SEGA Enterprises, Ltd.

Annual Report 1998

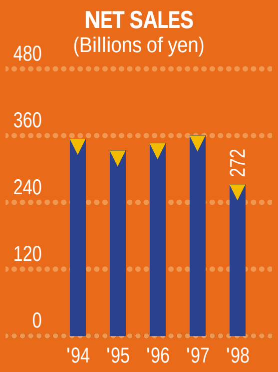
Year ended March 31, 1998

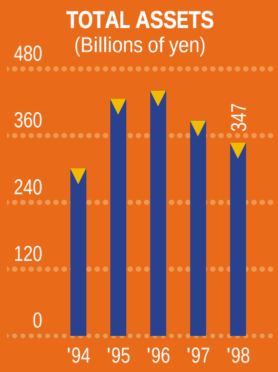
Dreamcast

SEGA proudly unveils the ultimate digital entertainment machine—Dreamcast. The product of an unprecedented technological partnership with major computer and media corporations, Dreamcast offers total system performance that tops not only all existing video game consoles, but all consumer entertainment devices, period. Dreamcast delivers what video game enthusiasts really want—an experience that looks and sounds totally real.

What's Important to SEGA

WHAT'S IMPORTANT TO SEGA?





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Realization!

Shoichiro Irimajiri
Representative Director and President

BUSINESS RESULTS

In fiscal 1998, non-consolidated net sales fell ¥88.5 billion, or 24.6%, to ¥271.5 billion (US$2,055.1 million), and recurring income amounted to ¥11.0 billion (US$83.5 million). However, due to substantial special losses, the Company posted a net loss for the year of ¥43.3 billion (US$327.8 million), compared with net income of ¥5.6 billion in fiscal 1997.

By business segment, net sales from amusement center operations climbed ¥2.8 billion, or 3.1%, to ¥91.0 billion (US$688.6 million), amusement machine sales edged up ¥3.6 billion, or 3.7%, to ¥101.9 billion (US$771.3 million), and consumer product sales sank ¥90.0 billion, or 54.8%, to ¥74.4 billion (US$563.0 million). Royalties on game software decreased ¥4.9 billion, or 53.3%, to ¥4.2 billion (US$32.2 million).

The Company maintained cash dividends applicable to the year of ¥38.0 (US$0.29) per share, comprising an interim dividend of ¥15.0 (US$0.11), a regular dividend of ¥15.0 (US$0.11), and a special dividend of ¥8.0 (US$0.06).

ANALYSIS

In fiscal 1998, the year ended March 31, 1998, the Japanese economy neared a state of full-scale recession. The slump in personal consumption took root as a long-term phenomenon due to the April 1997 rise in the national consumption tax rate and the abolition of special income tax breaks that were implemented at the beginning of the term. In the second half of the term, the economies of several Southeast Asian nations fell into disorder, while the financial system in Japan grew increasingly unstable and the first signs of a deflationary spiral appeared.

In the amusement industry, certain products—notably Print Club photo-sticker booths—enjoyed hit status, but on the whole the market continued to be stagnant amid the aforementioned slump in personal consumption.

Amid this operating environment, SEGA Enterprises, Ltd., put high priority on profitability in its consumer product operations. Focusing on the Japanese market, we offered new software titles with strong consumer appeal. However, sales in overseas markets deteriorated, and, as a result, net consumer product sales dropped substantially. Meanwhile, the Company developed and launched new amusement machines featuring the latest high-end technology and opened large-scale, innovative amusement facilities. Consequently, net sales from amusement machines and amusement center operations gained somewhat compared with those in the previous fiscal year.

However, SEGA also took aggressive steps during the year to dispose of unprofitable assets, including writing off inventories in preparation for the launch of the Company's new home video game console, Dreamcast. Moreover, the Company made substantial write-downs of investments in and advances to its subsidiaries SEGA of America, Inc., and SEGA Ozisoft Pty. Ltd., in consideration of their financial conditions. As a result, SEGA posted special losses for the term of ¥42.8 billion (US$323.8 million).

