March 31, 2002, and over 60% for the years ended March 31, 2001 and 2000, over 80% of our revenues for the year ended March 31, 1999 and over 90% of our revenues for the year ended March 31, 1998.

We are seeking to increase our revenue growth by enhancing our Internet-access services through the introduction of a greater variety of access options and bandwidth options, by expanding our value-added services, systems integration and Internet data center services 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.

Dedicated access services. Dedicated access services are services that connect our customers directly to one of our POPs by a dedicated line. Our six dedicated access services are IP Service (64 kbps-1.2 Gbps), IIJ FiberAccess/F (up to 10 Mbps or up to 100 Mbps), IIJ Ethernet Standard (10 Mbps), IIJ T1 Standard (1.5 Mbps), IIJ Economy (64 kbps or 128 kbps) and IIJ DSL/F (up to 1.5 Mbps). The dedicated access services accounted for 33.9% of our revenues for the year ended March 31, 2002, 40.1% for the year ended March 31, 2001, 39.5% for the year ended March 31, 2000, 52.8% for the year ended March 31, 1999, 54.8% for the year ended March 31, 1998 and 50.3% for the year ended March 31, 1997. Although the significance of these services to the overall mix of total revenues has been declining for the past several years, dedicated access services have been the foundation of our total revenues. Revenues from dedicated access services increased by approximately 6.0% compared to the prior fiscal year, with comparison of 27.8% for the year ended March 31, 2001. Despite the decline of unit price in the overall industry in Japanese telecommunications market, this modest increase was due to successful capturing of demands for higher bandwidth. In fact, contracted bandwidth for dedicated access service increased to 9.4 Gbps for the year ended March 31, 2002 from 3.5 Gbps for the previous fiscal year. In addition, average contracted bandwidth in IP Service jumped to approximately 9.0 Mbps for the year ended March 31, 2002 from 3.2 Mbps for the previous fiscal year. The number of IP Service contracts for the highest range of bandwidth 3 Mbps-1.2 Gbps increased to 156 for the year ended March 31, 2002 from 111 for the year ended March 31, 2001, which were 65.0% and 62.5% of our IP revenues, respectively. As a result of the successful capturing of contracts for high bandwidth, average revenues per contract has steadily increased to approximately ¥1.3 million at the end of March 2002 from ¥1.1 million at the end of March 2001. We expect market demand for high-end services from business customers to grow further and for existing subscribers to migrate to higher bandwidth, both of which are critical factors for the future of our success. If we fail to maintain the quality of our services which our customers value and appreciate, and/or fail to differentiate ourselves from our competitors, our revenues may be adversely affected.

In the year ended March 2002, some of our customers who had previously contracted for IP Service shifted to Internet data center connectivity services. As usage of Internet and network services increase, we expect our Internet data center to act as a hub of our total network solutions and the shift from IP service to Internet data center services will continue.

Lower-bandwidth subscribers opted to shift to services offered by other ISPs and our second-tier connectivity services because these subscribers preferred lower-priced services. To increase the number of subscribers to our other dedicated access services, we continued to provide second-tier, lower-priced new Internet access services in order to remain competitive. As a result, the number of dedicated access service contracts increased to 3,510 for the year ended March 31, 2002 from 2,598 for the year ended March 31, 2001, despite the decrease in the number of IP services. We have had a rapid increase in the number of subscribers to our second-tier service that we refer to as IIJ DSL/F, an access service over ADSL lines at maximum 1.5 Mbps speed. In this second-tier category, IIJ Economy and IIJT1 Standard used to be the growth driver, but due to the advent of inexpensive DSL access lines subscribers have been switching from IIJ Economy to IIJ DSL/F, which is faster and more inexpensive. If we fail to introduce second-tier services accommodating inexpensive access lines such as ADSL, FTTH (Fiber to The Home) and Ethernet-based lines in a timely manner, our customers may switch to our competitors' services and our revenues may be adversely affected as this is one of the fastest growing segments of the Japanese access market.

Dial-up access services. Another source of our revenue is our dial-up access services. Dial-up access is access to one of our POPs by making a local call whether using wire or wireless. Dial-up access services, which include services for corporate customers and individual users, accounted for 9.1% of our revenues for the year ended March 31, 2002, 13.9% for the year ended March 31, 2001, 17.8% for the year ended March 31, 2000, 27.8% for the year ended March 31, 1999, and 36.3% for the year ended March 31, 1998.

In the corporate market, our dial-up access services are important resources in offering total Internet solutions to corporate customers. Our revenues from dial-up access services will be affected primarily by our ability to attract new customers by offering remote access solutions in combination with dial-up access and security services. It will also be affected by the quality of service provided to subscribers.

Our ability to capture market share among individual customers has been somewhat limited due to our relatively low brand-name recognition among consumers not familiar with the Internet and our limited marketing budget to date. A primary focus of our efforts to increase our revenues from individual customers is our range of OEM services. An example is L-mode, in which our OEM services business partners' market and sell Internet access services to individual customers under their own names but provide such services through our Internet network infrastructure. L mode is the service of regional NTTs, which is offered through fixed telephone terminals. We act as Internet service provider for the L mode service offer. Our ability to introduce and expand these services successfully will affect our revenue growth from this source.

Systems integration revenues. Systems integration consists of system and content development, maintenance and operation of networks, and equipment sales related to systems integration. We are currently targeting systems integration to drive growth in revenues and income, and as a result, systems integration services was our largest source of revenues for the year ended March 31, 2002. For the year ended March 31, 2002, we had significant growth in our systems integration revenues, including related equipment sales, which increased by 36.0% for the year ended March 31, 2002 from the year ended March 31, 2001, surpassing our dedicated access services (33.9%).

We have increased systems integration revenues through contracts for iBPS, our e-business solutions packaged service. We introduced iBPS in February 2000 and have expanded our iBPS service line-up with additions such as data storage and CRM (Customer Relations Management). We expect iBPS services to positively influence our systems integration revenues and margins, especially since most of the time and expense required to develop this package has already been incurred. We are expanding our lineup of iBPS services in order to address the needs of the enterprise market, which we expect to continue to grow.

Over the long term, we seek to further improve gross margins through systems integration sales. The gross margin for systems integration services was 14.2% for the year ended March 31, 2002 in comparison with 13.6% for the year ended March 31, 2001. We seek to retain our systems integration customers as our customers for higher-margin consulting, co-location services, operation and maintenance, software development and upgrades included in systems integration. Systems integration sales also provide other benefits to us. Most of our systems integration customers become Internet access service customers as well, and we expect these relationships to continue. In addition, these projects enable us to accumulate experience and build on our reputation in systems integration, which we believe will give us the opportunity to share in the growth of the market for such services. As with other equipment sales, our revenues in any particular fiscal quarter may vary substantially as a result of concentrated sales from large projects.

The primary seasonal variations in systems integration revenues appear to relate to Japanese companies' budgetary cycles and result in greater revenues from systems integration at the end of the first half of the fiscal year and the end of the fiscal year as companies attempt to complete large systems integration projects during those periods. This seasonality may affect our revenues on a quarter-to-quarter basis. Also, lack of large-scale contracts or deferred contracts in the business may adversely affect our revenue growth in systems integration.

Internet Data Center Revenues. Our Internet data center services consist of data center connectivity services, facility services and operation and management services. Internet data center business is the core of our network service infrastructure and enables us to provide comprehensive network solutions to our customers. For the year ended March 31, 2002, we had significant growth in our Internet data center revenues, which increased to ¥2,209 million from ¥1,237 million for the previous fiscal year and ¥347 million for the year ended March 31, 2000, ¥161 million for the year ended March 31, 1999. We have seen an increase in the number of customers to 138 at the end of March 2002, from 113 at the end of March 2001 and 42 at the end of March 2000.

In the fiscal year ended March 2001, we completed the establishment of our multi-site data centers with a total of eight Internet data centers nationwide. In the fiscal year ended March 2002, we opened our ninth Internet data center in Kyoto. In addition, we expect to open two large-scale Internet data centers in early 2003, in Yokohama and Kawaguchi, in cooperation with Crosswave.

The growth in our revenues from Internet data center services will depend on whether and to what extent Japanese corporations outsource server and network management and operations as data traffic grows. Although the Internet data center market is experiencing strong price competition, we expect to capitalize on the market demand by offering not only co-location services, but also comprehensive network solutions services at our data centers in cooperation with our group companies.

IIJ CDN (Content Distribution Network) Business. In February 2002, we announced the launch of a new CDN business. Through the new CDN business, we will be able to provide an integrated broadband content transmission platform for broadband content providers, while at the same time enabling millions of broadband households in Japan to access our network platform free of charge although charges may be incurred for the content programs themselves. To expand the content distribution network, we started to connect various broadband access networks to our backbones and redesign our existing backbone network structure centered around connecting each IIJ Internet data center to all other IIJ Internet data centers, setting in place the infrastructure needed for full-scale broadband content transmission. For broadband content providers, we will offer comprehensive CDN platform services by leveraging our existing business lines, such as network, Internet data centers and systems integration businesses. These services will include access to the CDN backbone network, Internet data center services, and systems management through content management, user account management and billing services. The charging scheme for content providers will depend on each customer's requirements. By expanding our reach to broadband users throughout Japan and by changing the traffic flow within the industry, we expect to capture a significant share of Japan's broadband traffic. Also, we expect our enhanced network platform to serve as a basis for strengthening our total network solutions strategy going forward.

Additional factors affecting revenues. 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 on a commercial basis, including, for example, electronic transactions between businesses and expanding the range of devices that access the Internet. The active commercial application of the Internet will require high-quality and high-capacity connectivity services for both businesses and individuals. It will also require provision of total network solutions including various Internet access services, systems integration and other value-added services which 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 advancement of business usage will also depend upon the rate at which Japanese companies in certain industries begin or significantly increase their Internet usage, particularly the financial, manufacturing and retail segments. We believe Japanese companies in these and other industries have not yet fully embraced the Internet to the extent their counterparts in the United States have.

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 partially to strongly dependent on increasing acceptance of our services by large Japanese companies and by increases in their information technology (IT) budgets.

Although Internet use has continued to grow rapidly in Japan over the past few years, many businesses have limited their expenditures for information technologies, including Internet-related items. If the economic situation continues to decline or does not improve, our revenues may be adversely affected.

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.

Costs and Expenses

We provide our Internet access services on a high-quality network that we have developed and operate. Our backbone is constructed by using leased lines. Our primary cost of connectivity services and value-added services revenues is the leasing fees that we pay for these lines 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, cost of equipment sold, 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 rapid decrease in procurement price for international backbone lines, our costs have decreased as a result. For the year ended March 31, 2002, our leased line and other connectivity costs were equal to ¥10.9 billion or 27.3% of our revenues. For the previous fiscal year, these costs were equal to ¥12.6 billion, or 39.6% of our revenues.

As expected, our international backbone costs have declined in absolute terms to ¥2.5 billion for the fiscal year ended March 2002 from ¥5.5 billion for the fiscal year ended March 2001. This was due to a rapid decrease in procurement price for international backbone lines as significant additional capacity between Japan and the United States has come on to the market because of the completion of a number of undersea cables. These lower prices in the procurement market helped us reduce our international backbone costs. We expect the international backbone costs to be the same level in the next fiscal year even while we upgrade the capacity of our international backbone lines. If trans-Pacific leased line costs rise drastically in contrast with our expectation, our earnings and results of operations will be adversely affected.

Domestic backbone cost increased to ¥3.2 billion for the fiscal year ended March 2002 from ¥2.6 billion for the fiscal year ended March 2001, as we added capacity to handle the rapidly increasing domestic traffic as well as create links to our Internet data centers. Although telecom carriers including Crosswave are expanding available bandwidth in Japan, we continue to strengthen our domestic backbone network in order to accommodate rapid increase of domestic traffic as well as to implement our CDN business. As a result, we expect the domestic backbone costs to continue to rise in absolute terms for fiscal year ended March 2003. If the rate of expansion of our domestic backbone is much greater than we expect and if we do not generate revenues from our connectivity services as traffic increases, our earnings and results of operations will be adversely affected.

Dedicated local access line costs increased to ¥3.9 billion for the year ended March 2002 from ¥3.1 billion for the year ended March 2001. Other connectivity costs remained at the same level ¥1.4 billion for the fiscal years ended March 2002 and 2001. We collect dedicated local access line fees from the subscribers and pay these fees over to the carriers.

With respect to the cost of systems integration revenues, including related equipment sales, as noted above, 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, cost-effective total Internet solutions.

Our iBPS systems integration services started to generate higher margins for the year ended March 2002. Most of the time and expense required for this service has been already incurred.

Sales and Marketing. Our sales and marketing expenses consist primarily of costs related to marketing and general advertising and sales and marketing personnel expenses. Our sales and marketing expenses will increase as we expand our operations significantly and as we increase our sales and marketing activities. This increase will also include increases in sales personnel expenses and commissions payable to sales agents.

General and Administrative. Our general and administrative expenses include primarily expenses associated with our management, accounting, finance and administrative functions, including personnel expenses. We believe that these expenses will increase as we grow our business and as we add staff.

Other Income and Expenses. Our other income and expenses include, among other things, interest income and expenses and other items such as foreign exchange gains or losses and impairment losses on available-for-sale securities. Most of our interest expense is from bank borrowing, capital leases and unsecured convertible notes issued on April 11, 2000. 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. Interest income and interest expenses are also affected by the fluctuation of market interest rates.

Additionally, our results of operations may continue to be affected by currency market volatility, particularly if we have to convert the U.S. dollar funds to yen at unfavorable exchange rates. As noted, we continue to hold a certain amount of the proceeds from our initial public offering in U.S. dollars. These funds are not hedged by currency borrowings or other hedging instruments. To the extent there is additional strengthening of the yen, we will have additional unrealized foreign exchange losses. However, to the extent the dollar appreciates and/or we have uses for the U.S. dollar funds, our results of operations will not be adversely affected.

We also hold a large amount of 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 the market price or fair value per share has an other than temporary decline, lower than the book value per share, we will have impairment losses on other investments.

Crosswave Communications Inc.

Another important factor that will affect our future financial results is the performance of Crosswave. Our results of operations will be affected by the results of operations of Crosswave because we account for Crosswave using the equity method and Crosswave's operations are an integral part of our business and we are dependent on its fiber lines and data centers to a large extent.

Crosswave's primary expenses are related to the development of its domestic network, including primarily the fees that it pays to KDDI for dark fiber and maintenance of the lines as well as the costs of networking equipment. Other significant expenses include sales and marketing expenses.

We estimate that the total cash required to develop Crosswave's network as set forth in Crosswave's network development plan and to operate the infrastructure for the two years ending March 31, 2004 will be approximately ¥23 billion. However, if Crosswave takes initiatives not contemplated by its current business plan, such as expansion of its network to include domestic local access lines, expanding its business to include local access through fixed wireless access or entering into arrangements or long-term contracts to obtain rights to international lines or any other businesses, Crosswave's capital needs would increase.

In November 1998, Crosswave entered into a contract with KDDI, formerly KDD, to purchase an Indefeasible Right of Use (IRU) of a nationwide network of dark fiber in Japan for the period from May 1999 through March 2009. This contract was amended on March 15, 2002 to lower total cash payments to

KDDI from ¥69.8 billion to ¥44.4 billion for the seven years starting from April 2002. Under this contract, as amended, Crosswave is obliged to pay lease payments and maintenance fees to KDDI for the use of dark fiber. The contract is accounted for as an operating lease based on Statement of Financial Accounting Standards No. 13, "Accounting for Leases". The fixed portion of lease expense and maintenance expense is recognized on a straight-line basis over the term of the contract and the differences between such expenses and actual cash payments that fluctuate over the lease term are recorded as accrued expenses in our consolidated balance sheets.

We expect that Crosswave will continue to incur operating losses and net losses for the year ending March 31, 2003 and perhaps beyond and there is no guarantee that it will be able to generate returns thereafter sufficient to reverse its operating and net losses and clear its accumulated deficits. Crosswave has a limited operating history, the business environment surrounding Crosswave is uncertain and the manner in which Crosswave conducts its business may change significantly depending upon a number of considerations (e.g., networking equipment can be leased or purchased, or Crosswave may engage in the domestic local line business, the international leased line business or other businesses that are beyond the scope of its current business plan). Consequently, Crosswave's total annual expenses could be larger than we anticipate, or its revenues could be smaller than we anticipate; however, we are not directly responsible for any of the expenses of Crosswave beyond our equity investment except as provided for in the Cash Deficiency Support Agreement.

Item 6. Directors and Senior Management and Employees.

A. Directors and senior management.

Our directors, executive officers and statutory auditors as of July 19, 2002 were:

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 June 30, 2002
Koichi Suzuki	President, Chief Executive Officer and Representative Director	Sept. 3, 1946	June 2003	December 1992	2,320
Toshiya Asaba	Managing Director and Co-chief Technology Officer	June 12, 1962	June 2003	June 1999	*
Hideshi Hojo	Managing Director	Dec. 22, 1957	June 2003	June 2000	*
Yasuhiro Nishi	Director, Chief Financial Officer and Chief Accounting Officer	May 8, 1959	June 2003	June 1999	*
Kazumasa Utashiro	Director and Co-chief Technology Officer	Sept. 23, 1960	June 2003	June 2001	*
Takamichi Miyoshi	Director	May 5, 1963	June 2004	June 2002	*
Akio Onishi	Director	Dec. 9, 1958	June 2003	June 1998	*
Hideki Matsushita	Standing Statutory Auditor	Sept. 20, 1942	June 2004	June 1998	*
Bumpei Katayama	Statutory Auditor	Feb. 16, 1954	June 2004	June 2002	–
Hiroo Inoue	Statutory Auditor	Aug. 21, 1952	June 2004	June 2001	–

* 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 communication industry. From December 1992 to April 1994, Mr. Suzuki was a Director of IIJ. In addition, Mr. Suzuki is the Representative Director of Crosswave,

Crosswave Facilities, Crosswave Service, IIJ America, IIJ Media Communications, IIJ Technology, Internet Multifeed, Net Care, Asia Internet Holding, Asia Internet Holding, Taiwan and AIH Korea. He also serves as a Director of atom. Prior to joining us, Mr. Suzuki was employed at Japan Management Association where he served as general manager.

Toshiya Asaba has served as a Managing Director of IIJ since June 2002 and as our Co-Chief Technology Officer since May 1999. From 1995 to June 1999, Mr. Asaba was General Manager, Network Engineering Division. Mr. Asaba is also a Director of Asia Internet Holding, Asia Internet Holding, Taiwan, IIJ America and Internet Multifeed. Mr. Asaba joined us in 1992. Mr. Asaba had over 10 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.

Hideshi Hojo has served as a Managing Director of IIJ since June 2002 and as the head of the Sales Division in the Marketing Headquarters since February 1998. Mr. Hojo is also a General Manager of the Sales & Marketing Planning Division of Crosswave, General Manager of the Market Development Department of IIJ Technology, and Director of Net Care, Asia Internet Holding, East Communication Co., Ltd. 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.

Yasuhiro Nishi has served as a Director of IIJ since June 1999 and as our Chief Financial Officer and Chief Accounting Officer since May 1999. In addition, Mr. Nishi serves as President of AIH Taiwan, as Director of Net Care, Digital Weather Platform and as Statutory Auditor of Query Solutions and Cyber Net Communications. From March 1999 to June 1999, Mr. Nishi was the Manager of the Corporate Planning Department and the General Manager of the Strategic Sales Division. Prior to joining us, Mr. Nishi had 17 years of experience in the finance industry working at The Industrial Bank of Japan, Limited where he had been since 1982.

Kazumasa Utashiro has served as a Director of IIJ since June 2001 and as our Co-Chief Technology Officer since May 1999. He has 16 years of Unix software development and Internet-related research experiences. From April 1995 to June 1999, Mr. Utashiro was General Manager, Applied Technology Division. Mr. Utashiro joined us in 1994. Prior to joining us, Mr. Utashiro worked at Software Research Associates.