On a consolidated basis, net sales for fiscal 1998 amounted to ¥331.6 billion (US$2,510.3 million). The Company recorded a net loss of ¥35.6 billion (US$269.8 million).

What's Important to SEGA?

Vision!

The explosive growth of the information technology (IT) industry in recent years has changed society as well as the business world. SEGA believes its rightful place in the 21st century is as a leader in interactive digital entertainment. In our opinion, video games—a synergetic fusion of entertainment, interactivity, and cutting-edge technology—hold extraordinary potential to enable us to become the leading influence of the whole IT industry.

SEGA'S CORE COMPETENCE

SEGA's core competence—the capability it can apply throughout all its operations—is its creativity in using digital technology. However, creativity is useless if it is not pointed in a clear direction and can even be detrimental if pointed in the wrong direction. We attribute our success thus far to the skillful and correct use of creativity.

In concrete terms, this core competence is manifested in the following ways:

- The highest level of R&D in the video game industry, in terms of both quality and quantity
- Synergetic development of low-cost printed circuit boards for arcade and home-use machines
- Business operations encompassing both hardware and software

We have always sought to secure and maintain the No. 1 position in the industry, and these strengths are the tools that will help us achieve this goal.

THE LESSONS

In fiscal 1998, SEGA posted special losses of ¥42.8 billion, which contributed to the Company's first net loss since becoming a publicly traded company.

In the U.S. home video game market, SEGA's performance has slumped, squeezed by intense price competition among 32-bit machines. The 16-bit SegaGenesis, predecessor to the 32-bit SegaSaturn, contributed greatly to our spectacular business results from fiscal 1992 to fiscal 1994 and helped boost name recognition of the SEGA brand throughout the world. In hindsight, however, it was the very success of SegaGenesis in the U.S. market that ultimately resulted in the Company's net loss in fiscal 1998. We placed too much emphasis on the then existing market and formulated what turned out to be an ineffective strategy for making the transition from the 16-bit SegaGenesis to the 32-bit SegaSaturn. In a sense, we became trapped by our own success.

Moreover, in recent years the operating environment has changed radically. With the maturation of the video game industry, the market, our competitors, and our customers' desires have all changed.

Given the current business climate, securing and maintaining the No. 1 position in the consumer video game market will be a formidable challenge. However, now that we have a renewed awareness of market desires and the proper technology mix, if we fully harness our core competence—creativity in using digital technology—the No. 1 position will be well within our grasp.

As a leading company in amusement operations—comprising our amusement center and amusement machine businesses—SEGA has been one of the industry's driving forces. In Japan, however, the current market can hardly be called robust; the ongoing economic slump has chilled consumer spending tremendously, and, aside from Print Club photo-sticker booths, there have been few hit products to breathe new life into the market. Although SEGA holds a commanding market share, it is clear that, unless something changes, the market as a whole will shrink. What SEGA needs in order to create new markets and revitalize existing ones is a system for developing innovative new products and business formats as well as creating new businesses.

Ten years have passed since SEGA was first listed on the Second Section of the Tokyo Stock Exchange. During this time, SEGA has been at the forefront of the digital technology revolution and has thus achieved impressive growth.

In recent years, however, our overseas consumer product sales have stagnated, and our once rapidly advancing amusement operations have slowed down.

As we have outlined in this report, we have thoroughly reviewed our past successes and shortfalls and have taken some painful but necessary measures, including recognizing ¥42.8 billion in special losses. In response, we have established a new medium-to-long-term management plan that will revamp our corporate structure from top to bottom, including our business spheres, methods, philosophy, systems, and organization.

Now we would like to show you why we at SEGA are extremely excited about the future. We invite you to turn the page and discover our new 128-bit home video game console—Dreamcast.

What's Important to SEGA?

Dreamcast!

THE DREAM

Fall 1998 will be the dawn of a brilliant new era in home video game consoles as SEGA unveils the ultimate digital entertainment machine—Dreamcast. With 128-bit performance powered by a reduced instruction set computing (RISC) central processor, an independent 3-D graphics engine, and a dedicated 3-D sound chip, Dreamcast achieves a level of total system performance that surpasses not only all other home video game consoles but also all other consumer entertainment products, period. Dreamcast is designed to appeal to hard-core gamers, as well as casual gamers and people who have never enjoyed interactive entertainment, through games that look and sound totally authentic, with lifelike surroundings in which objects obey the laws of physics.

It took an unprecedented technological alliance to create an unprecedented gaming experience. SEGA chose business partners who are global leaders in their respective technological fields—Microsoft Corporation, Hitachi, Ltd., NEC Corporation, VideoLogic Inc., and Yamaha Corporation—and worked closely with each of them to enhance their technologies. SEGA then seamlessly integrated the resultant high-performance components in Dreamcast.

The ultimate result is the most authentic 3-D gaming experience ever conceived, supported by groundbreaking gaming components that are sure to change the face of the video game industry. Engrossing 3-D graphics, with polygon counts topping three million per second, are further brought to life through Dreamcast's dedicated real-time 3-D sound processor, surrounding the player with 64 channels of music, voices, and other sound effects.

Yet another revolutionary feature of Dreamcast is the Visual Memory System (VMS), a combination memory card and portable game card with a built-in LCD screen. Plugged into the Dreamcast controller, the LCD screen lets players set up secret moves against their opponents, thus adding an element of customization. Unplugged, the VMS card turns into a business-card-sized portable electronic game card, complete with controller buttons. Users can also save game features, such as user-created players, and share them with friends by linking two VMS cards together.

Dreamcast will be launched in Japan in fall 1998 and in North America and Europe in fall 1999. Prior to each debut, SEGA will launch a marketing blitz on a scale unprecedented in the video game industry. SEGA has enlisted prestigious advertising industry heavyweights in both Japan and North America to produce unforgettable advertising, sales promotions, event marketing, and retail merchandising. The campaign will be comprehensive to generate strong consumer enthusiasm at all levels and will be targeted specifically toward key demographic segments.

Dreamcast is driven by two overall goals—to deliver the best gaming experience the industry has ever seen through the most

versatile console ever and to win back the No. 1 position in the home video game console category. In quantitative terms, our goal is to capture more than 50% of the next-generation home-gaming market. In other words, we are aiming to blow away not only video game players but also video game industry competitors.

THE TEAM

SEGA has joined forces with global leaders in business and technology to create an optimal architecture for breakthrough system performance, a far cry from the bit-count battle that has defined the video game industry in the past.

Microsoft has provided a customized version of its Windows CE operating system, complete with DirectX services, that has been optimized for console gaming. This will make future software title development more efficient and versatile as well as allow networked, multi-player gaming. In cooperation with Microsoft, Dreamcast brings together the best features of console, PC, and on-line gaming in one system.

The central processor in Dreamcast is a customized Hitachi 200MHz SH-4 RISC chip, the latest generation of its SuperH RISC architecture. SEGA and Hitachi have retooled the chip to enhance its floating-point operations, the key ingredient for high-output 3-D gaming applications.

The muscle behind Dreamcast's high-end graphics engine is a custom-designed version of the PowerVR second-generation technology developed jointly by NEC and VideoLogic. With a peak performance of over three million polygons per second and unparalleled anti-aliasing technology, the PowerVR chip in Dreamcast outstrips even today's most advanced arcade systems.

Yamaha has contributed an extremely powerful real-time 3-D audio chip set. By off-loading audio processing to a dedicated unit, Dreamcast provides audio performance that matches that of home theater equipment. SEGA also worked with Yamaha to develop a high-speed CD-ROM drive that speeds up access time and allows for much bigger games and larger playing fields.

In closing, on behalf of the Board of Directors I would like to thank our shareholders for their support and ask for their continued backing as we move into an exciting future.