Takamichi Miyoshi has served as a Director of IIJ since June 2002 and as a General Manager of Network Operations and System Administration Division since July 2001. He also serves as Director of IIJ Technology and Director of atom. Mr. Miyoshi joined us in April 1993. From October 1994 to March 1998, he acted as General Manager of Network Operations and Systems Administration Division, and from April 1998 to June 2001 as General Manager of Technology Planning Division.

Akio Onishi has been a Director of IIJ since June 1998. Mr. Onishi joined us in April 1997 and served as Chief Strategic Officer from May 1999 to June 2000. Mr. Onishi became Chief Executive Officer of Crosswave in May 2000. Mr. Onishi is also a Director of Crosswave, Internet Multifeed, Net Care and DLJ*direct* SFG Securities Inc. Prior to joining us, Mr. Onishi worked at the Organization for Economic Cooperation and Development from February 1995 to April 1997, at McKinsey & Company Japan as a consultant from October 1989 to February 1995, and the Ministry of International Trade and Industry of Japan from April 1982 to July 1989.

Hideki Matsushita has been a Standing Statutory Auditor of IIJ since June 1998. Mr. Matsushita had been seconded from Dai-Ichi Life Insurance, a leading life insurance company in Japan, since April 1997.

Bumpei Katayama has served as a Statutory Auditor of IIJ since June 2002. Mr. Katayama has been General Manager of Information and Telecommunications Division of Sumitomo Corporation since April 2001. He started working at Sumitomo Corporation in April 1976.

Hiroo Inoue has served as a Statutory Auditor of IIJ since June 2001. Mr. Inoue has been general manager of Information Technology Business Department of Itochu Corporation since August 2000. He started working at Itochu Corporation in April 1975.

B. Compensation.

For the year ended March 31, 2002, the aggregate compensation we paid or accrued for all of our executive officers, directors and statutory auditors was approximately ¥178 million. Presently, our executive officers, directors and statutory auditors are not entitled to pension, retirement or similar benefits.

In May 2000, we implemented a stock option plan for our executive officers, directors and employees under which they have been granted options to acquire a total of 295 shares, equivalent to 590,000 ADSs, or approximately 1.2% of our total outstanding shares. Options to acquire an aggregate of 100 shares were granted to the executive officers and directors listed above 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 ¥13,055,664 per share. The options vest over two years and will be exercisable at various times from two years to ten years from the date of grant.

On March 31, 2001, certain directors of IIJ were provided with 375 warrants exercisable for shares of common stock of IIJ Technology. 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.

On August 2, 2001, options to purchase a total of 395 shares, equivalent to 790,000 ADSs, or approximately 1.8% of our total outstanding shares, were granted to 44 directors and employees. The option exercise price for the shares was determined as ¥2,018,306, which represents the price 5% above the 30-days average of the closing market prices beginning 45 days prior to the date of the grant. The options are exercisable at various times from two years to ten years from the date of grant.

C. Board practices.

Our Articles of Incorporation provides that a resolution of the Board of Directors shall be approved by the affirmative vote of the majority of the Directors present at the meeting of the Board of Directors at which a majority of all directors are present.

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

A meeting of the Board of Directors shall be convened and chaired by the President/Director. Should the President/Director be unable to so act, another director shall convene and chair such meeting in his/her place in the order predetermined by a resolution of the Board of Directors.

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 that this period may be shortened in case of emergency.

Pursuant to the home country practices exception granted to us by the Nasdaq National Market, we are permitted to follow corporate governance practices complying with relevant Japanese laws, stock exchange rules and generally accepted business practices, which are different from those followed by U.S. domestic companies under Nasdaq's listing standards. Nasdaq rules and our current practices relating to corporate governance have the following significant differences:

- Audit Committee. Nasdaq requires that a listed company have an audit committee consisting of at least three independent directors, and that the audit committee be charged with the responsibility of selecting, monitoring and communicating with the outside auditor of the company to ensure the outside auditor's independence. Pursuant to the home country practices exception, we do not have an audit committee with functions called for by Nasdaq rules.

- Shareholder Approval Policy. Nasdaq requires that shareholder approval be obtained prior to issuance of stock options or a purchase plan to officers or directors except, among others, when the plan under which the amount of securities issued does not exceed 1% of number of shares of common stock, or the voting power outstanding or 25,000 shares. Pursuant to the home country practices exception, we only follow relevant Japanese laws which, as discussed in "Rights of Shareholders of our Common Stock" in Item 10.A of this annual report, generally require us to obtain shareholder approval if stock options are to be issued with "specially favorable" conditions.

- Nasdaq also requires that, with certain exceptions specified in its rules, in connection with acquisition of stock or assets of another company, shareholder approval be obtained prior to issuance of common stock or securities convertible into or exercisable for common stock (1) if any director, an officer or substantial shareholder has a 5% interest, or all of them collectively have a 10% interest, in the stock or assets and the issuance would increase the outstanding common shares or voting power by more than 5%, and (2) if due to the issuance, the voting power of the common stock equals or exceeds 20% of the voting power outstanding before the issuance or if the number of shares of the common stock equals or exceeds 20% of the number of shares outstanding before the issuance. Pursuant to the home country practices exception, we only follow relevant Japanese laws which, as discussed in "Rights of Shareholders of our Common Stock" in Item 10.A of this annual report, generally require us to obtain shareholder approval with respect to the issuance of common stock or securities convertible into or exercisable for common stock if common stock is to be issued at a "specially favorable" price or convertible bonds or debentures with warrants to subscribe for new shares are to be issued with "specially favorable" conditions or warrants to subscribe for new shares are to be issued with "specially favorable" conditions.

The Listing and Hearing Review Council of the Nasdaq Stock Market recently issued a series of recommendations to the Securities and Exchange Commission to modify several disclosure and corporate governance requirements. Under the current proposals, non-U.S. issuers such as us would continue to be able to follow home country practices with respect to corporate governance requirements. If and when the proposed rules are finally adopted after the Securities and Exchange Commission's approval, there would be additional significant differences other than those discussed above between the Nasdaq rules and our current practices relating to corporate governance.

The rights of ADR holders, including their rights relating to corporate governance practices, are provided in the Deposit Agreement which is incorporated by reference as an exhibit to this annual report.

As is standard practice in Japan, we do not have an audit remuneration committee. Neither we nor any of our subsidiaries has any service contracts with any of our board and neither we nor any of our subsidiaries provides benefits to any of our board upon termination of employment.

D. Employees.

As of March 31, 2002, we had 775 employees, including employees of our consolidated subsidiaries. About 530 of these employees were in our engineering division, 182 in our sales division and 63 in our administrative division. The average number of temporary/part-time staff for the year ended March 31, 2002 was 97. We had 339 employees as of March 31, 2000 and 469 employees as of March 31, 2001. Our employees are not members of any union. Except for ten employees in the United States, employed in our subsidiary IIJ America, all of our employees work in Japan.

E. Share ownership.

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

Stock option plan

In June 2001, we implemented a stock option plan under which options to acquire a total of 395 shares or 790,000 ADS equivalents, or approximately 1.8% of total outstanding shares, were granted to 44 directors and employees on August 2, 2001. The option exercise price for the shares was determined to be ¥2,018,306 (US$15,210) per common share or ¥1,009 (US$7.60) per ADS—greater amount of the price at 5% above the 30-day moving average of closing market prices of our common shares beginning 45 days prior to the date of the grant. The options are exercisable at various times from two years to ten years from the date of grant.

Prior to the above stock option plan, in May 2000, we implemented a stock option plan under which our directors and employees were granted options to acquire a total of 295 shares or 590,000 ADS equivalents, or approximately 1.2% of total outstanding shares. The options were granted to 34 directors and employees on May 31, 2000. The option exercise price for the shares was determined to be ¥13,055,664 per common share, which represents the price 5% above the 30-day moving average of closing market prices beginning 45 days prior to the date of the grant. The options are exercisable at various times from two years to ten years from the date of grant.

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 June 30, 2002 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.

Name of Beneficial Owner	Shares of Common Stock Beneficially Owned (1)	
	Number	Percentage
Koichi Suzuki	2,320	10.32

Name of Beneficial Owner	Shares of Common Stock Beneficially Owned (1)	
Itochu Corp. and affiliates	1,611	7.17
Sumitomo Corp.	1,582	7.04
Joho Capital LLC (2)	2,710,656	6.03
NTT Communications	1,252	5.57
Directors and executive officers as a group (3)	2,539	11.29

(1) We are aware of a Schedule 13-D filed with the SEC on March 21, 2001 and amended on April 18, 2001, relating to the entering into a share-holders agreement by a group of shareholders including Sumitomo Corporation, NTT Communications Corporation, Koichi Suzuki, our President, Chief Executive and Representative Director, Dai-ichi Mutual Life Insurance Company, Hiroyuki Fukase, ITOCHU Corporation, Software Research Associates Inc., Applied Research Institute, Inc., Sumitomo Mitsui Banking Corporation, The Fuji Bank, Limited, The Sanwa Bank, Limited, Toyota Motor Corporation, Sony Corporation, Hiroyuki Fukase, KDDI, I.T.G. Co., The Japan Research Institute, Limited, Digital Technologies Corporation, Toyotsu Telecom Corporation and 13 other shareholders with respective shareholdings less than 1%. Because the shareholders' agreement restricts transfer of their respective shareholdings without the consent of the other shareholders party to the agreement, the shareholders as a group may be deemed to beneficially own 13,222 shares of common stock that are subject to the shareholders' agreement, representing 58.82% of our common stock at the time. However, the shareholders beneficial ownership of each other's holdings and beneficial ownership information in this table does not reflect any deemed beneficial ownership arising from the shareholders' agreement.

(2) Joho Capital holds American Depositary Receipts, or ADRs. Each share of IIJ is equal to 2,000 ADRs.

(3) 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 ADSs are traded only on the Nasdaq National Market. Our common stock is not otherwise registered for trading on any exchange. Of the 22,480 shares of common stock outstanding as of March 31, 2002, 6,041 shares were held in the form of 12,082,000 ADSs.

According to The Bank of New York, depositary for our ADSs, as of March 31, 2002, there were 4 ADR holders of record in the United States. According to our register of shareholders, as of March 31, 2002, there were 98 holders of common stock of record worldwide. As of March 31, 2002, the Bank of New York was the sole recordholder of our common stock in the United States and its shareholdings represented approximately 26.9% of the outstanding common stock on that date. 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.

Our major shareholders have the same voting rights as other holders of our common stock. 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 IIJ.

We have an employee stock holding association which holds 233 shares of common stock, or 1.04% of our outstanding shares, as of March 31, 2002. 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.

B. Related party transactions.

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 year ended March 31, 2002 are presented as follows:

	Millions of Yen
Accounts receivable	¥ 505
Accounts payable	610
Guarantees	3
Revenues	3,885
Costs and expenses	5,563

Among the transactions summarized above, our transactions with Crosswave are as follows:

Since April 1, 2001 through March 31, 2002, IIJ has paid approximately ¥3,448.8 million for services from Crosswave. IIJ Technology has paid ¥168.2 million for services that IIJ Technology purchased from Crosswave. IIJ received payments of approximately ¥593.8 million from Crosswave for network equipment that IIJ sold to Crosswave. IIJ Technology received ¥814.7 million for network systems that IIJ Technology sold to Crosswave. IIJ also received approximately ¥87.4 million in various access services that IIJ provided Crosswave.

In the year ended March 31, 2001, IIJ seconded a number of employees to Crosswave. For these employees, IIJ received approximately ¥196.4 million from Crosswave. Additionally, Net Care received approximately ¥327.1 million for services that were outsourced by Crosswave.

There are no loans, or guarantees of any kind, outstanding to or for the benefit of any directors, officers, statutory auditors, their respective family members or enterprises over which they exercise significant influence.

As of March 31, 2002, IIJ had a loan to IIJ America Inc., which amounted to $866,600.94 at 2.53% interest and payable on September 30, 2002. In addition, IIJ had loans to some equity method investees which amounted to ¥246.1 million.

In May 2002, to assist Crosswave in securing loan financing, IIJ entered into a ¥5.0 billion Cash Deficiency Support Agreement with Crosswave and four Japanese commercial banks. For further information on this agreement, see Item 5.B, "Cash Deficiency Support Agreement".

C. Interests of Experts and Counsel.

Not applicable.

Item 8. Financial Information.

The information required by this item has been attached hereto beginning on page F-1.

Item 9. The Offer and Listing.

American Depositary Shares representing our common stock have been quoted on the Nasdaq National Market since August 9, 1999 under the symbol "IIJI". The following table shows, for the periods indicated, the high and low closing per-ADS sale price of the ADSs.

The price history of our ADSs is reflected in the table below:

	NASDAQ ($)	
	High	**Low**
Year ended March 31, 2000*	132.81	23.69
Quarter ended June 30,2000	73.00	28.50
Quarter ended September 30, 2000	62.50	31.50
Quarter ended December 31, 2000	43.44	8.25
Quarter ended March 2001	14.94	6.75
Year ended March 31, 2001	73.00	6.75
Quarter ended June 2001	11.88	6.50
Quarter ended September 2001	8.40	4.25
Quarter ended December 2001	7.45	4.25
January 2002	6.80	5.94
February 2002	6.75	5.05
March 2002	6.50	5.20
Quarter ended March 2002	6.80	5.05
Year ended March 2002	11.88	4.25
April 2002	7.34	5.28
May 2002	6.00	5.45
June 2002	5.45	3.10
Quarter ended June 2002	7.34	3.10
July 2002 (through July 26)	6.50	2.01

* Since the Company's initial public offering in August, 1999.

Item 10. Additional Information.

A. Share Capital

Not applicable.

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,
- Telecommunications construction business,
- Manufacture, construction, development, sale, purchase, lease, export and import of telecommunications' machinery and equipment, telecommunications facilities, software and telecommunications systems,
- Administration, maintenance and operation of telecommunications' machinery and equipment, telecommunications facilities, software and telecommunications systems,
- Consulting service related to the foregoing,
- Research, study, education and training related to the foregoing,
- The sale and purchase of telephone subscriber's rights, and
- Any and all businesses incidental or related to the foregoing.

Provisions regarding Directors

There is no provision in the Articles as to a Director's power to vote on a proposal, arrangement or contract in which the Director is materially interested, but the Commercial Code of Japan provides that such Director is required to refrain from voting on such matters at the Board of Director's meetings.

The Code provides that compensation for Directors is determined at a general meeting of shareholders of a company. Within the upper limit approved by the shareholder's 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 Code 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 Code or the Articles.

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 Code or the Articles.

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 Code and the Articles of Incorporation include:

- the right to receive dividends when the payment of dividends has been approved at a shareholder's 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 shareholder's 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 (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 shareholder's meeting at which shareholders having a majority of the 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 Japanese Commercial Code and our Articles of Incorporation, a shareholders' meeting may adopt a resolution by a majority of the voting rights represented at the meeting. The Japanese Commercial Code 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. 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 those proxies are also shareholders who have voting rights. 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.

Following the April 1, 2002 amendments, which replaced the concepts of convertible bonds and bonds with warrants with a new concept of "bonds with stock acquisition rights", the Japanese Commercial Code 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 such as:

- a reduction of the stated capital,
- amendment of the Articles of Incorporation (except amendments that the board of directors are authorized to make under the Commercial Code),
- the removal of a director or statutory auditor,
- 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 Code provides additional specific rights for shareholders owning a substantial number of voting rights.

Shareholders holding one sixth or more of the total number of the voting rights of all shareholders have the right to oppose:

- short-form share transfer (Kan-i Kabushiki Kokan)
- short-form company split into an existing company (Kan-i Kyushu Bunkatsu) (only in respect of the shareholders of the exiting company that takes over the target business of the split company)
- short-form merger (Kan-i Gappei).

Shareholders holding 10% or more of the total number of voting rights of all shareholders 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 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,
- apply to a competent court for reorganization of the company, 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 have the right to:

- examine our accounting books and documents and make copies of them,

- apply to a competent court for permission to examine accounting books and documents of a subsidiary 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:

- demand that certain matters be made agenda items at a general meeting of shareholders, and

- 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 300 voting rights for six months or more have the right to demand that certain matters be made objects 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 Code or the Articles which forces shareholders to make additional contributions when requested by us.

Under the Code, in order to change the rights of stockholders which are stipulated and defined in the Articles of Incorporation, we must amend the Articles. Amendment must be approved by a special resolution of shareholders where two-thirds of shareholders vote at a shareholder's meeting at which shareholders having a majority of the voting rights of the stock 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 the 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 Board of Directors to convene a shareholder's meeting under the Code. Under the Articles, 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 shareholder's meeting.

Rights of Holders of Fractional Shares of our Common Stock

The amendment to the Commercial Code of Japan regarding fractional shares was enforced on October 1, 2001. Under the amended Commercial Code of Japan (the "New Code"), holders of fractional shares representing 1/100th of a share (this ratio can be varied or fractional share system can be abandoned by being provided in articles of incorporation) or integral multiples of 1/100th of a share have the following rights:

- to inspect and copy the register of fractional shares,
- to receive additional shares or money in the event of cancellation, consolidation or split of shares, stock transfer, exchange of shares, company split or merger, and to receive residual properties,
- to request a company to convert the shares if they are the fractional shares of convertible shares, unless otherwise provided for in articles of incorporation. Our Articles of Incorporation do not contain a provision against such conversion, and
- to receive dividend, interim dividend or preemptive rights, unless otherwise provided for in articles of incorporation. Our Articles of Incorporation do not contain a provision against such receipt.

Under the New Code, a certificate of fractional shares cannot be issued by a company, and the only way for holders of fractional shares to recover their investment is to request the company to purchase their fractional shares.

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 the 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 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 or other subordinated rules regarding the ownership threshold, above which shareholder ownership must be disclosed. Although 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, this is inapplicable to us as we are not a public company in Japan.

There is no provision in our Articles 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.

Other than contracts entered into in the ordinary course of business, we have entered into the following contracts which may be deemed material since July 1, 2000:

On May 21, 2002, in order to assist Crosswave in securing loan financing, we entered into a Cash Deficiency Support Agreement with Crosswave and four Japanese commercial banks. In accordance with the provisions of the CDS Agreement, we deposited ¥5 billion into a restricted account with a participating bank at the end of May 2002. Under the terms of the CDS Agreement, the deposited cash will be restricted over the period in which the Crosswave loans are outstanding and may only be used for debt service in the event Crosswave is otherwise unable to meet scheduled payments. We are not liable under the terms of the CDS Agreement for any amounts in addition to this amount of ¥5 billion. Any restricted cash withdrawn under the agreement will result in a corresponding unsecured funding to Crosswave by us that will be subordinate to the Crosswave loans outstanding under the agreement. The CDS Agreement provides that any such funding between us and Crosswave may be invested, based on the outcome of future negotiations as loans, bonds or equity of Crosswave.

On May 21, 2002, we entered into a Stock Acquisition Rights Placement Agreement. Under this agreement between Crosswave and the bank consortium consisting of four Japanese commercial banks, Crosswave granted stock acquisition rights to us and the bank consortium. These stock acquisition rights are exercisable from June 6, 2002 to May 31, 2009 at an exercise price of ¥38,595 per share, equivalent to $1.50 per ADS, which represents a 50% premium over the closing market price of Crosswave's ADSs as of May 9, 2002, for an aggregate of 30,000 common shares of Crosswave's common stock, equivalent to 6,000,000 ADSs.

D. Exchange controls.

There are no laws, decrees, regulations or other legislation in Japan which affect 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 United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (the "Treaty"), establishes 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. Under the Treaty, the maximum withholding rate for most shareholders is limited to 15% of the gross amount actually distributed. However, the maximum rate is 10% of the gross amount actually distributed, if the recipient is a corporation and

- during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year, if any, at least 10% of the voting shares of the paying corporation were owned by the recipient corporation, and

- not more than 25% of the gross income of the paying corporation for such prior taxable year, if any, consists of interest or dividends as defined in the Treaty.