Shoichiro Irimajiri

Shoichiro Irimajiri
Representative Director and President

AMUSEMENT CENTER OPERATIONS

In fiscal 1998, overall personal spending in Japan was flat, while the popularity of SEGA's Print Club photo-sticker booths peaked and began to decline, resulting in sluggish conditions for the Company's existing amusement centers. Nevertheless, SEGA bolstered its business results by opening innovative new amusement centers. The Company opened two new-style amusement complexes in July 1997—Festival Gate, in Osaka, and Club SEGA Yokohama, both of which have proved very popular. In September 1997, SEGA launched Kyoto Joypolis, its sixth amusement theme park. At these new amusement centers, SEGA introduced such exciting attractions as Horror Ride, which combines the very different thrills of haunted houses and roller coasters, and Wild River, a whitewater rafting simulator, along with such ancillary operations as souvenir shops, refreshment concessions, and karaoke rooms.

As a result, net sales from amusement center operations climbed ¥2.8 billion, or 3.1%, to ¥91.0 billion (US$688.6 million).

In fiscal 1999, SEGA will open two new amusement theme parks. Okayama Joypolis will feature a bowling alley, while the still-unnamed new facility in Osaka will be one of the anchor tenants of the new Hankyu 5 complex. The Company will also open major amusement centers in Sapporo, Shibuya (Tokyo), Hamamatsu, Matsuyama, Kitakyushu, and Okinawa. We are also aggressively developing entertainment complexes that combine movie theaters, bowling alleys, karaoke rooms, spas, food and beverage stands, and souvenir shops.

AMUSEMENT MACHINE SALES

In the domestic amusement machine market, no new product has gripped the public's imagination and become a social phenomenon the way our Making Club Series—Print Club, Name Club, and Stamp Club—has in recent years. Amid a stagnant economy and a mature market, SEGA had several other notable hits in fiscal 1998. These included Virtua Striker 2, a soccer game with intense, lifelike action; The Lost World, a simulation game that literally puts the player into the middle of a dinosaur rampage; Get Bass, an innovative fishing simulator; and Royal Ascot 2, a horseracing game in which the winner receives tokens. Although the initial explosive popularity of our Making Club Series waned, SEGA continued to introduce such well-received new units as Print Club 2, which offers the user more flexibility than its predecessor in designing frames, backgrounds, and text.

Among export products, the Company aggressively promoted such distinctive products as Virtua Striker 2; The House of the Dead, in which the player must shoot the undead or join them; Harley Davidson, a motorcycle simulator; and Top Skater, a unique freestyle skateboarding game.

Consequently, domestic sales of amusement machines advanced 4.9%, to ¥69.3 billion (US$524.9 million), while exports edged up 1.3%, to ¥32.6 billion (US$246.4 million). Net sales in this segment climbed ¥3.6 billion, or 3.7%, to ¥101.9 billion (US$771.3 million).

As an amusement industry leader, we are prepared to launch new products that are borne of highly advanced and innovative thinking in order to stay ahead of the competition. As a leader in marketing, we will do whatever it takes to reverse the decline of the video game market. Our supreme goal is to establish ourselves as a truly global entertainment business as we head into the 21st century.

CONSUMER PRODUCTS

In domestic consumer product sales, SEGA's 32-bit SegaSaturn system faced fierce competition. The Company's sales strategy was to offer new game software titles that are both appealing to players and highly profitable. Our lineup included such hits as Grandia, a role-playing game; Sakura Wars 2, an adventure game; and Make Your Own J. League Soccer Club 2, a simulation game. Overseas, a slowdown in sales was unavoidable due to ongoing price competition in the 32-bit game market as well as general economic instability in Asia.

As of the end of fiscal 1998, the Company had sold 8.8 million SegaSaturn game consoles and 80.0 million game software units.

SEGA continued to develop its presence in the PC software market by offering original PC titles. In the toy category, SEGA centered its operations on "edutainment" products and tie-ins with popular cartoon characters.

Despite these efforts, domestic sales decreased 40.8%, to ¥57.9 billion (US$438.4 million), while overseas sales declined 75.4%, to ¥16.4 billion (US$124.0 million). Net sales sank ¥90.0 billion, or 54.8%, to ¥74.4 billion (US$563.0 million).

In fiscal 1999, efforts in this segment will focus on Dreamcast, our groundbreaking 128-bit home video game console. Scheduled for release in fall 1998, Dreamcast will be the first system to truly deliver what video game enthusiasts want from advanced interactive entertainment—games that look and sound totally authentic, with natural physical properties. SEGA has teamed up with business and technology leaders worldwide who have contributed their expertise in computing, graphics, and sound to produce groundbreaking gaming components for the most authentic 3-D gaming experience ever conceived.

SIX-YEAR FINANCIAL SUMMARY

SEGA Enterprises, Ltd.
Years ended March 31, 1993, 1994, 1995, 1996, 1997 and 1998

	Millions of yen						Thousands of U.S. dollars
	1993	1994	1995	1996	1997	**1998**	**1998**
Net sales:							
Consumer products	¥229,270	¥235,880	¥188,486	¥169,524	¥164,395	**¥ 74,375**	**$ 563,020**
Amusement center operations	58,914	61,734	74,204	82,136	88,191	**90,958**	**688,554**
Amusement machine sales	57,558	52,144	61,400	84,976	98,241	**101,890**	**771,310**
Royalties on game software	1,195	4,274	9,233	9,546	9,103	**4,252**	**32,188**
Total	¥346,937	¥354,032	¥333,323	¥346,182	¥359,930	**¥271,475**	**$2,055,072**
Cost of sales	¥251,834	¥270,305	¥257,371	¥270,968	¥285,146	**¥216,596**	**$1,639,636**
Gross profit	95,103	83,727	75,952	75,214	74,784	**54,879**	**415,436**
Selling, general and administrative expenses	32,563	37,132	44,744	45,578	43,555	**41,172**	**311,673**
Operating income	62,540	46,595	31,208	29,636	31,229	**13,707**	**103,763**
Net (loss) income	28,017	23,223	14,085	5,304	5,572	**(43,300)**	**(327,782)**
Depreciation and amortization	15,591	20,049	22,164	23,142	22,914	**21,831**	**165,261**
Total assets	295,153	300,968	426,457	441,106	387,279	**346,538**	**2,623,301**
Total shareholders' equity	116,511	165,469	175,641	177,644	179,293	**132,036**	**999,516**
Financial ratios:							
Return on average assets	10.8%	7.8%	3.9%	1.2%	1.3%	**—%**	
Return on average equity	27.1	16.5	8.3	3.0	3.1	**—**	
Payout ratio	8.7	16.4	27.1	72.0	68.6	**—**	

	Yen						U.S. dollars
	1993	1994	1995	1996	1997	**1998**	**1998**
Net (loss) income per share—primary	¥288.7	¥232.8	¥140.2	¥52.8	¥55.4	**¥(430.3)**	**$(3.26)**
Net (loss) income per share—fully diluted	—	—	—	47.3	48.5	**—**	**—**
Cash dividends per share	25.0	38.0	38.0	38.0	38.0	**38.0**	**0.29**
Number of employees	3,034	3,492	3,758	3,764	3,872	**3,982**	

Notes: 1. All dollar figures refer to U.S. currency. Yen amounts have been translated, for convenience only, at ¥132.10=US$1.
2. Net income per share figures have been computed using the weighted average number of shares outstanding during each period.

Sales by division	Billions of yen 1997	**1998**	Millions of U.S. dollars **1998**
Net sales:	¥359.9	**¥271.5**	**$2,055.1**
Consumer products:	164.4	**74.4**	**563.0**
Domestic sales	97.7	**58.0**	**439.0**
Exports	66.7	**16.4**	**124.0**
Amusement center operations	88.2	**91.0**	**688.6**
Amusement machine sales:	98.2	**101.9**	**771.3**
Domestic sales	66.1	**69.4**	**525.3**
Exports	32.1	**32.5**	**246.0**
Royalties on game software	9.1	**4.2**	**32.2**

Note: U.S. dollar amounts are translated from yen, for convenience only, at the rate of ¥132.10=$1, the exchange rate prevailing at March 31, 1998.