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 to 15% 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, the United Kingdom and the United States of America. The withholding tax rate is further reduced if investors and IIJ 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 you if you are a U.S. holder, as defined below, and you hold your 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,
- certain insurance companies,
- broker-dealers,
- 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 of 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 depositary 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 ADSs, and ADSs 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 below "PFIC Rules."

Taxation of dividends

Under the United States federal income tax laws, you must include in your gross income the gross amount of any dividend paid by us out of our current or accumulated earnings and profits, as determined for United States federal income tax purposes. 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 ordinary income that you must include in income when you, in the case of shares, or the depositary, in the case of ADSs, receive the dividend, actually or constructively. The dividend will not be eligible for the dividends-received deduction.

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. The gain or loss generally will be 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. 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 generally will be "passive income" or, if received by financial institutions, "financial services income." Passive income or financial services income must be 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 is generally taxed at a maximum rate of 20% for property held more 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 are 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, and you will recognize the additional gain, if any, on sale or other disposition of your shares or ADSs as ordinary income for that taxable year. 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.

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 applicable.

G. Statement by experts.

Not applicable.

H. Documents on display.

We are subject to the information requirements of the Securities Exchange Act of 1934 and, in accordance therewith, we will file annual reports on Form 20-F within six months of its fiscal year end and other reports and information on Form 6-K with the Securities and Exchange Commission. These reports and other information can be inspected at the public reference room at the Securities and Exchange Commission at 450 Fifth Street, N.W., Washington, D.C. 20549. You can also obtain copies of such material by mail from the public reference room of the Securities and Exchange Commission at prescribed fees. You may obtain information on the operation of the Securities and Exchange public reference room by calling the Securities and Exchange Commission in the United States at 1-800-SEC-0330. The Securities and Exchange Commission also maintains a web site at www.sec.gov that contains reports, proxy statements and other information regarding registrants that file electronically with the Securities and Exchange Commission. We currently do not file reports and information electronically with the Securities and Exchange Commission.

In addition, documents referred to in this 20-F filing may be inspected at Internet Initiative Japan's Tokyo headquarters, located at Takebashi Yasuda Bldg., 3-13, Kanda Nishiki-cho, Chiyoda-ku, Tokyo 101-0054, Japan.

I. Subsidiary information.

Not applicable.

Item 11. Quantitative and Qualitative Disclosures about Market Risk.

We are exposed to market risk primarily from changes in foreign currency exchange rates, interest rates and equity prices. Our earnings and cash flows may be negatively impacted by fluctuating interest and foreign exchange rates as well as equity prices associated with assets, liabilities or anticipated transactions which may affect our operating results and financial condition. We seek to minimize market risk through our regular operating and financing activities and, following the evaluation of the exposures, selectively enter into derivative hedging instruments. Interest rate swap agreements are used by us primarily to reduce exposure to changes in interest rates that are associated with long-term bank borrowings. We do not hold derivative instruments for speculative purposes. Also, we do not hold or issue financial instruments for trading purposes.

Foreign currency exchange rate risk

Transaction risk

Our periodic payment obligations under certain trans-Pacific dedicated line leases are denominated in U.S. dollars. We do not have any material periodic U.S. dollar revenue to match the dollar payments, and thus we are exposed to fluctuations in the yen-dollar exchange rate.

Translation risk

Our reporting currency is the Japanese yen. We have assets and liabilities outside Japan, primarily in the United States, that are subject to fluctuations in foreign currency exchange rates. We prepare financial statements of our foreign operations in their functional currencies prior to consolidation in our financial statements. As a result, changes in the value of yen relative to the functional currencies of the underlying operations create translation gains and losses, which are recorded outside of our statement of operations in other comprehensive income until we dispose of or liquidate (which has not occurred in the past, nor do we expect it to occur in the future) the relevant foreign operation.

Foreign Currency-Denominated Assets

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 $44,169 thousand (¥5,393 million) and $26,082 thousand (¥3,474 million) at March 31, 2001 and 2002, respectively. The potential loss in fair value for such financial instruments from a 10% adverse change in quoted foreign currency exchange rates would be approximately ¥539 million and ¥347 million at March 31, 2001 and 2002, respectively.

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, 2002	**Millions of Yen**						
	Expected Maturity Date						
	2003	**2004**	**2005**	**2006**	**2007**	**Total**	**Fair Value**
Long-term Debt Obligations:							
Fixed rate long-term borrowings and convertible notes	1,400	400	15,000	–	600	17,400	14,704
Average interest rate	1.864%	1.250%	1.750%	–	1.710%	1.746%	
Variable rate long-term borrowings	–	1,000	1,400	–	–	2,400	2,400
Average interest rate	–	0.869%	1.009%	–	–	0.951%	
Interest Rate Swap							

Contracts—							
Notional amount-							
Variable to Fixed:	–	1,000	1,000	–	–	2,000	(34)
Average pay rate	–	1.960%	1.500%	–	–	1.730%	
Average receive rate	–	0.869%	0.819%	–	–	0.844%	

March 31, 2001

	Millions of Yen						
	Expected Maturity Date						
	2002	2003	2004	2005	2006	Total	Fair Value
Long-term Debt Obligations:							
Fixed rate long-term borrowings and convertible notes	–	1,400	–	15,000	–	16,400	13,150
Average interest rate	–	1.864%	–	1.750%	–	1.759%	
Variable rate long-term borrowings	–	–	1,400	–	–	1,400	1,420
Average interest rate	–	–	0.978%	–	–	0.978%	
Interest Rate Swap Contracts—							
Notional amount-							
Variable to Fixed:	–	–	1.000	–	–	1,000	(26)
Average pay rate	–	–	1.960%	–	–	1.960%	
Average receive rate	–	–	0.869%	–	–	0.869%	

Investment 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. These investments are subject to changes in the market prices of the securities. As of March 31, 2001 and 2002, the fair value of such investments was ¥6,701 million and ¥3,385 million, respectively. The potential loss in fair value resulting from a 10% adverse change in equity prices would be approximately ¥670 million and ¥339 million as of March 31, 2001 and 2002, respectively.

Credit Risk

As of March 31, 2002, we did not have any significant concentration of business transacted with an individual counterparty or group of counterparties that could, if suddenly eliminated, severely impact our operations.

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

Use of proceeds

On August 9, 1999, we completed an initial public offering of ADSs representing our shares. The offering was lead managed by Goldman Sachs & Co. and Morgan Stanley & Co. Incorporated. The ADSs are quoted on the Nasdaq National Market. Registration Statement (No. 333-10584) for the offering was declared effective August 3, 1999.

	Amount of Shares Registered and Sold	Aggregate Offering price of Shares Registered and Sold
Internet Initiative Japan Inc.	3,600	$ 165,600,000
ASCII Corporation	300	13,800,000
JAFCO	80	3,680,000
Nikko Capital	40	1,840,000
ORIX Capital	30	1,380,000
Sanwa Capital	20	920,000
Total	4,070	$ 187,220,000

* Based on initial public offering price before underwriting discount and offering expenses.

In connection with the issuance and distribution of ADSs, we incurred approximately $14,886,300 in expenses. Of these expenses, $11,160,000 was for underwriting discounts and commissions, approximately $816,800 was to reimburse the underwriters for certain of their expenses, and approximately $2,909,500 was for other expenses related to the registration and offering of the ADSs. No finders' fees were paid.

We received approximately ¥17.5 billion in net proceeds from the sale of ADSs in the initial public offering. Of the net proceeds, we have used approximately ¥8 billion for our investment in Crosswave, ¥0.7 billion for our investment in IIJ Technology, ¥0.5 billion for repayment of long-term borrowing and ¥3.5 billion for lease of plant and equipment. In August 2001, we invested ¥0.3 billion for our investment in Asia Internet Holding.

Item 15. [Reserved]

Item 16. [Reserved]

PART III

Item 17. Financial Statements.

Not applicable.

Item 18. Financial Statements.

See Financial Statements for Internet Initiative Japan Inc. and Subsidiaries attached hereto beginning on page F-1. The separate Financial Statements for Crosswave Communications Inc. to the Form 20-F Annual Report for the year ended March 31, 2002 are also attached to this annual report on Form 20-F immediately following the Financial Statements for Internet Initiative Japan Inc. and Subsidiaries.

Item 19. Exhibits.

1.1 Articles of Incorporation, as amended (with English translation)

1.2 Share Handling Regulations (with English translation)*

1.3 Regulations of the Board of Directors (with English translation)*

1.4 Regulations of the Board of Statutory Auditors, as amended (with English translation)

2.1 Specimen Common Stock Certificate*

2.2 Bylaws of the IIJ Employee Shareholders' Association (with English translation)*

4.1 Right of Use Agreement for Transmission Network Facilities, dated November 30, 1998, between Crosswave Communications Inc. and Teleway Corporation (presently, KDD Corporation) (with English translation)**

4.2 Memorandum on Amendments to the Original Agreement, dated November 30, 1998, between Crosswave Communications Inc. and Teleway Corporation (presently, KDD Corporation) (with English translation)**

4.3 Confirmation of IRU Fees, dated November 30, 1998, between Crosswave Communications Inc. and Teleway Corporation (presently, KDD Corporation) (with English translation)**

4.4 Memorandum on Business Cooperation, dated November 30, 1998, between Crosswave Communications Inc. and Teleway Corporation (presently, KDD Corporation) (with English translation)*

4.5 Basic Agreement to Delegate Services, dated April 1, 1997, between Internet Initiative Japan Inc. and IIJ Technology Inc. (with English translation)*

4.6 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)*

4.7 Basic Agreement to Delegate Services, dated January 30, 1995, between Internet Initiative Japan Inc. and IIJ Media Communications Inc. (with English translation)*

Initiative Japan Inc. and IIJ Media Communications Inc. (with English translation)*

4.8 Memorandum of Understanding Regarding Technical Cooperation, dated April 1, 1997, between Internet Initiative Japan Inc. and IIJ Media Communications Inc. (with English translation)*

4.9 Basic Agreement to Delegate Services, dated April 1, 1998, between Internet Initiative Japan Inc. and Net Care, Inc. (with English translation)*

4.10 Software License Agreement between Trusted Information Systems, Inc. ("TIS") and IIJ, dated November 9, 1994, including two amendment agreements thereto, dated March 30, 1998 and February 17, 1999 (TIS merged into Networks Associates, Inc. ("NAI") on April 30, 1998, and NAI acceded to the Agreement.)*

4.11 Purchase and Sales Agreement, dated January 8, 1999, between Internet Initiative Japan Inc. and Crosswave Communications Inc. (with English translation)*

4.12 Individual Agreement on Entrustment of Business between Internet Initiative Japan Inc. and Asia Internet Holding Co., Ltd., dated July 1, 1998 (with English translation)*

4.13 Enforcement Rules with regard to the Payment of Fee for Right of Use of Transmission Network Facilities, dated September 30, 1999, between Crosswave Communications Inc. and KDD Corporation establishes rules with regard to the payment of a fee by Crosswave Communications Inc. to KDD Corporation (with English translation)***

4.14 Sales Cooperation Agreement, dated August 20, 1999, between Crosswave Communications Inc. and Internet Initiative Japan Inc. (with English translation)***

4.15 Business Entrustment Agreement, dated April 1, 1999 between Crosswave Communications Inc. and Internet Initiative Japan Inc. (with English translation)***

4.16 Letter of Confirmation, dated November 16, 1999 between Crosswave Communications Inc. and Internet Initiative Japan Inc. (with English translation)***

4.17 Agreement On Trial Service Of the International Dedicated Line dated June 1, 2000 between Crosswave Communications Inc. and Internet Initiative Japan Inc. (with English translation)***

4.18 Data Center Service Agency Agreement dated March 1, 2000 between Crosswave Communications Inc. and Internet Initiative Japan Inc. (with English translation)***

4.19 Shareholders' Agreement, dated May 11, 2000, between Internet Initiative Japan Inc., Toyota Motor Corporation and Sony Corporation ****

4.20 Cash Deficiency Support Agreement, dated May 21, 2002, among Internet Initiative Japan Inc., Crosswave Communications Inc., The Sumitomo Trust & Banking Co., Ltd., UFJ Bank Limited, Mizuho Corporate Bank, Ltd. and Sumitomo Mitsui Banking Corporation (with English translation)

4.21 Stock Acquisition Rights Placement Agreement, dated May 21, 2002, among Internet Initiative Japan Inc., Sumitomo Mitsui Banking Corporation, and UFJ Bank Limited and

The Sumitomo Trust & Banking Corporation. (with English translation)

8.1 List of Significant Subsidiaries (See "Our Group Companies" in Item 4.B. of this Form 20-F)

99.1 Letter to the Securities and Exchange Commission regarding representations made by Asahi & Co., a member firm of Anderson Worldwide SC, dated July 30, 2002, to Internet Initiative Japan Inc. regarding Crosswave Communications Inc.

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* 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 corresponding exhibit to the Form F-1 of Crosswave Communications Inc. (File No. 333-12264) declared effective on August 3, 1999. Portions of the corresponding exhibit to our Form F-1 Registration Statement (File No. 333-10584) were previously omitted pursuant to a confidential treatment request.

*** Incorporated by reference to the corresponding exhibit to the Form F-1 of Crosswave Communications, Inc. (File No. 333-12264) declared effective on August 3, 2000.

**** Incorporated by reference to the corresponding exhibit to our annual report on Form F-20/A (File No. 0-30204) filed on October 23, 2000.

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: ________________________________

Name: Koichi Suzuki

Title: President, Chief Executive Officer and Representative Director

Date: July 30, 2002

Internet Initiative Japan Inc. and Subsidiaries

Index to Consolidated Financial Statements

INDEPENDENT AUDITORS' REPORT

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. ("IIJ") and subsidiaries (the "Company") as of March 31, 2001 and 2002, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended March 31, 2002 (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 did not audit the financial statements of Crosswave Communications Inc. ("Crosswave"), a 37.85 percent owned equity method investee, IIJ's investment in which is accounted for by use of the equity method. The Company's equity investment of ¥11,368,160 thousand and ¥6,298,451 thousand in Crosswave's net assets at March 31, 2001 and 2002, respectively, and equity in net losses of ¥3,139,814 thousand, ¥4,136,869 thousand, and ¥5,421,255 thousand for each of the three years in the period ended March 31, 2002, are included in the accompanying consolidated financial statements. The financial statements of Crosswave were audited by other auditors whose report dated June 5, 2002 has been furnished to us, and our opinion, insofar as it relates to the amounts included for Crosswave, is based solely on the report of such other auditors.

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

In our opinion, based on our audits and the report of the other auditors, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of March 31, 2001 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2002, 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.

Deloitte Touche Tohmatsu

Tokyo, Japan
July 23, 2002

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Balance Sheets
March 31, 2001 and 2002

ASSETS	Thousands of Yen 2001	Thousands of Yen 2002	Thousands of U.S. Dollars (Note 1) 2002
CURRENT ASSETS:			
Cash (Note 13)	¥ 13,570,707	¥ 11,045,919	$ 83,240
Accounts receivable, net of allowance for doubtful accounts of ¥123,745 thousand and ¥45,123 thousand ($340 thousand) at March 31, 2001 and 2002, respectively (Notes 3 and 4)	5,417,456	8,981,912	67,686
Inventories	245,520	620,409	4,675
Prepaid expenses	253,648	416,945	3,142
Other current assets (Note 8)	347,600	143,798	1,084
Total current assets	19,834,931	21,208,983	159,827
INVESTMENTS IN AND ADVANCES TO EQUITY METHOD INVESTEES (Note 4)	13,895,654	8,854,028	66,722
OTHER INVESTMENTS (Notes 2 and 13)	8,455,840	5,406,065	40,739
PROPERTY AND EQUIPMENT, net (Notes 5 and 6)	6,927,575	7,755,426	58,443
GUARANTEE DEPOSITS	837,115	1,266,055	9,541
OTHER ASSETS, net of allowance for doubtful accounts of ¥15,476 thousand and ¥102,751 thousand ($774 thousand) at March 31, 2001 and 2002, respectively (Notes 3, 8 and 13)	689,687	772,226	5,819
TOTAL	¥ 50,640,802	¥ 45,262,783	$ 341,091

(Continued)

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Balance Sheets
March 31, 2001 and 2002

LIABILITIES AND SHAREHOLDERS' EQUITY	Thousands of Yen 2001	Thousands of Yen 2002	Thousands of U.S. Dollars (Note 1) 2002
CURRENT LIABILITIES:			
Short-term borrowings (Note 7)	¥ 5,620,000	¥ 3,820,232	$ 28,789
Accounts payable (Note 4)	4,313,811	7,085,579	53,395
Accrued expenses	211,302	247,606	1,866
Other current liabilities	455,212	506,797	3,819
Long-term borrowings—current portion (Notes 7 and 13)	-	1,400,000	10,550
Capital lease obligations—current portion (Note 6)	1,644,354	1,973,769	14,874
Total current liabilities	12,244,679	15,033,983	113,293
LONG-TERM BORROWINGS (Notes 7 and 13)	2,800,000	3,400,000	25,622
CONVERTIBLE NOTES (Notes 7 and 13)	15,000,000	15,000,000	113,037
CAPITAL LEASE OBLIGATIONS—Noncurrent (Note 6)	2,679,224	2,861,556	21,564
ACCRUED RETIREMENT AND PENSION COSTS (Note 9)	124,640	100,841	760
OTHER NONCURRENT LIABILITIES (Note 8)	188,413	108,376	816
Total liabilities	33,036,956	36,504,756	275,092
MINORITY INTEREST	676,096	1,032,746	7,783
COMMITMENTS AND CONTINGENCIES (Notes 4 and 12)			
SHAREHOLDERS' EQUITY (Notes 10 and 11):			
Common stock —authorized, 75,520 shares; issued and outstanding, 22,480 shares	7,082,336	7,082,336	53,371
Additional paid-in capital	17,068,353	17,068,353	128,623
Accumulated deficit	(10,762,334)	(18,208,469)	(137,215)
Accumulated other comprehensive income	3,539,395	1,783,061	13,437
Total shareholders' equity	16,927,750	7,725,281	58,216
TOTAL	¥ 50,640,802	¥ 45,262,783	$ 341,091

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, 2002

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2000	2001	2002	2002
REVENUES (Note 4):				
Connectivity and value-added services:				
Dedicated access	¥ 9,998,533	¥ 12,779,284	¥ 13,541,980	$ 102,049
Dial-up access	4,496,159	4,422,884	3,644,091	27,461
Value-added:				
Internet data center	346,805	1,236,524	2,209,412	16,650
Other	537,660	898,996	1,651,741	12,447
Other	407,912	591,819	1,667,986	12,570
Total	15,787,069	19,929,507	22,715,210	171,177
Systems integration	7,640,360	10,555,675	14,355,325	108,179
Equipment sales	1,874,503	1,390,407	2,834,078	21,357
Total revenues	25,301,932	31,875,589	39,904,613	300,713
COST AND EXPENSES:				
Cost of connectivity and value-added services (Notes 4 and 6)	15,090,991	18,983,305	19,799,402	149,204
Cost of systems integration	6,272,322	9,117,410	12,314,158	92,797
Cost of equipment sales	1,806,974	1,288,530	2,540,089	19,142
Total cost	23,170,287	29,389,245	34,653,649	261,143
Sales and marketing (Note 14)	2,603,462	3,251,900	3,038,412	22,897
General and administrative	1,234,189	1,617,984	1,839,525	13,862
Research and development	363,546	286,850	319,370	2,407
Total cost and expenses	27,371,484	34,545,979	39,850,956	300,309
OPERATING INCOME (LOSS)	(2,069,552)	(2,670,390)	53,657	404
OTHER INCOME (EXPENSES):				
Interest income	362,485	454,527	121,867	918
Interest expense	(277,274)	(643,266)	(659,101)	(4,967)
Foreign exchange gains (losses)	(1,127,921)	1,132,083	254,882	1,921
Other—net (Note 2)	297,591	(44,024)	(660,790)	(4,979)
Other income (expenses)—net	(745,119)	899,320	(943,142)	(7,107)
LOSS FROM OPERATIONS BEFORE INCOME TAX EXPENSE (BENEFIT)	(2,814,671)	(1,771,070)	(889,485)	(6,703)
INCOME TAX EXPENSE (BENEFIT) (Note 8)	(1,280,123)	(925,678)	1,099,035	8,282
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES	(70,484)	159,850	24,467	184
EQUITY IN NET LOSS OF EQUITY METHOD INVESTEES (Note 4)	(3,179,469)	(4,014,680)	(5,482,082)	(41,312)
NET LOSS	¥ (4,784,501)	¥ (4,700,222)	¥ (7,446,135)	$ (56,113)

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Statements of Operations
Three Years in the Period Ended March 31, 2002

	Yen			U.S. Dollars
	2000	2001	2002	2002
WEIGHTED-AVERAGE NUMBER OF COMMON SHARES OUTSTANDING	21,190	22,480	22,480	
BASIC AND DILUTED NET LOSS PER COMMON SHARE	¥ (225,791)	¥ (209,085)	¥ (331,234)	$ (2,496)

See notes to consolidated financial statements.