OVERVIEW

In fiscal 1998, ended March 31, 1998, the video game industry had certain trend-setting hits, but the overall market continued to soften amid slumping personal consumption in Japan. Given these conditions, in amusement machine sales, SEGA introduced groundbreaking new machines, taking advantage of advanced technology. We also created the market for large-prize machines and worked to develop new kinds of amusement centers. In consumer products, we placed high priority on offering software with strong consumer appeal.

However, the Company reported special losses of ¥42.8 billion. This was mainly attributable to efforts to improve asset quality, including the disposal of inventories in preparation for the launch of Dreamcast, SEGA's next-generation home video game console, as well as the transfer of losses posted by two affiliated companies to SEGA's non-consolidated accounts.

As a result, non-consolidated net sales sank 24.6%, to ¥271.5 billion (US$2,055.1 million). The net loss for the term amounted to ¥43.3 billion (US$327.8 million), in contrast to ¥5.6 billion in net income posted in the previous year.

Despite the net loss for the year, cash dividends were maintained at ¥38.0 (US$0.29) per share, in line with SEGA's stable cash dividend policy.

NET SALES

SEGA's non-consolidated net sales dropped ¥88.5 billion, or 24.6%, to ¥271.5 billion (US$2,055.1 million). Amusement machine sales increased ¥3.6 billion, or 3.7%, to ¥101.9 billion (US$771.3 million). Sales of consumer products plunged ¥90.0 billion, or 54.8%, to ¥74.4 billion (US$563.0 million). The main reason for this dramatic decline was the ferocity of competition from rival companies' products. Overseas sales were particularly dismal, plummeting ¥50.3 billion, or 75.4%, to ¥16.4 billion (US$124.0 million), resulting primarily from unstable economic conditions in Asia and intensified competition worldwide.

Amusement center operations reported a ¥2.8 billion, or 3.1%, increase, to ¥91.0 billion (US$688.6 million). This was due primarily to the development of new businesses as well as the establishment of new facilities, as sales at existing facilities were flat.

Royalties on game software fell ¥4.9 billion, or 53.3%, to ¥4.2 billion (US$32.2 million), mainly because several overseas production licenses expired.

Exports represented 18.9% of net sales, a decrease of 10.5 percentage points from the previous term, in which exports represented 29.4% of net sales. This was mainly a consequence of the sharp fall in consumer product sales.

COSTS, EXPENSES, AND EARNINGS

Cost of sales decreased ¥68.6 billion, or 24.0%, to ¥216.6 billion (US$1,639.6 million). As this improvement was somewhat less than the 24.6% drop in net sales, the cost of sales ratio went up 0.6 percentage point, from 79.2% to 79.8%. Although the cost of procuring such components as integrated circuit chips fell for the most part, the percentage of fixed charges rose due to the decline in net sales.

We managed to reduce selling, general and administrative (SG&A) expenses ¥2.4 billion, or 5.5%, to ¥41.2 billion (US$311.7 million). However, R&D expenditures went up, primarily to fund the development of Dreamcast. Therefore, as a percentage of net sales, SG&A expenses increased 3.1 percentage points, from 12.1% to 15.2%. Total R&D expenses expanded ¥3.1 billion, or 12.6%, to ¥27.1 billion (US$205.5 million). As a percentage of net sales, R&D expenses climbed 3.3 percentage points, from 6.7% to 10.0%.

Total other income (expenses) grew from expenses of ¥17.0 billion to expenses of ¥48.8 billion (US$369.7 million). This was primarily the result of ¥42.8 billion in special losses, which included a ¥40.3 billion provision for doubtful accounts related to investments in and advances to subsidiaries and affiliates.

As a result of these factors, the Company recorded a ¥35.1 billion (US$266.0 million) loss before income taxes. Net loss amounted to ¥43.3 billion (US$327.8 million).

Net loss per share, primary, amounted to ¥430.3.

FINANCIAL POSITION

During the term, the Company made extensive efforts to improve asset quality. As a result, non-consolidated total assets were down ¥40.7 billion, or 10.5%, from the previous year-end, to ¥346.5 billion (US$2,623.3 million).

Total current assets fell ¥48.1 billion, or 21.2%, to ¥178.2 billion (US$1,349.2 million). This was the primary cause of the decline in total assets. Cash and time deposits sank ¥33.1 billion, as certain necessary capital expenditures as well as investments and advances were carried out using funds on hand. Trade accounts receivable dropped ¥8.2 billion due to decreases in notes and accounts receivable, while other current assets shrank ¥1.1 billion.

Turning to property and equipment, the Company invested a total of ¥19.7 billion in acquiring amusement centers and renovating their interiors. Total property and equipment rose ¥1.8 billion, to ¥76.8 billion (US$581.2 million), as the amount of capital expenditures was less than the amount of depreciation. SEGA reported a ¥41.6 billion increase in investments in subsidiaries. However, with a view to improving the quality of its assets, the Company also transferred ¥42.4 billion to the reserve for doubtful accounts. As a result, total investments and advances climbed ¥4.4 billion, to ¥59.8 billion (US$452.6 million).

Total current and long-term liabilities rose ¥6.5 billion, or 3.1%, to ¥214.5 billion (US$1,623.8 million). Within this amount, long-term debt and current portion of long-term debt totaled ¥144.8 billion (US$1,096.3 million), roughly the same as at the previous term-end. Non-interest-bearing liabilities swelled ¥6.6 billion, or 10.5%, to ¥69.7 billion (US$527.5 million). This was mainly the result of an ¥11.9 billion rise in notes and accounts payable as well as a ¥5.2 billion contraction in accrued expenses, income taxes payable, and other current liabilities.

Reflecting the sharp reduction in retained earnings caused by the net loss for the year, total shareholders' equity dropped ¥47.3 billion, or 26.4%, to ¥132.0 billion (US$999.5 million). The equity ratio decreased 8.2 percentage points, from 46.3% to 38.1%.

CASH FLOWS

In fiscal 1998, cash and cash equivalents fell ¥34.8 billion, to ¥57.5 billion (US$435.2 million). However, as this is approximately 2.5 times the Company's average monthly net sales of ¥22.6 billion, SEGA believes the Company has sufficient liquidity.

Net cash provided by operating activities was ¥46.2 billion (US$349.7 million). Although the Company posted a net loss for the term of ¥43.3 billion, the addition of ¥69.8 billion in noncash items generated a net cash inflow of ¥26.5 billion. These noncash items mainly included depreciation, provision for doubtful accounts relating to investments in and advances to related companies—the primary cause of the net loss for the term—and loss on write-down of assets. A fall in the asset burden of operating assets and liabilities and other assets and liabilities, centered on trade receivables and inventory liabilities, generated a cash inflow of ¥19.6 billion.

Net cash used in investing activities amounted to ¥77.2 billion (US$584.5 million). This was chiefly the result of ¥23.1 billion (US$174.5 million) in acquisition of property and equipment, a ¥47.1 billion (US$356.7 million) increase in investments in subsidiaries and affiliates, and ¥12.7 billion in other investments, net.

Net cash used in financing activities totaled ¥3.8 billion (US$28.9 million). No fund procurement or repayment occurred during the term; therefore, financing activities consisted entirely of dividend payments.