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Statements of Shareholders' Equity
Three Years in the Period Ended March 31, 2002

		Thousands of Yen				
	Shares of Common Stock Outstanding	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (loss) (Note 11)	Total
BALANCE, APRIL 1, 1999	18,880	¥ 1,100,000	¥ 651,906	¥ (1,277,611)	¥ 10,640	¥ 484,935
Net loss				(4,784,501)		(4,784,501)
Other comprehensive income, net of tax					1,941,719	1,941,719
Total comprehensive loss						(2,842,782)
Initial public offering, net of stock issue cost	3,600	5,982,336	11,376,651			17,358,987
BALANCE, MARCH 31, 2000	22,480	7,082,336	12,028,557	(6,062,112)	1,952,359	15,001,140
Net loss				(4,700,222)		(4,700,222)
Other comprehensive income, net of tax					1,587,036	1,587,036
Total comprehensive loss						(3,113,186)
Effect of IPO by Crosswave, an equity method investee (Note 4)			5,039,796			5,039,796
BALANCE, MARCH 31, 2001	22,480	7,082,336	17,068,353	(10,762,334)	3,539,395	16,927,750
Net loss				(7,446,135)		(7,446,135)
Other comprehensive loss, net of tax					(1,756,334)	(1,756,334)
Total comprehensive loss						(9,202,469)
BALANCE, MARCH 31, 2002	22,480	¥ 7,082,336	¥ 17,068,353	¥ (18,208,469)	¥ 1,783,061	¥ 7,725,281

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Statements of Shareholders' Equity
Three Years in the Period Ended March 31, 2002

	Thousands of U.S. Dollars (Note 1)				
	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Note 11)	Total
BALANCE, MARCH 31, 2001	$ 53,371	$ 128,623	$ (81,102)	$ 26,672	$ 127,564
Net loss			(56,113)		(56,113)
Other comprehensive loss, net of tax				(13,235)	(13,235)
Total comprehensive loss					(69,348)
BALANCE, MARCH 31, 2002	$ 53,371	$ 128,623	$ (137,215)	$ 13,437	$ 58,216

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, 2002

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2000	2001	2002	2002
OPERATING ACTIVITIES:				
Net loss	¥ (4,784,501)	¥ (4,700,222)	¥ (7,446,135)	$ (56,113)
Adjustments to reconcile net loss to net cash provided by operating activities:				
Depreciation and amortization	2,032,498	2,697,703	3,027,587	22,815
Provision for retirement and pension costs, less payments	31,957	10,414	(23,799)	(179)
Provision for doubtful accounts	80,088	82,526	78,482	591
Loss on disposal of property and equipment	9,249	23,614	22,851	172
Loss (gain) on short-term and other investments	(204,565)	183,460	432,952	3,263
Foreign exchange losses (gains)	1,127,921	(1,132,083)	(219,524)	(1,654)
Equity in net loss of equity method investees	3,179,469	4,014,680	5,482,082	41,312
Minority interest in net (loss) income of consolidated subsidiaries	70,484	(159,850)	(24,467)	(184)
Deferred income taxes	(1,420,965)	(965,418)	1,081,241	8,148
Others		45,114	11,913	90
Changes in operating assets and liabilities:				
Increase in accounts receivable	(1,594,053)	(999,291)	(3,559,335)	(26,822)
Decrease (increase) in inventories, prepaid expenses and other current assets	(767,851)	551,753	(671,177)	(5,058)
Increase in accounts payable	2,328,625	650,495	2,808,704	21,166
Decrease in income taxes payable (increase in refundable income taxes)	134,406	(109,809)	(8,433)	(64)
Increase (decrease) in accrued expenses and other current liabilities	975,803	(463,672)	168,271	1,268
Net cash provided by (used in) operating activities	1,198,565	(270,586)	1,161,213	8,751
INVESTING ACTIVITIES:				
Purchases of property and equipment	(1,156,011)	(1,367,073)	(1,237,434)	(9,325)
Investments in newly controlled companies, net of cash acquired	292,710			
Investments in and advances to equity method investees	(5,440,000)	(7,552,117)	(362,714)	(2,734)
Purchases of short-term and other investments	(7,647,120)	(23,487,334)	(399,600)	(3,011)
Proceeds from sale and redemption of short-term and other investments	6,434,223	23,053,058		
Payments of guarantee deposits	(86,670)	(171,793)	(430,455)	(3,244)
Refund of guarantee deposits	11,055	36,739	1,830	14
Refund from insurance policies	540,171		6,115	46
Payment for refundable insurance policies	(5,718)	(11,442)	(16,103)	(121)
Other	(77,814)	(44,252)	(18,837)	(142)
Net cash used in investing activities	(7,135,174)	(9,544,214)	(2,457,198)	(18,517)
FORWARD	¥ (5,936,609)	¥ (9,814,800)	¥ (1,295,985)	$ (9,766)

Internet Initiative Japan Inc. and Subsidiaries

Consolidated Statements of Cash Flows
Three Years in the Period Ended March 31, 2002

	Thousands of Yen			Thousands of U.S. Dollars (Note 1)
	2000	2001	2002	2002
FORWARD	¥ (5,936,609)	¥ (9,814,800)	¥ (1,295,985)	$ (9,766)
FINANCING ACTIVITIES:				
Proceeds from issuance of long-term borrowings and convertible notes	200,000	17,102,639	2,000,000	15,072
Repayments of long-term borrowings	(572,000)	(690,000)		
Principal payments under capital leases	(1,674,011)	(1,914,472)	(2,037,133)	(15,352)
Net increase (decrease) in short-term borrowings	6,878,906	(8,070,376)	(1,799,768)	(13,563)
Proceeds from issuance of common stock	17,358,987			
Proceeds from issuance of subsidiary stock to minority shareholders			375,000	2,826
Net cash provided by (used in) financing activities	22,191,882	6,427,791	(1,461,901)	(11,017)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(1,158,322)	799,277	233,098	1,757
NET INCREASE (DECREASE) IN CASH	15,096,951	(2,587,732)	(2,524,788)	(19,026)
CASH, BEGINNING OF YEAR	1,061,488	16,158,439	13,570,707	102,266
CASH, END OF YEAR	¥ 16,158,439	¥ 13,570,707	¥ 11,045,919	$ 83,240
ADDITIONAL CASH FLOW INFORMATION:				
Interest paid	¥ 290,682	¥ 526,850	¥ 563,557	$ 4,247
Income taxes paid	7,090	141,597	26,227	198
NONCASH INVESTING AND FINANCING ACTIVITIES:				
Acquisition of assets by entering into capital leases	2,308,864	2,595,626	2,535,943	19,110
Exchange of common stock investment:				
Market value of common shares acquired	234,298			
Cost of investment	77,682			
Investments in newly controlled companies:				
Assets acquired	1,495,163			
Cash acquired, net of cash paid	292,710			
Liabilities assumed	1,787,873			
Effect of IPO by Crosswave, an equity method investee, on additional paid-in capital		5,039,796		

See 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. IIJ and subsidiaries (collectively, the "Company") provide Internet access services throughout Japan and into the United States of America and into the rest of Asia through a direct connection to the A-Bone, an Internet backbone connecting the countries in the Asian Pacific region. 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, including system integration revenues. Substantially all revenues are from customers operating in Japan.

Certain reclassifications have been made to conform to 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 29, 2002 of ¥132.70= $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. ("Technology"), IIJ Media Communications Inc. ("MC") and IIJ America, Inc. ("IIJ America") of which have fiscal year ending March 31, except for IIJ America. IIJ America's fiscal year ends December 31. 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. All significant events that occurred during the intervening period are appropriately reflected in the accompanying consolidated financial statements. IIJ obtained controlling equity interest over MC and Technology by additional investments in May and June 1999, respectively. The Company's investments had been previously accounted for by the equity method. 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.

The excess of cost of the Company's investments in subsidiaries and equity method investees over their equity in the net assets at dates of acquisition ("goodwill") is being amortized over a five-year period. See ***New Accounting Standards,*** which discusses a new accounting pronouncement regarding goodwill.

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

The Company participates in a dynamic high technology industry and believes that changes in any of the following areas could have a material adverse effect on the Company's future financial position, results of operations or cash flows: advances and trends in new technologies and industry standard; competitive pressures in the form of new products or price reductions on current products; change in product mix in changes in the overall demand for products offered by the Company; changes in certain strategic relationship or customer relationship, litigation or claims against the Company based on intellectual property, product, regulatory or other factors; risk associated with change in domestic and international economic and/or political conditions or regulations; fluctuations in foreign currency exchange rates; availability of necessary components; and the Company's ability to attract and retain employees necessary to support its growth.

Sources of Supplies—The Company relies on telecommunications carriers to provide long-distance lines for backbone and local connections to customers, including Crosswave Communications Inc. ("Crosswave"), an equity method investee, and third-party suppliers for the use of hardware components such as routers and servers. The Company believes that its use of multiple carriers, suppliers and alternative facilities significantly mitigate concentrations of credit risk. However, any disruption of telecommunication services or the inability of suppliers to deliver hardware components on a timely basis or to develop alternative sources of components could have an adverse effect on operating results.

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 valuation allowances for deferred tax assets, allowance for doubtful accounts, and estimated 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 Economy). Dial-up Internet access services are provided to both enterprises and individuals (IIJ4U). The term of these contracts is one or three year periods 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 miscellaneous Internet access related services such as Firewalls and co-location services. Value added services also include monthly fees from data center services which began during the fiscal year ended March 31, 2001 and include connectivity, housing, monitoring and security services. Connectivity and value-added services revenues–other consist principally of call-center customer support and income from the rental of servers and routers. 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. Maintenance, monitoring, and operating service revenues are recognized ratably over the contract period, which is generally for one year.

Equipment sales represent revenues earned in which the Company acts as principal in the transaction, takes title to the equipment and has risks and rewards of ownership while in inventory. This category also includes sales of network systems to Crosswave, an equity method investee, for the three years in the period ended March 31, 2002.

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 judged taking into consideration the guidance in Staff Accounting Bulletin ("SAB") No. 59, "Noncurrent Marketable Equity Securities" issued by the Securities and Exchange Commission ("SEC"). 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, however, if the value of a security has declined and is judged to be other than temporary, the security is written down to the estimated fair value.

***Inventories*—**Inventories consist mainly of network equipment purchased for development of network systems and are carried at the average cost, which approximate market values.

***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.

***Guarantee Deposits*—**Guarantee deposits substantially consist of refundable lease deposits for office premises.

***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. There were no impairment losses for long-lived assets for the three years in the period ended March 31, 2002.

***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 carryforward. Valuation allowances are provided against assets that are not likely to be realized.

***Retirement and Pension Plan*—**Pension costs have been determined in accordance with the provisions of SFAS No. 87, " Employers' Accounting for Pensions."

***Foreign Currency Transactions*—**Foreign currency assets and liabilities, which consist substantially of cash and short-term investments denominated in U.S. dollars and accounts payable for the payment of connectivity leases in U.S. dollars to international carriers, 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*—**On April 1, 2001, The Company adopted SAFS No. 133, "Accounting for Derivative Instruments and Hedging Activities", and SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities, an amendment of SFAS No. 133. These new standards require that an entity recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. In accordance with these new standards, 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 an 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. An ineffective portion of the gain or loss is reported in earning immediately. The cumulative effect adjustment upon the adoption of SFAS No. 133 and SFAS No. 138 resulted in a decrease to other comprehensive income of approximately ¥25,594 thousand ($193 thousand).
Prior to the adoption of SFAS No. 133 and SFAS No.138, gains or losses on foreign exchange forward contracts and on foreign currency denominated cash and short-term investments which were designated to hedge identifiable commitments for the payment of connectivity leases in U.S. dollars had been deferred and included in the measurement of the related transactions. Interest swap contracts were considered to effectively hedge interest to be paid on floating rate borrowings thereby fair value of the swap contracts was not remeasured, but the differential to be paid or received under the swap contracts was accrued and included in interest expense.

***Stock-Based Compensation*—**SFAS No. 123, "Accounting for Stock-Based Compensation," encourages, but dose not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No.25, " Accounting for Stock Issued to Employees" and related interpretations. Accordingly, the companies recognize 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, 2001 and 2002.

***Advertising*—**Advertising costs are expensed as incurred.

Basic and Diluted Net Loss per Share — Basic and diluted net loss per share are computed using the weighted average number of shares of common stock outstanding during the year. All potential common shares have been excluded from the computation of diluted net loss per share for all periods presented because the effect would be antidilutive. Diluted net loss per share does not include the effects of the following potential common shares:

	Years ended March 31,		
	2000	2001	2002
Shares issuable under stock options	0	290	685
Shares issuable related to convertible notes on an "as-if-converted" basis	0	625	625

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 loss on cash flow hedging derivative instruments.

New Accounting Standards— On July 20, 2001, the FASB issued SFAS No. 141,"Business Combinations," and SFAS No 142,"Goodwill and Other Intangible Assets." The statements change the accounting for business combinations and goodwill in two significant ways. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. Use of the poling-of-interests method is prohibited. SFAS No. 142, "Goodwill and Other Intangible Assets," changes the accounting for goodwill from an amortization method to an impairment – only approach. Thus, amortization of goodwill, including goodwill recorded in past business combinations and acquisitions, will cease upon adoption of that statement, which for the Company will be April 1, 2002. The company expects that the adoption of SFAS No. 142 will reduce annual amortization expense by approximately ¥357 million ($2,690 thousand). Additionally, the Company does not expect to have significant goodwill impairment charges associated with the adoption of this statement.

On August 16, 2001, the FASB issued SFAS No. 143,"Accounting for Assets Retirement Obligation," which is effective for fiscal years beginning after June 15, 2002. The pronouncement addresses the recognition and remeasurement of obligations associated with the retirement of a tangible long-lived assets and the associated assets retirement costs. Management does not expect this pronouncement to have a material impact on the Company's consolidated financial position or results of operations.

On October 3, 2001, the FASB issued SFAS No. 144,"Accounting for the Impairment or Disposal of Long-Lived Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS No. 144 applies to all long-lived assets (including discontinued operations) and it develops one accounting model for long-lived assets that are to be disposed of by sale. Management does not expect this pronouncement to 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, principally marketable shares of common stock of Japanese enterprises were classified as available-for-sale securities. Information regarding the securities classified as available-for-sale at March 31, 2001 and 2002, is as follows:

	Thousands of Yen			
	Cost	Unrealized Gains	Unrealized Losses	Fair Value
March 31, 2001				
Available-for-sale—Equity securities	¥ 655,749	¥ 6,093,732	¥ 48,538	¥ 6,700,943
March 31, 2002				
Available-for-sale—Equity securities	¥ 356,669	¥ 3,048,701	¥ 19,944	¥ 3,385,426

	Thousands of U.S. Dollars			
	Cost	Unrealized Gains	Unrealized Losses	Fair Value
March 31, 2002				
Available-for-sale—Equity securities	$ 2,688	$ 22,974	$ 150	$ 25,512

Other investments include non-marketable equity and debt securities amounting to ¥1,754,897 thousand and ¥2,020,639 thousand ($15,227 thousand) at March 31, 2001 and 2002, respectively.

Losses on write-down of investments in marketable and nonmarketable equity securities, included in other income (expense), were recognized to reflect the decline in value considered to be other than temporary totaling ¥245,424 thousand and ¥152,802 thousand, respectively for the year ended March 31, 2001, totaling ¥301,580 thousand ($2,273 thousand) and ¥131,372 thousand ($990 thousand), respectively for the year ended March 31, 2002.

Gain on exchange of securities of ¥156,616 thousand, included in other income (expense), for the year ended March 31, 2000, represented a non-monetary gain upon the exchange of non-marketable securities for marketable common shares in a merger transaction.

3. ALLOWANCE FOR DOUBTFUL ACCOUNTS

An analysis of allowance for doubtful accounts for the years ended March 31, 2000, 2001 and 2002, is as follows:

	Thousands of Yen			
	Balance at Beginning of Year	Credits Charged Off	Provision for Doubtful Accounts	Balance at End of Year
Year ended March 31, 2000	¥ 43,580	¥ (25,816)	¥ 80,088	¥ 97,852
Year ended March 31, 2001	¥ 97,852	¥ (41,157)	¥ 82,526	¥ 139,221
Year ended March 31, 2002	¥ 139,221	¥ (69,829)	¥ 78,482	¥ 147,874

	Thousands of U.S. Dollars			
	Balance at Beginning of Year	Credits Charged Off	Provision for Doubtful Accounts	Balance at End of Year
Year ended March 31, 2002	$ 1,049	$ (526)	$ 591	$ 1,114

4. INVESTMENTS IN AND ADVANCES TO EQUITY METHOD INVESTEES

IIJ utilizes various business units in Japan and neighboring countries to form and operate its Internet business. Businesses operated by the non-consolidated investees include dedicated high-speed data communication services, data center services (Crosswave), connectivity services in Asian countries (Asia Internet Holding Co., Ltd., “AIH”), multifeed technology services and location facilities for connecting high-speed Internet backbones (Internet Multifeed Co., “Multifeed”), Web page design services (atom Co., Ltd.), data center services in Asian countries (AyalaPort Makati Inc., “Ayala”, and i-Heart Inc.) and network construction, consulting, design and maintenance services (Net Chart Japan Corporation).

IIJ's ownership percentages of these equity method investees range from 20 to 50 percent. As the Company has significant influence over the investees' business planning and execution, such investments are accounted for by the equity method.

Transactions between the Company and the equity method investees include IIJ's sale of network systems to Crosswave in the amount of ¥1,373,577 thousand, ¥315,925 thousand and ¥1,078,863 thousand ($8,130 thousand) for the years ended March 31, 2000, 2001 and 2002, respectively, of which cost of purchased equipment sold amounted to ¥1,358,000 thousand, ¥305,039 thousand and ¥949,537 thousand ($7,156 thousand), respectively. In addition, there are other transactions with equity method investees for cost of dedicated high-speed data communication services by Crosswave, cost of subcontracting services by Technology (prior to becoming a majority-owned consolidated subsidiary) and Internet access cost and revenues with AIH.

The aggregate amounts of balances and transactions of the Company with these equity method investees as of March 31, 2001 and 2002 and for each of the three years in the period ended March 31, 2002, were summarized as follows:

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Accounts receivable		¥ 267,957	¥ 504,701	$ 3,803
Accounts payable		328,347	610,124	4,598
Guarantees		12,400	3,200	24
Revenues	¥ 2,649,717	2,001,092	3,885,203	29,278
Costs and expenses	772,633	2,443,710	5,562,817	41,920

The Company's investments in and advances to these equity method investees and respective ownership percentage at March 31, 2001 and 2002, consisted of the following:

	Thousands of Yen				Thousands of U.S. Dollars
		2001		2002	2002
Crosswave	37.85%	¥13,032,714	37.85%	¥ 7,612,573	$ 57,367
AIH	20.63	282,086	26.69	597,506	4,503
Ayala	25.71	119,943	25.64	209,410	1,578
Multifeed	28.30	182,338	28.30	145,095	1,093
Other		278,573		289,444	2,181
Total		¥13,895,654		¥ 8,854,028	$ 66,722

A summary of financial information of these equity method investees as of March 31, 2001 and 2002 and for each of the three years in the period ended March 31, 2002, in the aggregate, is as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Current assets	¥ 29,360,935	¥ 15,358,140	$ 115,736
Noncurrent assets	33,924,868	52,444,711	395,212
Total assets	63,285,803	67,802,851	510,948
Current liabilities	13,261,010	22,814,667	171,926
Noncurrent liabilities	16,983,584	25,299,749	190,654
Minority interests other than IIJ	20,923,956	12,556,604	94,624
Equity in net assets	¥ 12,117,253	¥ 7,131,831	$ 53,744

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Revenues	¥ 4,100,780	¥ 7,319,490	¥ 15,259,296	$ 114,991
Cost and expenses	11,837,556	17,693,390	28,195,005	212,472
Operating loss	(7,736,776)	(10,373,900)	(12,935,709)	(97,481)
Other income (expense)—net	(204,244)	138,932	(500,186)	(3,769)
Loss from consolidated operations before income tax expense	(7,941,020)	(10,234,968)	(13,435,895)	(101,250)
Income tax expense	41,219	176,294	107,021	807
Minority interests in consolidated subsidiaries		15,302	4,623	35
Net loss	¥ (7,982,239)	¥ (10,395,960)	¥ (13,538,293)	$ (102,022)

The excess of carrying value of investments in equity method investees over the companies' equity in the underlying net assets at March 31, 2001 and 2002 amounted to ¥1,684,772 thousand and ¥1,554,746 thousand ($11,716 thousand), primarily related to Crosswave amounting to ¥1,664,554 thousand and ¥1,314,122 thousand ($9,903 thousand), respectively.

IIJ's major non-consolidated business unit is Crosswave, a Japanese stock corporation formed in October 1998 with ownership interests held by IIJ (40 percent), Toyota Motor Corporation ("Toyota") (30 percent) and Sony Corporation ("Sony") (30 percent). On August 9, 2000, Crosswave completed an initial public offering of 17,392,000 American Depository Shares ("ADSs"), representing 86,960 shares of common stock at an initial offering price of $14.00 per ADSs in the NASDAQ National Market in the United States of America. Concurrently, IIJ purchased 15,000 newly issued Crosswave common shares amounting to ¥4,565,400 thousand in the aggregate. Proceeds from these transactions to Crosswave amounted to ¥31,032,546 thousand. The effect of the increase in equity in net assets of Crosswave resulting from such proceeds, net of IIJ's additional investment was accounted for as a capital transaction and credited directly to additional paid-in capital in the amount of ¥5,039,796 thousand. On December 27, 2000, IIJ also purchased 3,000,000 ADSs, representing 15,000 shares of Crosswave from the market in the aggregate amount of ¥2,737,200 thousand. As a result of these transactions, the ownership of IIJ, Sony, Toyota at March 31, 2002 was 37.85 percent, 23.9 percent and 23.9 percent, respectively.

IIJ's investment in Crosswave with carrying amounts of ¥13,032,714 thousand and ¥7,612,573 thousand ($57,367 thousand) at March 31, 2001 and 2002, respectively, were quoted on an established market at a value of ¥12,522,615 thousand and ¥5,597,286 thousand ($42,180 thousand), respectively. The Company has considered both the amount and duration of the decline in market value as indications of other than temporary impairment. The Company has considered other information related to the value of its investment including discounted cash flows and concluded that no write down is required.

The major financial accounts of Crosswave as of March 31, 2001 and 2002 and for the years ended March 31, 2000, 2001 and 2002, included in the above-summarized financial information, were as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Current assets	¥ 25,936,811	¥ 12,316,973	$ 92,818
Noncurrent assets	33,265,631	50,522,536	380,728
Total assets	59,202,442	62,839,509	473,546
Current liabilities	12,189,498	21,196,170	159,730
Noncurrent liabilities	16,894,922	24,923,523	187,819
Minority interests other than IIJ	18,749,862	10,421,365	78,533
Equity in net assets	¥ 11,368,160	¥ 6,298,451	$ 47,464

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Revenues	¥ 231,786	¥ 2,628,655	¥ 9,487,603	$ 71,497
Costs and expenses	7,891,703	13,592,033	22,352,415	168,443
Operating loss	(7,659,917)	(10,963,378)	(12,864,812)	(96,946)
Other income (expense)—net	(189,377)	101,235	(536,337)	(4,042)
Loss before minority interests	(7,849,294)	(10,862,143)	(13,401,149)	(100,988)
Minority interests in consolidated subsidiaries		15,302	4,623	35
Net loss	¥ (7,849,294)	¥ (10,846,841)	¥ (13,396,526)	$ (100,953)

Crosswave's revenue from IIJ and its subsidiaries and equity method investees accounted for 86.2%, 64.4%, and 43.2% of its total revenue in the years ended March 31, 2000, 2001, and 2002, respectively.

Crosswave is obligated under various capital leases and non-cancelable operating leases, which expire at various dates during the next nine years.

At March 31, 2001 and 2002, the gross amount of equipment and related accumulated depreciation recorded under capital leases were as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Capitalized leases, primarily data communications equipment	¥ 16,233,830	¥ 28,826,179	$ 217,228
Accumulated depreciation	(2,816,321)	(5,968,309)	(44,976)
Capitalized leases—net	¥ 13,417,509	¥ 22,857,870	$ 172,252

Future minimum lease payments under capital leases and non-cancelable operating leases other than a non-cancelable IRU contract with KDDI as of March 31, 2002 are as follows:

	Thousand of Yen		Thousands of U.S. Dollars	
	Capital Leases	Operating Leases	Capital Leases	Operating Leases
Year ending March 31:				
2003	¥ 4,745,655	¥ 755,334	$ 35,762	$ 5,692
2004	4,711,678	634,972	35,506	4,785
2005	4,672,607	554,012	35,212	4,175
2006	4,767,980	546,631	35,930	4,119
2007	2,545,026	525,890	19,179	3,963
2008 and thereafter	2,148,120	2,787,758	16,188	21,008
Total minimum lease payments	23,591,066	¥ 5,804,597	177,777	$ 43,742
Less amount representing interest (rates ranging from 1.65% to 7.44%)	(2,773,345)		(20,899)	
Present value of net minimum payments	20,817,721		156,878	
Less current portion	(3,814,719)		(28,747)	
Noncurrent portion	¥ 17,003,002		$ 128,131	

On March 28, 2000, Crosswave entered into a contract with Global Crossing to purchase an indefeasible right of use (“IRU”) in units of dedicated capacity of an international data traffic connection on fiber optic lines between Japan and the United States for the period from March 2000 through December 2023, for the total contract price of $25,000 thousand. Crosswave paid the initial contract fee of $6,250 thousand (25% of the total contract price) upon signing of the contract in March 2000 and the remaining contract fee of $18,750 thousand in March 2001 in accordance with the payment schedule set forth in the contract. The contract is accounted for as a capital lease based on the criteria set forth in SFAS No. 13, and is recorded in property and equipment as a capitalized lease. It is being depreciated on a straight-line basis over the contract term. The contract requires Crosswave to pay an annual maintenance fee of $150,000 per minimum capacity unit for the five units, totaling $750,000.

On May 1, 2000, Global Crossing assigned and transferred all of its rights and obligations under the contract dated as of March 28, 2000 to Asia Global Crossing, which was a subsidiary of Global Crossing. According to the IRU contract with Asia Global Crossing, Crosswave activated five additional capacity units between Japan and the United States in the year ended March 31, 2002. The contract requires Crosswave to pay an annual maintenance fee of $150,000 per minimum capacity unit for the ten units, totaling $1,500,000. The maintenance fee will be reduced by 2% per year after 3 years from activation of the capacity units in accordance with the contract, which will reduce the total minimal maintenance fee by $30,000 per year.

Crosswave is also obligated under a non-cancelable IRU contract with KDDI accounted for as an operating lease. As of March 31, 2002, future minimum lease payments for the fixed portion of this operating lease contract and maintenance fees under the related non-cancelable maintenance service contract are as follows:

	Thousands of Yen		Thousands of U.S. Dollars	
Year Ending March 31	Lease	Maintenance	Lease	Maintenance
2003	¥ 3,450,000	¥ 1,050,000	$ 25,999	$ 7,913
2004	3,950,000	1,050,000	29,766	7,913
2005	5,450,000	1,050,000	41,070	7,913
2006	6,061,000	1,050,000	45,674	7,913
2007	6,061,000	1,050,000	45,674	7,913
2008 and thereafter	12,122,000	2,100,000	91,349	15,823
Total minimum payments	¥ 37,094,000	¥ 7,350,000	$ 279,532	$ 55,388

For the network construction, Crosswave has placed firm orders to purchase related materials and equipment amounting to approximately ¥12.9 billion ($97.1 million) as of March 31, 2002.

On May 21, 2002, Crosswave entered into a syndicated financing facilities agreement (“Agreement”) with four Japanese commercial banks for the total amount of ¥20 billion. The Agreement consists of six-year long-term loans of up to ¥15 billion (“Tranche A”) and a short-term line of credit up to ¥5 billion (“Tranche B”).
Tranche A is secured by substantially all assets of Crosswave and is limited for the purposes of project costs including capital expenditures for network and data center construction and other operating expenses as defined in the Agreement. Tranche A can be drawn down as necessary over the first two-year period according to the mutually agreed business plan if Crosswave meets certain predetermined quantitative thresholds. Such thresholds are set based on the mutually agreed business plan in terms of cumulative sales amount, cumulative number of customers, and cumulative operating income/loss before depreciation and amortization, and are monitored by the banks for the purpose of determining the amount of draw down available. Tranche A loans bear interest at TIBOR (Tokyo Interbank Offered Rate) plus 2.95% per annum and would be repaid in eight equal semi-annual installments commencing from October 2004.
Tranche B is available for operating purposes and can be drawn up to the amount of outstanding accounts receivable balance for a maximum of three months during the contract period. Tranche B bears interest at the short-term prime rate plus 0.3% per annum.
The Agreement requires Crosswave to maintain project accounts with the agent bank in which all cash receipts of Crosswave must be deposited during the term of financing. Withdrawals from such accounts are restricted for Crosswave’s operational purposes only and require the banks’ approval.
Financial covenants include sales amounts set based on the mutually agreed business plan during the six-year period of the financing, as well as debt-equity ratio and debt-service coverage ratio. Those financial covenants and the quantitative thresholds for Tranche A draw down are set and monitored based on accounting principles generally accepted in Japan for Crosswave on an only parent company basis. Technical defaults on these financial covenants allow the banks to demand payback of the loans.
In connection with the financing, Crosswave has granted stock acquisition rights to the bank consortium and IIJ for a consideration. These stock acquisition rights are exercisable for a period from June 6, 2002 to May 31, 2009 at an exercise price of $1.50 per ADS, which represents a 50% premium over the closing market price of Crosswave’s ADSs as of May 9, 2002, for an aggregate of 30,000 common shares of Crosswave’s common stock, equivalent to 6,000,000 ADSs. These stock acquisition rights may be exercised to result in dilution to the other shareholders of their share ownership percentages.

5. PROPERTY AND EQUIPMENT

Property and equipment as of March 31, 2001 and 2002 consisted of the followings:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Data communications equipment	¥ 395,666	¥ 698,158	$ 5,261
Office and other equipment	406,531	508,993	3,836
Leasehold improvements	248,722	302,177	2,277
Purchased software	3,024,528	3,948,128	29,752
Capitalized leases, primarily data communications equipment	7,458,936	8,493,003	64,002
Total	11,534,383	13,950,459	105,128
Less accumulated depreciation and amortization	(4,606,808)	(6,195,033)	(46,685)
Property and equipment—net	¥ 6,927,575	¥ 7,755,426	$ 58,443

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

6. LEASES

***Operating Leases*—**The Company has operating lease agreements with telecommunications carriers and others, including Crosswave, for the use of connectivity lines, including local access lines that customers use to connect to IIJ's network. The leases for domestic backbone are generally either non-cancelable for a minimum one-year lease period or cancelable during a lease period principally of six years, with a significant penalty for cancellation (either 25 percent or 35 percent). The lease for domestic backbone with Crosswave is for a one-year period and non-cancelable. The leases for international backbone available as of March 31, 2002, are entered into with carriers for lease periods ranging from one to five years and are substantially non-cancelable. The Company also leases its office premises and certain office equipment under non-cancelable operating leases which expire on various dates through the year 2005 and also leases its network operation centers under non-cancelable operating leases.

Lease expenses related to backbone lines for the years ended March 31, 2000, 2001 and 2002, amounted to ¥7,192,864 thousand, ¥8,122,256 thousand and ¥5,656,116 thousand ($42,623 thousand), respectively. Lease expenses for local access lines for the years ended March 31, 2000, 2001 and 2002, which are only attributable to dedicated access revenues, amounted to ¥2,089,791 thousand, ¥3,142,392 thousand and ¥3,872,101 thousand ($29,179 thousand), respectively. Other lease expenses for the years ended March 31, 2000, 2001 and 2002, amounted to ¥1,288,271 thousand, ¥1,858,987 thousand and ¥2,764,026 thousand ($20,829 thousand), 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 ¥7,458,936 thousand and ¥3,221,325 thousand at March 31, 2001 and ¥8,493,003 thousand ($64,002 thousand) and ¥3,772,937 thousand ($28,432 thousand) at March 31, 2002, respectively.

As of March 31, 2002, future lease payments under non-cancelable operating leases, including the aforementioned 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:						
2003	¥ 989,904	¥ 1,118,716	¥ 2,096,859	$ 7,460	$ 8,430	$ 15,801
2004	106,323	397,589	1,677,546	801	2,996	12,642
2005	85,206	29,706	962,226	642	224	7,251
2006	79,020	18,519	293,213	595	140	2,210
2007	39,258	18,519	8,701	296	140	66
2008 and thereafter		141,977	10,384		1,070	78
Total minimum lease payments	¥ 1,299,711	¥ 1,725,026	5,048,929	$ 9,794	$ 13,000	38,048
Less amounts representing interest			(213,604)			(1,610)
Present value of net minimum capital lease payments			4,835,325			36,438
Less current portion			(1,973,769)			(14,874)
Noncurrent portion			¥ 2,861,556			$ 21,564

7. BORROWINGS AND CONVERTIBLE NOTES

Short-term borrowings at March 31, 2001 and 2002, consist of unsecured notes payable to banks of ¥50,000 thousand and ¥50,000 thousand ($377 thousand) and bank overdrafts of ¥5,570,000 thousand and ¥3,770,232 thousand ($28,412 thousand), respectively. Short-term borrowings bear fixed-rate interest and their weighted average rates on the short-term borrowings at March 31, 2001 and 2002 were 1.402 percent and 1.393 percent, respectively.

Long-term borrowings as of March 31, 2001 and 2002, consisted of the following:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Unsecured long-term loans payable to banks, maturing at various dates through 2007 (see Note 13). Weighted average interest rates were 1.86% and 1.72% for the years ended March 31, 2001 and 2002, respectively.	¥ 1,400,000	¥ 2,400,000	$ 18,086
Unsecured long-term loans payable to banks, maturing at various dates through 2005 (see Note 13). Interest is payable at a variable rate based on TIBOR which was 0.12% as of March 31, 2001 and 2002, respectively. Weighted average interest rates were 0.98% and 0.95% for the years ended March 31, 2001 and 2002, respectively.	1,400,000	2,400,000	18,086
Less current portion		(1,400,000)	(10,550)
Long-term borrowings, less current portion	¥ 2,800,000	¥ 3,400,000	$ 25,622

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 ¥1,000,000 thousand and ¥2,000,000 thousand ($15,072 thousand) of the long-term loan outstanding at March 31, 2001 and 2002 after giving effect to such swap agreements were 1.960 and 1.730 percent per annum, respectively.

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 guarantees 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. The Company has never received requests to provide collateral or guarantees from its banks. Also, provisions of certain loan agreements grant certain rights of possession to the lenders in the event of default.

Annual maturities of long-term borrowings outstanding as of March 31, 2002, are as follows:

Year Ending March 31	Thousands of Yen	Thousands of U.S. Dollars
2003	¥ 1,400,000	$ 10,550
2004	1,400,000	10,550
2005	1,400,000	10,550
2006		
2007	600,000	4,522
Total	¥ 4,800,000	$ 36,172

The Company entered into bank overdraft agreements with certain Japanese banks for which the unused balance outstanding as of March 31, 2002, was ¥3,939,768 thousand ($29,689 thousand).

The 1.750 percent unsecured yen convertible notes due March 2005 in the aggregate principal amount of ¥15,000,000 thousand ($113,037 thousand) were issued on April 11, 2000. The notes are subject to conversion currently at ¥24,000 thousand ($181 thousand) per share at any time on or after July 3, 2000 and on or before March 15, 2005.

8. INCOME TAXES

Income taxes imposed by the national, prefectural and municipal governments of Japan resulted in a normal statutory rate of approximately 42 percent for the years ended March 31, 2000, 2001 and 2002, respectively. Total income tax recognized for the years ended March 31, 2000, 2001 and 2002, are applicable to the following:

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Income tax expense (benefit):				
Current	¥ 140,842	¥ 39,740	¥ 17,794	$ 134
Deferred (benefit)	(1,420,965)	(965,418)	1,081,241	8,148
Other comprehensive income	1,389,143	1,150,014	(1,266,877)	(9,547)
Total income tax	¥ 109,020	¥ 224,336	¥ (167,842)	$ (1,265)

Loss from operations before income tax expense (benefit) consists of the following components:

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Domestic	¥ (2,484,652)	¥ (1,523,117)	¥ (735,359)	$ (5,542)
Foreign	(330,019)	(247,953)	(154,126)	(1,161)
Total	¥ (2,814,671)	¥ (1,771,070)	¥ (889,485)	$ (6,703)

Net deferred income tax assets and liabilities at March 31, 2001 are reflected on the accompanying consolidated balance sheets under captions of other current assets, other assets and other noncurrent liabilities in the amount of ¥11,360 thousand, ¥1,416 thousand and ¥188,413 thousand, respectively.

The approximate effect of temporary differences and carryforwards giving rise to deferred tax balances at March 31, 2001 and 2002, was as follows:

	Thousands of Yen				Thousands of U.S. Dollars	
	2001		2002		2002	
	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		¥ 2,530,398		¥ 1,272,079		$ 9,586
Valuation of limited partnership investments for tax purpose	¥ 4,736			21,919		165
Capitalized leases	35,133		¥ 42,048		$ 317	
Accrued expenses	89,513		100,069		754	
Retirement and pension cost	52,349		42,353		319	
Stock and notes issue cost	32,356			54,526		411
Allowance for doubtful accounts	2,773		38,234		288	
Depreciation	37,105		55,032		415	
Operating loss carryforward	2,743,252		3,258,292		24,554	
Other	41,900	1,242	65,631	1,241	495	10
Total	3,039,117	2,531,640	3,601,659	1,349,765	27,142	10,172
Valuation allowance	(693,114)		(2,251,894)		(16,970)	
Total	¥ 2,346,003	¥ 2,531,640	¥ 1,349,765	¥ 1,349,765	$ 10,172	$ 10,172

As of March 31, 2001 and 2002, the valuation allowance for deferred tax assets has been provided amounts which are not considered “more likely than not” to be realized. The net changes in the valuation allowance for deferred tax assets were decreases of ¥61,943 thousand, ¥201,017 thousand and an increase of ¥1,558,780 thousand ($11,747 thousand) for the years ended March 31, 2000, 2001 and 2002, respectively. As of March 31, 2002, IIJ, certain domestic subsidiaries and IIJ America, a U.S. subsidiary, had tax operating loss carryforwards of ¥6,042,193 thousand ($45,533 thousand), ¥589,923 thousand ($4,446 thousand) and $8,145 thousand, respectively. These loss carryforwards are available to offset future taxable income, and will expire in the period ending March 31, 2007 in Japan and December 31, 2021 in the United States of America, respectively. Loss before income tax expense (benefit) and minority interest for the years ended March 31, 2000, 2001 and 2002, included a loss from the foreign subsidiary of ¥342,620 thousand, ¥210,917 thousand and ¥72,055 thousand ($543 thousand), respectively, and a valuation allowance for deferred tax assets giving rise to operating loss carryforwards and temporary differences of the subsidiary was fully provided in the periods.

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, 2002, is as follows:

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Amount computed by using normal Japanese statutory tax rate	¥ (1,168,857)	¥ (734,893)	¥ (373,584)	$ (2,815)
Increase (decrease) in taxes resulting from:				
Expenses not deductible for tax purpose	(56,765)	(33,725)	(23,214)	(175)
Increase (decrease) in valuation allowance	(52,187)	(186,905)	1,557,870	11,740
Realization of tax benefit of operating loss carryforwards of subsidiaries	(4,367)	(1,821)	(18,275)	(138)
Other—net	2,053	31,666	(43,762)	(330)
Income tax expense (benefit) as reported	¥ (1,280,123)	¥ (925,678)	¥ 1,099,035	$ 8,282

9. RETIREMENT AND PENSION PLANS

IIJ and certain subsidiaries have unfunded retirement benefits 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, 2000, 2001 and 2002, included the following components:

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Service cost	¥ 87,225	¥ 109,473	¥ 115,258	$ 869
Interest cost	5,371	7,772	6,930	52
Expected return on plan assets	(1,064)	(4,877)	(6,733)	(51)
Amortization of transition obligation	402	402	402	3
Recognized net actuarial loss	1,607	1,589		
Net periodic pension cost	¥ 93,541	¥ 114,359	¥ 115,857	$ 873

The funded status as of March 31, 2001 and 2002, is as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Change in benefit obligation:			
Benefit obligation at beginning of year	¥ 313,873	¥ 350,671	$ 2,643
Service cost	109,473	115,258	869
Interest cost	7,772	6,930	52
Actuarial (gain) loss	(71,520)	9,156	69
Benefit paid	(8,927)	(10,359)	(79)
Benefit obligation at end of year	¥ 350,671	¥ 471,656	$ 3,554
Change in plan assets:			
Fair value of plan assets at beginning of year	¥ 130,059	¥ 216,840	$ 1,634
Actual return on plan assets	(8,237)	(6,186)	(47)
Employer contribution	101,263	134,312	1,013
Benefits paid	(6,245)	(5,015)	(38)
Fair value of plan assets at end of year	216,840	339,951	2,562
Funded status	(133,831)	(131,705)	(992)
Unrecognized actuarial loss	3,165	25,240	190
Unrecognized transition obligation	6,026	5,624	42
Accrued pension cost	¥ (124,640)	¥ (100,841)	$ (760)
Actuarial assumptions as of March 31:			
Discount rate	2.0%	2.0%	
Expected long-term rate of return on plan assets	2.5	2.5	
Rate of compensation increase	3.0	3.0	

IIJ'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 pension trust funds managed by a certain trust bank and a life insurance company, consist of Japanese Government bonds, other debt securities and marketable equity securities. Plan assets managed by the insurance company are included in 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, 2000, 2001 and 2002, under the Multi-Employer Plan, including its substitutional portion, amounted to ¥121,818 thousand, ¥178,053 thousand and ¥234,148 thousand ($1,764 thousand).

Under the Japanese Commercial Code, retirement benefits for directors and statutory auditors are approved by the shareholders. The amount of benefits to retiring directors and statutory auditors of IIJ are also determined by the shareholders. IIJ estimated accrued benefit at March 31, 2001 to a retiring director of ¥35,770 thousand and the benefit were determined by the shareholders at June 27, 2001 and paid. There were no benefits determined or paid to retired directors or corporate auditors for each of three years other than above benefits.

10. SHAREHOLDERS' EQUITY

IIJ is subject to the Japanese Commercial Code (the “Code”) to which certain amendments became effective from October 1, 2001.

Prior to October 1, 2001, the Code required at least 50% of the issue price of new shares, with a minimum of the par value thereof, to be designated as the common stock account as determined by resolution of the Board of Directors. Proceeds in excess of amounts designated as the common stock account were credited to capital surplus. Effective October 1, 2001, the Code was revised and common stock par values were eliminated resulting in all shares being recorded with no par value.

Prior to October 1,2001, the Code imposed certain restrictions on the repurchase and use of treasury stock. Effective October 1, 2001, the Code eliminated these restrictions allowing IIJ to repurchase treasury stock by a resolution of the shareholders at the general shareholders meeting and dispose of such treasury stock by resolution of the Board of Directors after March 31, 2002. The repurchased amount of treasury common stock, cannot exceed the amount available for future dividend plus amount of common stock, capital surplus or legal reserve to be reduced in the case where such reduction was resolved at the general shareholders meeting.

The Code permits, upon approval of the Board of Directors, transfers of amount from capital surplus to the common stock account.

The Code also permits IIJ, upon approval by 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. Prior to October 1, 2001, the amount calculated by dividing the total amount of shareholders’ equity by the number of outstanding shares after the stock split could not be less than ¥50,000. The revised Code eliminated this restriction.

Prior to October 1, 2001, the Code provided that an amount at least equal to 10% of the aggregate amount of cash and certain other cash payments which are made as an appropriation of retained earnings applicable to each fiscal period shall be appropriated and set aside as a legal reserve until such reserve equals 25% of the common stock account. Effective October 1, 2001, the revised Code allows for such appropriations to be set aside total capital surplus and legal reserve equals 25% of the common stock account. The amount of total capital surplus and legal reserve which exceeds 25% of the common stock account can be transferred to retained earnings by resolution of the shareholders, which may be available for dividends. In addition, the Code permits to transfer a portion of legal reserve to the common stock account by resolution of the Board of Directors.

In August 1999, IIJ completed an initial public offering of 7,160,000 ADSs representing 3,580 shares of common stock at an initial offering price of $23.00 per ADS in the NASDAQ National Market in the United States of America. The net proceeds to IIJ from the initial public offering, after deducting applicable underwriting discounts and stock issue cost, was ¥17,358,987 thousand. Stock issue costs amounting to ¥1,751,253 thousand were deducted from additional paid-in capital.

Stock Option Plans— In March 2000, 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 the Company and the subsidiary. 1,000 warrants were purchased and maintained by the Company. Warrants are exercisable upon issuance. All of the warrants remain outstanding as of March 31, 2002.

IIJ has two stock option plans that provide for the granting of stock options to certain directors and employees. Options are exercisable after 23 months or less and expire eight years after the grant date. No option was available for additional grant as of March 31, 2002. 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.

The following table summarizes the transactions of IIJ's stock option plans for the three years in the period ended March 31, 2002:

	Number of Shares	Weighted Average Exercise Price (Thousands of yen per common shares)
Unexercised options outstanding		
—March 31, 2000	-	-
Option granted	295	¥13,056
Option exercised	-	-
Option forfeited	5	13,056
Unexercised options outstanding		
—March 31, 2001	290	¥13,056
Option granted	395	2,018
Option exercised	-	-
Option forfeited	-	-
Unexercised options outstanding		
—March 31, 2002	685	¥ 6,691

Summarized information about stock options outstanding as of March 31, 2002 is as follows:

	Outstanding		Exercisable
Exercise Price (Thousand of Yen)	Number of Options	Remaining Life (in years)	Number of Options
¥ 13,056	290	8.0	Nil
2,018	395	9.3	Nil

The fair value of IIJ's options for the years ended March 31, 2001 and 2002 reported below has been estimated at the date of grant using a Black-Scholes option pricing model with the following assumptions:

	2001	2002
Stock Options:		
Expected life from vest date (in years)	4.0	4.0
Risk-free interest rates	1.39%	0.72%
Volatility	148%	51%
Dividend yield	-	-

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. The Company's options have characteristics significantly different from those of traded options, and changes in the subjective input assumptions can materially affect the fair value estimate. Based upon the above assumptions, the fair value of IIJ's stock options granted during the year ended March 31, 2001 and 2002 were ¥11,875 thousand per common share and ¥621 thousand ($4.68 thousand) per common share, respectively.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized over the options' vesting period. Had the Company's stock options been accounted for under SFAS No. 123, " Accounting for Stock-Based Compensation", pro forma net loss and net loss per common for the years ended March 31, 2001 and 2002, including the effects of fair values associated with the granted stock options of Technology is as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Net loss:			
As reported	¥ 4,700,220	¥ 7,446,135	$ 56,113
Pro forma	6,440,248	9,203,222	69,354

	Yen		U.S. Dollars
	2001	2002	2002
Basic and diluted net loss per common shares:			
As reported	¥ 209,085	¥ 331,234	$ 2,496
Pro forma	286,488	409,396	3,085

11. OTHER COMPREHENSIVE INCOME

The change in each component of other comprehensive income (loss) for the years ended March 31, 2000, 2001 and 2002, is as follows:

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Other comprehensive income (loss), before tax:				
Foreign currency translation adjustments	¥ 23,701	¥ (1,141)	¥ 26,933	$ 203
Unrealized holding gain (loss) on securities:				
Amount arising during the period	3,307,161	2,492,767	(3,318,017)	(25,004)
Less: Reclassification adjustments for losses included in net loss		(245,424)	(301,580)	(2,273)
Net unrealized holding gain (loss) during the period	3,307,161	2,738,191	(3,016,437)	(22,731)
Loss on cash flow hedging derivative instruments				
Effect of adopting SFAS No. 133			(25,594)	(193)
Amount arising during the period			(22,385)	(169)
Less: Reclassification adjustments for losses included in net loss			14,272	108
Net loss on cash flow hedging derivative instruments			(33,707)	(254)
Total	3,330,862	2,737,050	(3,023,211)	(22,782)
Income tax effect	(1,389,143)	(1,150,014)	1,266,877	9,547
Other comprehensive income (loss), net of tax	¥1,941,719	¥ 1,587,036	¥ (1,756,334)	$(13,235)

The components of accumulated other comprehensive income (loss) at March 31, 2001 and 2002 are as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Foreign currency translation adjustments	¥ 33,182	¥ 60,115	$ 453
Net unrealized holding gain on securities	3,506,213	1,756,653	13,238
Loss on cash flow hedging derivative instruments		(33,707)	(254)
	¥ 3,539,395	¥ 1,783,061	$ 13,437

12. COMMITMENTS AND CONTINGENT LIABILITIES

The Company has contracted for connectivity lines with Crosswave as of March 31, 2002, that, in aggregate, require monthly payments of ¥266,503 thousand ($2,008 thousand).

The purchase commitments for network system equipment outstanding at March 31, 2002, amounted to ¥150,476 thousand ($1,134 thousand).

In December 2001, a class action complaint alleging violations of the federal securities laws was filed against the Company in the United States District Court for the Southern District of New York, naming IIJ and certain of its officers and directors, and the Goldman Sachs Group Inc. and Morgan Stanley Dean Witter, Inc., both of which served as underwriters of our initial public offering, as defendants. 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 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. The IIJ 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, the Company jointed in an 'omnibus' motion to dismiss the amended complaint filed by the issuers and individuals named in the various coordinated cases. The Company believes these claims are without any merit, and intend to defend these actions vigorously. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation.

13. 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 institution.

Changes in fair value of interest rate swaps designated as hedging instrument is reported in accumulated other comprehensive income during the year ended March 31, 2002. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the hedged bank borrowings affect earnings.

There was no ineffectiveness recognized in earning for the year ended March 31, 2002. For the year ended March 31, 2002, net derivative loss of ¥14,272 thousand ($108 thousand) were reclassified to interest expense.

During the year ending March 31, 2003, approximately ¥16,883 thousand ($127 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.

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 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 is not practicable are investments in a number of unaffiliated and unlisted smaller sized companies and the estimate of their fair values can not be made without incurring excessive costs. The carrying amounts or notional amounts and fair value of financial instruments are summarized below:

	Thousands of Yen				Thousands of U.S. Dollars	
	2001		2002		2002	
	Carrying Amount or Notional Amount	Fair Value	Carrying Amount or Notional Amount	Fair Value	Carrying Amount or Notional Amount	Fair Value or Gain (Loss)
Other investments for which it is:						
Practicable to estimate fair value	¥ 6,700,943	¥ 6,700,943	¥ 3,385,426	¥ 3,385,426	$ 25,512	$ 25,512
Not practicable	1,754,897		2,020,639		15,227	
Noncurrent refundable insurance policies (other assets)	21,488	21,488	31,475	31,475	237	237
Long-term borrowings and convertible notes, including current portion	17,800,000	14,570,363	19,800,000	17,104,110	149,209	128,893
Interest rate swap contracts	1,000,000	(25,594)	2,000,000	(33,707)	15,072	(254)

Cash at March 31, 2001 and 2002, includes U.S. dollar denominated bank deposits of ¥5,392,974 thousand and ¥3,473,827 thousand ($26,178 thousand), respectively.

14. ADVERTISING EXPENSES

Advertising expenses incurred during the years ended March 31, 2000, 2001 and 2002, consist principally of advertisement within magazines, journals and newspapers and amounted to ¥731,071 thousand, ¥735,763 thousand and ¥397,263 thousand ($2,994 thousand), respectively.

15. SUBSEQUENT EVENTS

On May 21, 2002, in connection with the Crosswave Financing Facilities Agreement (the “Agreement”) discussed in Footnote 4, the Company entered into a Cash Deficiency Support Agreement ("CDS Agreement") with Crosswave and the four Japanese commercial banks. In accordance with the provisions of the CDS

Agreement, the Company deposited ¥5 billion into a restricted account with a participating bank at the end of May in 2002. Under the terms of the CDS Agreement, the deposited cash will be restricted over the period in which the Crosswave loans are outstanding and may only be used for debt service in the event Crosswave is otherwise unable to meet scheduled payments under the Agreement. The Company is not liable under the terms of the CDS Agreement for any amounts in addition to this amount of ¥5 billion. Any restricted cash withdrawn under the CDS agreement will result in a corresponding unsecured funding to Crosswave by the Company that will be subordinate to the Crosswave loans outstanding under the Agreement. The CDS Agreement provides that any such funding between the Company and Crosswave may be invested, based on the outcome of future negotiations as loans, bonds or equity of Crosswave.

* * * * * *

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND SCHEDULE

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors and Shareholders of Crosswave Communications Inc.:

We have audited the accompanying consolidated balance sheets of Crosswave Communications Inc. and subsidiaries as of March 31, 2001 and 2002, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended March 31, 2002. These consolidated 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Crosswave Communications Inc. and subsidiaries as of March 31, 2001 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

Our audits were made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The schedule of valuation and qualifying accounts (schedule II) listed in the Index to Consolidated Financial Statements and Schedule is presented for the purpose of complying with the Securities and Exchange Commission's rules and is not part of the basic consolidated financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, fairly states in all material aspects, the financial data required to be set forth therein in relation to the basic consolidated financial statements taken as a whole.

Our audit also comprehended the translation of Japanese yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made on the basis set forth in Note 1.

Asahi & Co.

Tokyo, Japan

June 5, 2002

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

March 31, 2001 and 2002

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
CURRENT ASSETS:			
Cash and cash equivalents (Note 1)	¥ 24,039,851	¥ 8,675,543	$ 65,377
Accounts receivable, less allowance for doubtful accounts of ¥1,848 thousand and ¥ 25,384 thousand ($191 thousand) in 2001 and 2002, respectively (Note 4):	644,058	1,903,894	14,347
Receivable of proceeds from sale and lease back transaction	190,659	941,373	7,094
Refundable consumption tax and other current assets	1,062,243	796,163	6,000
Total current assets	25,936,811	12,316,973	92,818
PROPERTY AND EQUIPMENT, net (Notes 1, 2, 4, 5 and 7):	31,368,009	48,599,299	366,235
DEPOSITS AND OTHER ASSETS, net of allowance for doubtful accounts of ¥160,574 thousand ($1,296 thousand) in 2001 and 2002 (Notes 2 and 3)	1,897,622	1,923,237	14,493
Total assets	¥ 59,202,442	¥ 62,839,509	$ 473,546

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS – (Continued)

March 31, 2001 and 2002

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
CURRENT LIABILITIES:			
Current portion of capital lease obligations (Notes 1, 6 and 13)	¥ 1,935,208	¥ 3,814,719	$ 28,747
Current portion of long-term debt (Notes 7 and 13)	236,028	340,672	2,567
Accounts payable (Note 4)	4,599,700	9,537,552	71,873
Accrued expenses (Notes 2 and 4)	5,386,713	6,870,406	51,774
Other current liabilities	31,849	632,821	4,769
Total current liabilities	12,189,498	21,196,170	159,730
CAPITAL LEASE OBLIGATIONS, less current portion (Notes 1, 6 and 13)	9,231,915	17,003,002	128,131
LONG-TERM DEBT, less current portion (Notes 7 and 13)	7,648,127	7,869,864	59,306
OTHER LIABILITIES (Notes 1 and 8)	14,880	50,657	382
Total liabilities	29,084,420	46,119,693	347,549
COMMITMENTS AND CONTINGENCIES (Notes 2, 6, 14 and 15)			
MINORITY INTEREST	84,540	79,917	602
SHAREHOLDERS' EQUITY (Note 10 and 11):			
Common stock no par value; authorized 600,000 shares at March 31, 2001 and 2002; issued and outstanding 501,960 shares at March 31, 2001 and 2002	30,494,526	30,494,526	229,801
Additional paid-in capital	18,317,795	18,317,795	138,039
Accumulated deficit	(18,779,471)	(32,175,997)	(242,472)
Accumulated other comprehensive income (Note 12)	632	3,575	27
Total shareholders' equity	30,033,482	16,639,899	125,395
Total liabilities and shareholders' equity	¥ 59,202,442	¥ 62,839,509	$ 473,546

The accompanying notes to consolidated financial statements are an integral part of these statements.

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

For the years ended March 31, 2000, 2001 and 2002

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
REVENUE (Notes 1 and 4)	¥ 231,786	¥ 2,628,655	¥ 9,487,603	$ 71,497
OPERATING COSTS AND EXPENSES (Note 4):				
Cost of data communication services	6,098,725	9,513,127	16,150,915	121,710
Depreciation and amortization	841,648	2,306,980	3,842,815	28,959
Sales and marketing	431,019	632,983	1,094,193	8,245
General and administrative	520,311	1,138,943	1,264,492	9,529
	7,891,703	13,592,033	22,352,415	168,443
Operating loss	(7,659,917)	(10,963,378)	(12,864,812)	(96,946)
OTHER INCOME (EXPENSE):				
Interest expense, net (Note 7)	(195,852)	(280,835)	(721,162)	(5,435)
Foreign exchange gain	10,121	553,001	270,473	2,038
Other, net	(3,646)	(170,931)	(85,648)	(645)
	(189,377)	101,235	(536,337)	(4,042)
Loss before minority interests and income taxes	(7,849,294)	(10,862,143)	(13,401,149)	(100,988)
MINORITY INTERESTS IN CONSOLIDATED SUBSIDIARIES	–	15,302	4,623	35
INCOME TAXES (Notes 1 and 9)	–	–	–	–
Net loss	¥ (7,849,294)	¥ (10,846,841)	¥ (13,396,526)	$ (100,953)

PER SHARE DATA (Note 1):	Japanese Yen			U.S. Dollars
Basic and dilutive net loss per share	¥ (46,643)	¥ (23,308)	¥ (26,688)	$ (201)
Weighted average number of common shares outstanding	168,285	465,366	501,960	501,960

The accompanying notes to consolidated financial statements are an integral part of these statements.

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

For the years ended March 31, 2000, 2001 and 2002

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
COMMON STOCK:				
Balance, beginning of the year	¥ 6,353,934	¥ 19,854,796	¥ 30,494,526	$ 229,801
Common stock issued 272,000 shares and 101,960 shares for the years ended March 31, 2000 and 2001, respectively.	13,500,862	10,639,730	–	–
Balance, end of the year	¥ 19,854,796	¥ 30,494,526	¥ 30,494,526	$ 229,801
ADDITIONAL PAID-IN CAPITAL				
Balance, beginning of the year	¥ –	¥ –	¥ 18,317,795	$ 138,039
Common stock issued 101,960 shares for the year ended March 31, 2001, net of stock offering expenses.	–	18,317,795	–	–
Balance, end of the year	¥ –	¥ 18,317,795	¥ 18,317,795	$ 138,039
ACCUMULATED DEFICITS:				
Balance, beginning of the year	¥ (83,336)	¥ (7,932,630)	¥ (18,779,471)	$ (141,519)
Net loss	(7,849,294)	(10,846,841)	(13,396,526)	(100,953)
Balance, end of the year	¥ (7,932,630)	¥ (18,779,471)	¥ (32,175,997)	$ (242,472)
ACCUMULATED OTHER COMPREHENSIVE INCOME:				
Balance, beginning of the year	¥ –	¥ –	¥ 632	$ 5
Other comprehensive income, net of tax	–	632	2,943	22
Balance, end of the year	¥ –	¥ 632	¥ 3,575	$ 27

The accompanying notes to consolidated financial statements are an integral part of these statements.

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended March 31, 2000, 2001 and 2002

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss	¥ (7,849,294)	¥ (10,846,841)	¥ (13,396,526)	$ (100,953)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	841,648	2,306,980	3,842,815	28,959
Unrealized foreign currency exchange gain	(10,016)	(641,051)	(282,688)	(2,130)
Minority interest in net loss of consolidated subsidiaries	–	(15,302)	(4,623)	(35)
Changes in operating assets and liabilities:				
Increase in accounts receivable	(60,895)	(583,734)	(987,940)	(7,445)
Decrease (increase) in refundable consumption tax and other current assets	(274,087)	(823,162)	33,602	253
Increase (decrease) in accounts payable	585,102	(569,649)	2,149,641	16,199
Increase in accrued expenses and other current liabilities	2,784,331	2,624,055	2,338,841	17,625
Increase in other liabilities	–	14,880	35,777	269
Net cash used in operating activities	(3,983,211)	(8,533,824)	(6,271,101)	(47,258)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchases of property and equipment	(6,858,941)	(11,328,145)	(17,632,536)	(132,875)
Payments for deposits	(295,927)	(625,110)	(130,763)	(985)
Increase in other assets, net	(102,040)	(137,077)	(962,610)	(7,255)
Proceeds from sale and lease back of equipment	5,534,639	4,155,161	12,362,936	93,165
Net cash used in investing activities	(1,722,269)	(7,935,171)	(6,362,973)	(47,950)

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
CASH FLOWS FROM FINANCING ACTIVITIES:				
Principal payments under capital lease obligations	¥ (627,759)	¥ (1,649,325)	¥ (2,719,529)	$ (20,494)
Principal payments under installment loans	–	(92,312)	(287,737)	(2,168)
Proceeds from issuance of common stock, net of underwriting commissions	13,500,862	29,368,896	–	–
Proceeds from minority shareholders	–	100,000	–	–
Stock offering expenses	–	(404,357)	–	–
Net cash (used in) provided by financing activities	12,873,103	27,322,902	(3,007,266)	(22,662)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	–	946,582	277,032	2,088
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	7,167,623	11,800,489	(15,364,308)	(115,782)
CASH AND CASH EQUIVALENTS AT BEGINNING OF THE YEAR	5,071,739	12,239,362	24,039,851	181,159
CASH AND CASH EQUIVALENTS AT END OF THE YEAR	¥ 12,239,362	¥ 24,039,851	¥ 8,675,543	$ 65,377
SUPPLEMENTAL DISCLOSURES TO STATEMENT OF CASH FLOWS:				
Cash paid during the year for:				
Income taxes	–	–	–	–
Interest expenses	¥ 198,457	¥ 517,073	¥ 835,473	$ 6,296
Non-cash transactions - additions to capital lease obligations and installment loans for acquisition of property and equipment during the year	¥ 12,089,208	¥ 11,288,511	¥ 12,991,345	$ 97,900

The accompanying notes to consolidated financial statements are an integral part of these statements.

1. Description of Business, Basis of Financial Statements and Summary of Significant Accounting Policies

Business and Organization

Crosswave Communications Inc. (Crosswave) was established on October 28, 1998 as a joint venture among Internet Initiative Japan Inc. (IIJ), Sony Corporation (Sony) and Toyota Motor Corporation (Toyota) for the purpose of operating a nationwide fiber optic network for high-speed, large capacity data communications. Under the joint venture agreement dated January 26, 1999, the ownership interest in Crosswave of IIJ, Sony and Toyota on March 31, 2000 was 40%, 30% and 30%, respectively. On August 4, 2000, Crosswave issued an additional 86,960 shares of common stock, equivalent to 17,392,000 American Depository Shares (ADSs), through an initial public offering (IPO) on National Association of Securities Dealers Automated Quotations (NASDAQ) at $14 per ADS for ¥26,467,146 thousand. Simultaneously with the IPO, Crosswave made a private placement of 15,000 shares, which was equivalent to 3,000,000 ADSs, to IIJ at $14 per ADS for ¥4,565,400 thousand. In December 2000, IIJ purchased an additional 3,000,000 outstanding ADSs of Crosswave. As a result, the ownership interests of the original shareholders as of March 31, 2001 were 37.9% for IIJ, 23.9% for Sony and 23.9% for Toyota.

During the fiscal year ended March 31, 2001, Crosswave established three subsidiaries: Crosswave Facilities Inc. (CWF), Crosswave Services Inc. (CWS) and Crosswave Communications America, Inc. (CWCA). The initial capital investments in these subsidiaries are ¥150,000 thousand and ¥50,000 thousand in cash for CWF and CWS, respectively, and $233 thousand in cash and in an IRU for network capacity valued at $767 thousand for CWCA. Crosswave owns 60% of CWF, which mainly engages in maintenance of telecommunication facilities. CWS, wholly owned by Crosswave, performs customer service functions and other customer related administrative tasks on behalf of Crosswave. CWCA, a US-based corporation, also wholly owned by Crosswave, manages the US-side operations of the US-Japan international fiber optic network.

Crosswave is a Type I Carrier as designated by the Ministry of Public Management, Home Affairs, Posts and Telecommunications of Japan, and is licensed to provide telecommunication services through its own telecommunication network facilities. The telecommunications industry in Japan is highly regulated and therefore regulatory matters could impact the ability of Crosswave and its subsidiaries (collectively the “Company”) to conduct its business.

Crosswave has incurred net losses since inception as it continues to build its network and customer base. The Company intends to fund its future liquidity requirements through capital raising activities and/or funding from other sources including its existing shareholders. If these efforts are not successful, future operations of the Company will be adversely affected.

See Note 15 for a syndicated financing facilities agreement the Company entered into subsequent to the March 31, 2002.

Summary of Significant Accounting Policies

(a) Basis of Financial Statements

The Company maintains its books of accounts in conformity with financial accounting standards of Japan. The financial statements presented herein have been prepared in a manner and reflect certain adjustments which are necessary to conform them with accounting principles generally accepted in the United States of America. The major adjustments include those related to accounting for leases, recognition of certain revenues, depreciation and amortization and accruals for certain expenses.

(b) Consolidation Policy

The consolidated financial statements include the accounts of Crosswave and three of its majority-owned subsidiaries, CWF, CWS and CWCA. All significant intercompany balances and transactions are eliminated in consolidation. Investments in which the Company has less than 20% ownership interest and in which there is no significant influence are accounted for under the cost method of accounting.

(c) Concentration of Risk

The Company is highly dependent on IIJ, its 37.9 % shareholder, not only as its main customer and its main sales agent but also for procurement of equipment and as a source of managerial and technical personnel and expertise. Revenue from IIJ and its subsidiaries and affiliates accounted for 86.2%, 64.4% and 43.2% of total revenue in the years ended March 31, 2000, 2001 and 2002, respectively. See also Note 4 for disclosures of related party transactions.

(d) Translation into U.S. Dollars

The Company 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 at Federal Reserve Bank of New York on March 29, 2002 of ¥132.70 to $1 solely for convenience of readers outside Japan. 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 at the above or any other rate.

(e) Use of Estimates

Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent liabilities to prepare these financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

(f) Revenue Recognition

The Company provides various network services, including high-speed backbone service, wide area Ethernet platform service and dial-up port service, and data center service directly to its customers on a fixed monthly fee basis, as well as through other carriers on a sales commission basis. Revenues from these services are recognized as the services are provided to customers.

Initial set-up fee revenues are deferred and recognized over the estimated average period that the customers are expected to remain connected to the system which the Company provides.

(g) Sources of Data Communication Services

As more fully described in Note 2, the Company relies on other data communication carriers through indefeasible right of use (IRU) contracts in units of capacity of data traffic connections operated by these carriers to provide data communication services to its customers. In addition to the part through such IRU contracts, the Company has its own network and is further building it out by installing fiber optic lines along national roadways into the conduits built by the Ministry of Land, Infrastructure and Transport.

The Company believes that its anticipated use of multiple carriers and its ability to use its own network developments will significantly mitigate concentration of supplier risks in this respect.

Cost of data communication services in the accompanying consolidated statement of operation consists primarily of lease and rental payments for use of data traffic connections.

(h) Loss Per Share

Basic and diluted earning per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding. Dilutive potential common shares are additional common shares from outstanding stock options that are assumed to be exercised. No dilution has resulted from those shares, as the effect is antidilutive.

(i) Cash and Cash Equivalents

Cash and cash equivalents include all highly liquid debt instruments with an initial maturity of three months or less.

(j) Foreign Currency Translation

Purchases denominated in foreign currencies are recorded using the exchange rates in effect as of the transaction dates. The related foreign currency accounts payable balances are restated based on exchange rates prevailing at each balance sheet date with the resulting gain/loss charged to income.

Assets and liabilities of a foreign subsidiary are translated into Japanese yen at the exchange rates in effect at the balance sheet date. Revenue and expense accounts are translated at average exchange rates during the current year. The resulting translation adjustments are included in other comprehensive income.

(k) Property and Equipment

Property and equipment are stated at cost. Equipment under capital leases is stated at the present value of minimum lease payments. Depreciation and amortization of property and equipment, including purchased software, is computed on a straight-line method using the following estimated useful lives.

Data communication equipment	3-30 years
Purchased software	5
Leasehold improvements	38 or 50
Other equipment	3-15

Property under capital lease, including certain IRUs, is depreciated on a straight-line basis over the shorter of the lease term or estimated useful life of the asset.

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 other income or expenses.

(l) Capitalized Internal Use Software Costs

Under the provisions of Statement of Position (“SOP”) 98-1, “Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,” the Company has capitalized costs associated with software systems for internal use, that have reached the application stage and meet recoverability tests, as Purchased software within Property and Equipment in the accompanying consolidated balance sheets. Such capitalized costs primarily include external direct costs utilized in developing or obtaining the applications. Capitalization of such costs ceases at the point in which the project is substantially complete and ready for its intended use, and the costs capitalized are depreciated on a straight-line basis over the estimated useful life of each application.

(m) IRU Contracts

The Company has entered into various IRU contracts with data communication carriers for network data transmission capacity. Accounting for each IRU is based on whether it is a service contract or a lease under Statement of Financial Accounting Standards (SFAS) No.13 “Accounting for Leases.” The Company has determined based on current industry practices and interpretations that each of its IRUs qualifies as a lease. Further classifications have been made as either an operating lease or a capital lease in accordance with the established criteria.

(n) Capital Leases

All leased property, including certain IRUs, meeting specified criteria under SFAS No. 13 are capitalized as property and equipment based on the present value of the future minimum lease payments.

(o) Long-Lived Assets

The Company's long-lived assets, primarily consisting of property and equipment and IRUs, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows (undiscounted and without interest charges) expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. There was no impairment loss for long-lived assets for the years ended March 31, 2000, 2001 and 2002.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed of and supercedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of", and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30 for the disposal of a business. The Company will adopt SFAS No. 144 on April 1, 2002 and does not expect that the adoption will have a material effect on the results of operations, financial position or cash flows.

(p) Derivative Financial Instruments

Effective April 1, 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 requires that all derivative instruments be reported on the balance sheet as either assets or liabilities measured at fair value. For derivative instruments designated and effective as fair value hedges, changes in the fair value of the derivative instrument and of the hedged item attributable to the hedged risk are recognized in earnings. For derivative instruments designated as cash flow hedges, the effective portion of any hedge is reported in other comprehensive income until it is recognized in earnings in the same period in which the hedged item affects earnings. The ineffective portion of all hedges will be recognized in current earnings each period. Changes in fair value of derivative instruments that are not designated as a hedge will be recorded each period in current earnings. There was no derivative instrument employed by the Company as of March 31, 2002. The Company has had a limited use of forward exchange contracts and there was no derivative financial instruments employed at March 31, 2002.

(q) Retirement and Pension Plan

Crosswave has unfunded retirement benefits and non-contributory defined benefit pension plans which together cover substantially all of its employees who are not directors. These plans are accounted for in accordance with SFAS No. 87, "Employers' Accounting for Pensions."

(r) Income Taxes

Income taxes are provided based on income for financial reporting purposes. Deferred income taxes are recognized under the asset and liability method for the estimated future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Valuation allowances are provided against assets which are not likely to be realized.

(s) Stock-Based Compensation

The Company accounts for its employee stock option plan under the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25 "Accounting for Stock Issued to Employees."

(t) Other Comprehensive Income

Other comprehensive income consists of the translation adjustment resulting from the translation of financial statements of a foreign subsidiary.

(u) Segment information

To date, as presented in the accompanying consolidated financial statements, the Company has managed its business and measured results based on a single data communication services operating segment with substantially all its facilities located in Japan.

(v) Advertising expense

Advertising expense is charged to income as incurred.

(w) Reclassification

Certain amounts for previous periods were reclassified to conform with the presentation of the year ended March 31, 2002.

(x) New Accounting Standards

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." The standard requires that obligations associated with the retirement of tangible long-lived assets be recorded as liabilities when those obligations are incurred, with the amount of the liability initially measured at fair value. The associated asset retirement costs are capitalized as a part of the carrying amount of the long-lived asset. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company will adopt on April 1, 2003 and does not expect that the adoption will have a material effect on the results of operations, financial position or cash flows.

2. IRU Contracts With Carriers

Significant IRU contracts that the Company has entered into are as follows:

On November 30, 1998, the Company entered into a contract with KDDI to purchase an IRU in units of capacity of a nationwide network of dark fiber in Japan for 10 years commencing from May 1999 through March 2009, which was then amended on March 15, 2002 with regard to the amounts of lease payments under the contract effective April 2002. Under this contract, as amended, the Company is obliged to make lease payments and maintenance fees to KDDI for the use of dark fiber. The contract is accounted for as an operating lease based on the criteria set forth in SFAS No. 13, "Accounting for Leases." The lease and maintenance expense is recognized on a straight-line basis over the term of the contract and the differences between such expenses and actual cash payments that fluctuate over the lease term are recorded as accrued expenses in the accompanying consolidated balance sheets. Lease expense under this operating lease amounted to ¥3,137,787 thousand, ¥3,501,215 thousand and ¥3,657,196 thousand ($27,560 thousand) for the years ended March 31, 2000, 2001 and 2002, respectively. It was included in cost of data communication services in the accompanying consolidated statements of operations.

On October 8, 1999, the Company entered into a contract with Pacific Gateway Exchange (PGE) to purchase an IRU in units of dedicated capacity of an international data traffic connection on fiber optic lines between Japan and the United States for 20 years for $25,920 thousand, and made a prepaid contract fee of $1,296 thousand, which is included in deposits and other assets in the accompanying consolidated balance sheet as of March 31, 2000. During the fiscal year ended March 31, 2001, the Company canceled the contract and negotiated with PGE for the refund of the contract prepayment. Subsequently on December 29, 2000, PGE filed a voluntary petition under Chapter 11 of Title 11 of the United States Code in the United States Bankruptcy Court of the Northern District of California. As a result, the Company fully reserved the ¥160,574 thousand ($1,296 thousand) of the contract prepayment as of March 31, 2001 and 2002, and the related expenses are accrued and included in other expenses in the accompanying consolidated statement of operation for the year ended March 31, 2001.

On March 28, 2000, the Company also entered into a contract with Global Crossing to purchase an IRU in units of dedicated capacity of an international data traffic connection on fiber optic lines between Japan and the United States for the period from March, 2000 through December 2023, for the total contract price of $25,000 thousand. The Company paid the initial contract fee of $6,250 thousand (25% of the total contract price) upon signing of the contract in March 2000 and the remaining contract fee of $18,750 thousand in March 2001 in accordance with the payment schedule set forth in the contract. The contract is accounted for as a capital lease based on the criteria set forth in SFAS No. 13, and is recorded in property and equipment as a capitalized lease in the accompanying consolidated balance sheets. It is being depreciated on a straight-line basis over the contract term. The contract requires the Company to pay an annual maintenance fee of $150,000 per minimum capacity unit.

On March 31, 2000, Global Crossing assigned and transferred all of its rights and obligations under the contract dated as of March 28, 2000 to Asia Global Crossing, which was a subsidiary of Global Crossing.

According to the IRU contract with Asia Global Crossing, the Company activated five capacity units between Japan and the United States in the year ended March 31, 2000 and additional five in the year ended March 31, 2002. The contract requires the Company to pay an annual maintenance fee of $150,000 per minimum capacity unit for the ten units, totaling $1,500,000.

The maintenance fee will be reduced by 2% per year after 3 years from activation of the capacity units in accordance with the contract, which will reduce the total minimal maintenance fee by $30,000 per year.

3. Investment in Joint Venture

The Company has acquired various investments in joint venture as follows:

Company name	Initial Acquisition Date	Ownership Percentage	Carrying Amount in Original Currency	Carrying Value (Thousands of Yen)
SKIP City Corporation (Saitama Japan)	Feb., 2000	5.13%	¥10,000 thousand	¥10,000
i-Heart, Inc.(Seoul, Korea)	Jun., 2000	3.17%	100,000,000 Won	¥ 9,890
Ayalaport Makati, Inc. (Manila, Philippines)	Oct., 2000	13.97%	37,400,000 Peso	¥ 82,404

Those investments with less than 20% ownership interest have been accounted for using the cost method of accounting and included in Deposits and other assets in the accompanying consolidated balance sheets.

Under the joint venture agreement related to SKIP City Corporation, an additional contribution is scheduled in February 2003, which ultimately decreases the Company’s share in the joint venture to 2.02%

On August 31, 2001, the Company and the other shareholders entered into a credit agreement to commit shareholder loans of up to 69,205 thousand Philippine Peso (¥181,317 thousand) aggregately, for operating and capital expenditure requirements of Ayalaport Makati, Inc. Interest rate under the agreement is 8.5% per annum, compounded monthly and each loan matures six months after the date of loan execution. The Company made loans of ¥10,763 thousand ($81 thousand) on December 14, 2001 and ¥14,065 thousand ($106 thousand) on January 31, 2002.

4. Related Party Transactions

Summarized below are significant transactions with related parities for the years ended March 31, 2000, 2001 and 2002, and the related transaction balances as of March 31, 2001 and 2002.

	Thousands of Yen		
2000:	IIJ and its subsidiaries/ affiliates	Sony and its subsidiaries/ affiliates	Toyota and its subsidiaries/ affiliates
Transactions			
Revenue	¥ 199,914	¥ 12,555	¥ 1,701
Purchases of property	1,378,677	–	–
Operating costs and expenses	344,845	357,330	30,434

	Thousands of Yen		
2001:	IIJ and its subsidiaries/ affiliates	Sony and its subsidiaries/ affiliates	Toyota and its subsidiaries/ affiliates
Transactions			
Revenue	¥ 1,693,696	¥ 273,396	¥ 4,911
Purchases of property	538,141	–	14,000
Operating costs and expenses	550,007	49,909	53,258
Balances:			
Accounts receivable	326,528	54,097	1,411
Accounts payable	230,242	2,991	4,094

	Thousands of Yen		
2002:	IIJ and its subsidiaries/ affiliates	Sony and its subsidiaries/ affiliates	Toyota and its subsidiaries/ affiliates
Transactions			
Revenue	¥ 4,101,178	¥ 1,219,093	¥ 46,851
Purchases of property	2,435,025	5,601	4,500
Operating costs and expenses	1,111,213	92,117	52,576
Additions to capital lease obligations for acquisition of property	–	448,938	–
Principal payments under capital lease obligations	–	41,463	–
Interest expenses	–	7,606	–
Balances:			
Accounts receivable	526,290	257,384	12,320
Accounts payable and Accrued expenses	875,007	2,442	3,954
Capital lease obligations	–	407,475	–

	Thousands of U.S. Dollars		
2002:	IIJ and subsidiaries/ affiliates	Sony and subsidiaries/ affiliates	Toyota and its subsidiaries/ affiliates
Transactions			
Revenue	$ 30,906	$ 9,187	$ 353
Purchases of property	18,350	42	34
Operating costs and expenses	8,374	694	396
Additions to capital lease obligations for acquisition of property	−	3,383	−
Principal payments under capital lease obligations	−	312	−
Interest expenses	−	57	−
Balances:			
Accounts receivable	3,966	1,940	93
Accounts payable and Accrued expenses	6,594	18	30
Capital lease obligations	−	3,071	−

The Company has management service agreements with IIJ, Sony and Toyota under which directors, managerial and technical employees are seconded from these shareholders to the Company, whose services are charged as service fees to the Company based principally on their payroll costs. Operating costs and expenses presented in the table above included service fees paid for such services to IIJ, Sony and Toyota totaling ¥301,335 thousand, ¥27,653 thousand and ¥30,256 thousand, respectively, for the year ended March 31, 2000, ¥478,286 thousand, ¥43,160 thousand and ¥52,145 thousand, respectively, for the year ended March 31, 2001 and ¥772,199 thousand ($5,819 thousand), ¥ 39,835 thousand ($300 thousand) and ¥ 50,261 thousand ($379 thousand), respectively, for the year ended March 31, 2002.

During the year ended March 31, 2000, the Company paid Intervision Inc., a subsidiary of Sony, ¥317,852 thousand for advertising and promotion services provided by Intervision Inc., which is included in operating costs and expenses in the table above.

5. Property and Equipment

Property and equipment at March 31, 2001 and 2002 consisted of the following:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Property and equipment, at cost:			
Capitalized leases, primarily data communication equipment	¥ 16,233,830	¥ 28,826,179	$ 217,228
Data communication equipment	3,452,584	6,862,000	51,711
Purchased software	390,591	391,536	2,951
Land	8,000,032	8,000,032	60,287
Leasehold improvements and other equipment	334,528	373,592	2,815
Construction in progress	6,051,795	10,832,440	81,631
	34,463,360	55,285,779	416,623
Less: accumulated depreciation	(3,095,351)	(6,686,480)	(50,388)
Property and equipment, net	¥ 31,368,009	¥ 48,599,299	$ 366,235

6. Leases

The Company uses fiber optic lines and occupies conduits where the Company installs its own fiber optic lines under non-cancelable lease contracts. The Company also uses various data communication equipment, including DWDM and SONET, under capital lease contracts. The Company is obliged to make lease payments under such lease contracts, which expire at various dates during the next nineteen years.

At March 31, 2001 and 2002, the gross amount of equipment and related accumulated depreciation recorded under capital leases were as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Capitalized leases, primarily data communication equipment	¥ 16,233,830	¥ 28,826,179	$ 217,228
Less accumulated depreciation	(2,816,321)	(5,968,309)	(44,976)
	¥ 13,417,509	¥ 22,857,870	$ 172,252

Depreciation of assets under capital leases is included in depreciation and amortization expense in the accompanying consolidated statements of operations.

Future minimum lease payments under capital leases and non-cancelable operating leases as of March 31, 2002 are as follows:

	Thousands of Yen		Thousands of U.S. Dollars	
Year ending March 31,	Capital Leases	Operating Leases	Capital Leases	Operating Leases
2003	¥ 4,745,655	¥ 755,334	$ 35,762	$ 5,692
2004	4,711,678	634,972	35,506	4,785
2005	4,672,607	554,012	35,212	4,175
2006	4,767,980	546,631	35,930	4,119
2007	2,545,026	525,890	19,179	3,963
2008 and thereafter	2,148,120	2,787,758	16,188	21,008
Total minimum lease payments	23,591,066	¥ 5,804,597	177,777	$ 43,742
Less amount representing interest (rates ranging from 1.65% to 7.44%)	(2,773,345)		(20,899)	
Present value of net minimum payments	20,817,721		156,878	
Less Current potion	(3,814,719)		(28,747)	
Non current	¥17,003,002		$ 128,131	

The Company purchased data communication equipment totaling ¥2,578,720 thousand and ¥12,302,815 thousand ($92,711 thousand) which was in turn sold to leasing companies and leased back as a capital lease during the years ended March 31, 2001 and 2002, respectively. Such equipment was included in capital leases described above. There was no gain or loss realized from these sale and lease back transactions.

As explained in Note 2, the Company is obliged under a non-cancelable IRU contract with KDDI accounted for as an operating lease. As of March 31, 2002, future minimum lease payments under this operating lease contract and maintenance fees under the related non-cancelable maintenance service contract are as follows:

	Thousands of Yen		Thousands of U.S. Dollars	
Year ending March 31,	Lease	Maintenance	Lease	Maintenance
2003	¥ 3,450,000	¥ 1,050,000	$ 25,999	$ 7,913
2004	3,950,000	1,050,000	29,766	7,913
2005	5,450,000	1,050,000	41,070	7,913
2006	6,061,000	1,050,000	45,674	7,913
2007	6,061,000	1,050,000	45,674	7,913
2008 and thereafter	12,122,000	2,100,000	91,349	15,823
Total minimum payments	¥37,094,000	¥ 7,350,000	$ 279,532	$ 55,388

The Company occupies offices and other facilities and uses certain equipment under cancelable lease arrangements. Rental expenses for such cancelable leases totaled ¥336,510 thousand, ¥830,976 thousand and ¥1,235,877 thousand ($9,313 thousand), respectively for the years ended March 31, 2000, 2001 and 2002.

7. Long-term Debt

Long-term debt at March 31, 2001 and 2002 are as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Long-term installments payable for the purchases of data communication equipment, with interest rate of 4.36%, secured by the equipment, due the years ending March, 2002-2007	¥ 1,484,130	¥ 1,248,101	$ 9,406
Long-term installments payable for the purchases of data communication equipment, with interest rate ranging from 3.93% to 4.39%, secured by the equipment, due the years ending March, 2002-2008	–	562,410	4,238
Long-term installments payable for the purchase of land with interest rate 2.85%, secured by the land, and matures in August 2010	6,400,025	6,400,025	48,229
Total long-term debt	7,884,155	8,210,536	61,873
Less current portion	(236,028)	(340,672)	(2,567)
	¥ 7,648,127	¥ 7,869,864	$ 59,306

The schedule of the future principal payment is as follows:

Year ending March 31,	Thousands of Yen	Thousands of U.S. Dollars
2003	¥ 340,672	$ 2,567
2004	355,637	2,680
2005	371,260	2,798
2006	986,927	7,437
2007	1,531,382	11,540
2008 and thereafter	4,624,658	34,851
Total	¥ 8,210,536	$ 61,873

On September 29, 2000, the Company entered into a long-term installment loan to purchase land located in Yokohama, Kanagawa prefecture, Japan. The total principal of the loan is ¥8,000,032 thousand with interest rate of 2.85%, ¥1,600,006 thousand of which was paid as an initial down payment upon the inception of the loan. The principal is payable in ten semi-annual installments commencing from February 2006 after the payments of interest over the first five years. The installment loan is secured by the land where the construction of a data center is currently in progress.

The Company incurred interest expense totaling ¥669,013 thousand and ¥835,169 thousand ($6,294 thousand) in the years ended March 31, 2001 and 2002, respectively, of which ¥91,591 thousand and ¥182,400 thousand ($1,375 thousand), respectively, were capitalized as cost of the related construction.

8. Employee Retirement and Pension Plans

On April 1, 2000, the Company established an unfunded defined benefits pension plan and a severance indemnity plan. Under these plans, all of the Company's employees are entitled, upon voluntary retirement after 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 payroll at the time of retirement, length of service and certain other factors. The Company's employees who do not meet these conditions are entitled to lump-sum severance indemnities.

Net periodic pension cost for the year ended March 31, 2001 and 2002 included the following components:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Service cost	¥ 14,759	¥ 28,335	$ 214
Interest cost	121	442	3
Expected return on plan assets	–	–	–
Net amortization and deferral	–	358	3
Net periodic cost	¥ 14,880	¥ 29,135	$ 220

The funded status as of March 31, 2001 and 2002 is as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Change in benefit obligation:			
Benefit obligation, beginning of year	¥ –	¥ 22,108	$ 167
Service cost	14,759	28,335	214
Interest cost	121	442	3
Actuarial loss	7,228	19,041	143
Benefit paid	–	–	–
Benefit obligation, end of year	22,108	69,926	527
Funded status	(22,108)	(69,926)	(527)
Unrecognized net loss	7,228	25,911	195
Net amount recognized	¥ (14,880)	¥ (44,015)	$ (332)

Actuarial assumption as of March 31:	2001	2002
Weighted-average discount rate	2%	2%
Rate of increase in future compensation levels	3%	3%
Expected long-term rate of return on plan assets	–	–

The accrued pension liability of ¥14,880 thousand and ¥44,015 thousand ($332 thousand) is included in other liabilities in the accompanying consolidated balance sheet as of March 31, 2001 and 2002, respectively.

9. Income Taxes

The Company is subject to national, municipal and local taxes in Japan based on income. Deferred income taxes were principally calculated at the rate of 42%.

The effects of temporary differences that give rise to deferred tax assets and liabilities at March 31, 2001 and 2002 are as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Deferred tax assets:			
Net operating loss carryforwards	¥ 5,542,131	¥ 10,247,210	$ 77,221
Accrued expenses	2,229,758	2,872,780	21,648
Other current liabilities	19,756	251,658	1,896
Lease obligation	134,084	235,912	1,778
Depreciation	44,976	44,976	339
Other	20,131	33,670	254
Total gross deferred tax assets	7,990,836	13,686,206	103,136
Less valuation allowance	(7,833,293)	(13,393,142)	(100,928)
Deferred tax assets	157,543	293,064	2,208
Deferred tax liabilities:			
Stock issuance cost	118,763	176,156	1,327
Capitalized interest	38,468	115,076	867
Other	312	1,832	14
Total gross deferred tax liabilities	157,543	293,064	2,208
Net deferred tax assets	¥ –	¥ –	$ –

Because of the uncertainty in realization of the future tax benefits, the net deferred tax assets at March 31, 2001 and 2002 are fully offset by a valuation allowance.

At March 31, 2002, the Company had net operating loss carryforwards for income tax purposes of ¥24,398,119 thousand ($183,859 thousand) which were available to offset future taxable income as follows.

Expiring in the year ending March 31,	Thousands of Yen	Thousands of U.S. Dollars
2003	¥ –	$ –
2004	–	–
2005	128,552	969
2006	4,966,749	37,428
2007	8,005,611	60,329
2008 and thereafter	11,297,207	85,133
Total	¥ 24,398,119	$ 183,859

10. Shareholders' Equity

Under the Japanese Commercial Code (the "Code"), the amount available for dividends is based on retained earnings as recorded on the books of account maintained in conformity with accounting principals and practices generally accepted in Japan ("Japanese GAAP"). At March 31, 2002, the accumulated deficit recorded on Crosswave's books of account under Japanese GAAP was ¥24,624,110 thousand ($185,562 thousand), and therefore no dividends may be paid at the present time.

Under the Code, at least 50 percent of the issue price of new shares is required to be designated as stated capital. The portion which is to be designated as stated capital is determined by resolution of the Board of Directors. Proceeds in excess of the amounts designated as stated capital, as reduced by stock issuance costs less the applicable tax benefits, are credited to additional paid-in capital.

Effective October 2001, the Code has no longer required minimum par value of share issued. The par value description on the Company's consolidated balance sheets has changed to "no par" accordingly.

On May 11, 2000, a decrease in the number of authorized shares from 1,600,000 to 600,000 was approved at the shareholders meeting.

11. Employee Stock Options

In August 2000, the Company established stock option plans under which employees and directors may be granted options to purchase common stock. Options are generally granted at not less than the fair market value at the grant date, vested over two-year period, and expire in ten years after the grant date.

A summary of option transactions under the plans is as follows:

	Number of shares	Weighted Average Exercise Price
Outstanding, April 1 2000	–	–
Granted	3,800	¥ 318,578
Outstanding, April 1, 2001	3,800	318,578
Granted	2,225	34,190
Outstanding, March 31 2002	6,025	¥ 213,555

For the total 6,025 outstanding shares as of March 31, 2002, the weighted average remaining contractual life is eight years, and no share is reserved.

The Company has accounted for these stock options granted under APB No. 25, "Accounting for Certain Transactions Involving Stock Compensation." There has been no compensation costs recorded, as there was no intrinsic value to the options at the date of grant.

Impact of compensations costs, had the Company elected to recognize compensation costs based on the fair value method according to the provisions of SFAS No. 123, on the Company's net income and earnings per common share would have been insignificant.

12. Other Comprehensive Income

The changes in each component of other comprehensive income for the years ended March 31, 2000, 2001 and 2002 are as follows:

	Thousands of Yen			Thousands of U.S. Dollars
	2000	2001	2002	2002
Accumulated other comprehensive income, beginning of the year:	¥ –	¥ –	¥ 632	$ 5
Foreign currency translation adjustments, net of tax	–	632	2,943	22
Accumulated other comprehensive income, end of the year:	¥ –	¥ 632	¥ 3,575	$ 27

Accumulated other comprehensive income as of March 31, 2001 and 2002 represent translation adjustments in the amount of ¥632 thousand and ¥3,575 thousand ($27 thousand), respectively.

13. Fair Value of Financial Instruments

For financial instruments other than capital lease obligations and long-term debt, the carrying amount approximates fair value because of the short maturity of these instruments. Based on the borrowing rates currently available to the Company for bank loans with similar terms and average maturities, the fair value of capital lease obligations and long-term debt at March 31, 2001 and 2002 are as follows:

	Thousands of Yen		Thousands of U.S. Dollars
	2001	2002	2002
Capital lease obligations	¥11,764,087	¥21,859,848	$ 164,731
Long-term debt	9,450,043	8,120,207	61,192

14. Commitments

For the network construction, the Company has placed firm orders to purchase related materials and equipment amounting to approximately ¥12.9 billion ($97.1 million) as of March 31, 2002.

15. Subsequent event

On May 21, 2002, the Company entered into a syndicated financing facilities agreement ("Agreement") with four Japanese commercial banks for the total amount of ¥20 billion. The Agreement consists of six-year long-term loans of up to ¥15 billion ("Tranche A") and a short-term line of credit up to ¥5 billion ("Tranche B").

Tranche A is secured by substantially all assets of the Company and is limited for the purposes of project costs including capital expenditures for network and data center construction and other operating expenses as defined in the Agreement. Tranche A can be drawn down as necessary over the first two-year period according to the mutually agreed business plan, if the Company could meet certain predetermined quantitative thresholds. Such thresholds are set based on the mutually agreed business plan in terms of cumulative sales amount, cumulative number of customers, and cumulative operating income/loss before depreciation and amortization, and are monitored by the banks for the purpose of determining the amount of draw down available. Tranche A loans bear interest at TIBOR (Tokyo Interbank Offered Rate) plus 2.95% per annum and would be repaid in eight equal semi-annual installments commencing from October 2004.

Tranche B is available for operating purposes and can be drawn up to the amount of outstanding accounts receivable balance for a maximum of three months during the contract period. Tranche B bears interest at the short-term prime rate plus 0.3% per annum.

The Agreement requires the Company to maintain project accounts with the agent bank in which all cash receipts of the Company need to be deposited during the term of financing. Withdrawals from such accounts are restricted for the Company's operational purposes only and require the banks' approval.

Financial covenants include sales amounts set based on the mutually agreed business plan during the six-year period of the financing, as well as debt-equity ratio and debt-service coverage ratio. Those financial covenants and the quantitative thresholds for Tranche A draw down are set and monitored based on accounting principles generally accepted in Japan for the Company on an only parent company basis. Technical defaults on these financial covenants may cause the banks to demand payback of the loans.

On May 21, 2002, in connection with the financing, IIJ entered into a Cash Deficiency Support Agreement ("CDS Agreement") with the Company and the bank consortium. In accordance with the provisions of the CDS Agreement, IIJ deposited ¥5 billion into a restricted account with a participating bank at the end of May 2002. Under the terms of the CDS Agreement, the deposited cash will be restricted over the period in which the loans are outstanding and may only be used for debt service in the event the Company is otherwise unable to meet scheduled payments under the Agreement. IIJ is not liable under the terms of the CDS Agreement for any amounts in addition to the ¥5 billion. Any restricted cash withdrawn under the CDS Agreement will result in a corresponding unsecured funding to the Company by IIJ that will be subordinate to the loans outstanding under the Agreement. The CDS Agreement provides that any such funding between the Company and IIJ may be invested, based on the outcome of future negotiations as loans, bonds or equity of the Company.

In connection with the financing, the Company has granted stock acquisition rights to the bank consortium and IIJ for a consideration. These granted stock acquisition rights are exercisable for a period from June 6, 2002 to May 31, 2009 at an exercise price of $1.50 per ADS, which represents a 50% premium over the closing market price of the Company's ADSs as of May 9, 2002, for an aggregate of 30,000 common shares of the Company's common stock, equivalent to 6,000,000 ADSs. These stock acquisition rights may be exercised to result in dilution to the other shareholders of their share ownership percentages.

CROSSWAVE COMMUNICATIONS INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS SCHEDULE

For the years ended March 31, 2000, 2001 and 2002

SCHEDULE II – VALUATION AND QUALIFYING ACCOUNTS

	Thousands of Yen			
	Balance at Beginning of year	Additions	Deductions	Balance at End of year
2000				
Allowance for doubtful accounts	¥ –	¥ 150	¥ –	¥ 150
2001				
Allowance for doubtful accounts	150	1,848	150	1,848
Allowance for uncollectible contract prepayment	–	160,574	–	160,574
2002				
Allowance for doubtful accounts	1,848	25,384	1,848	25,384
Allowance for uncollectible contract prepayment	160,574	–	–	160,574

	Thousands of U.S. Dollars			
	Balance at Beginning of the year	Additions	Deductions	Balance at End of the year
2002				
Allowance for doubtful accounts	$ 14	$ 191	$ 14	$ 191
Allowance for uncollectible contract prepayment	1,296	–	–	1,296