NON-CONSOLIDATED BALANCE SHEETS

SEGA Enterprises, Ltd.
March 31, 1997 and 1998

	Millions of yen		Thousands of U.S. dollars (Note 3)
ASSETS	1997	**1998**	**1998**
Current Assets:			
Cash and cash equivalents (Note 2 [3]):			
Cash	¥ 60,590	**¥ 34,468**	**$ 260,924**
Time deposits	15,520	**8,520**	**64,498**
Short-term investments (Note 5)	16,225	**14,503**	**109,788**
	92,335	**57,491**	**435,210**
Notes and accounts receivable:			
Trade	26,370	**18,157**	**137,449**
Subsidiaries and affiliates	50,236	**43,946**	**332,672**
Other	6,377	**9,916**	**75,064**
	82,983	**72,019**	**545,185**
Less allowance for doubtful accounts	(577)	**(485)**	**(3,671)**
	82,406	**71,534**	**541,514**
Inventories (Note 4)	39,800	**36,952**	**279,727**
Prepaid expenses	9,660	**11,201**	**84,793**
Other current assets	2,120	**1,054**	**7,979**
Total current assets	226,321	**178,232**	**1,349,223**
Investments and Advances:			
Investments in securities (Note 5)	20,686	**18,827**	**142,521**
Investments in and advances to subsidiaries and affiliates (Note 8)	29,777	**73,372**	**555,428**
Other investments	5,565	**9,979**	**75,541**
	56,028	**102,178**	**773,490**
Less allowance for doubtful accounts	(593)	**(42,387)**	**(320,871)**
Total investments and advances	55,435	**59,791**	**452,619**
Property and Equipment, at Cost:			
Amusement machines and facilities	62,684	**69,072**	**522,877**
Buildings and structures	44,504	**47,872**	**362,392**
Machinery and equipment	21,531	**20,947**	**158,569**
	128,719	**137,891**	**1,043,838**
Less accumulated depreciation	(76,229)	**(83,813)**	**(634,466)**
	52,490	**54,078**	**409,372**
Land	22,531	**22,574**	**170,886**
Construction in progress	—	**126**	**951**
Total property and equipment	75,021	**76,778**	**581,209**
Fixed Leasehold Deposits (Note 6)	22,023	**22,373**	**169,364**
Deferred Charges and Intangible Assets	8,479	**9,364**	**70,886**
Total assets	¥387,279	**¥346,538**	**$2,623,301**

The accompanying notes are an integral part of these statements.

LIABILITIES AND SHAREHOLDERS' EQUITY	Millions of yen 1997	1998	Thousands of U.S. dollars (Note 3) 1998
Current Liabilities:			
Current portion of long-term debt (Note 9)	¥ —	**¥ 19,897**	**$ 150,621**
Notes and accounts payable:			
Trade	36,963	**50,308**	**380,833**
Subsidiaries and affiliates	799	**522**	**3,951**
Other	1,739	**563**	**4,262**
	39,501	**51,393**	**389,046**
Accrued expenses	14,210	**11,605**	**87,850**
Income taxes payable (Note 7)	6,134	**4,088**	**30,946**
Other current liabilities	2,296	**1,726**	**13,066**
Total current liabilities	62,141	**88,709**	**671,529**
Long-Term Liabilities:			
Long-term debt (Note 9)	144,926	**124,923**	**945,670**
Accrued employees' retirement benefits (Note 10)	633	**595**	**4,504**
Accrued retirement benefits for directors and corporate auditors (Note 10)	286	**275**	**2,082**
Total long-term liabilities	145,845	**125,793**	**952,256**
Commitments and Contingent Liabilities (Note 14)			
Shareholders' Equity:			
Common stock:			
Authorized—200,000,000 shares at March 31, 1997 and 1998			
Issued, par value ¥50 per share—100,633,718 shares at March 31, 1997 and 1998	39,154	**39,154**	**296,397**
Additional paid-in capital	38,700	**38,700**	**292,960**
Legal reserve (Note 11)	1,981	**2,377**	**17,994**
Voluntary reserves (Note 11)	89,892	**90,892**	**688,055**
Special tax-purpose reserves (Note 2 [12])	313	**302**	**2,286**
(Deficit) Retained earnings (Note 16)	9,253	**(39,389)**	**(298,176)**
Total shareholders' equity	179,293	**132,036**	**999,516**
Total liabilities and shareholders' equity	¥387,279	**¥346,538**	**$2,623,301**

NON-CONSOLIDATED STATEMENTS OF INCOME

SEGA Enterprises, Ltd.
For the years ended March 31, 1996, 1997 and 1998

	Millions of yen			Thousands of U.S. dollars (Note 3)
	1996	1997	**1998**	**1998**
Net Sales (Notes 12 and 13)	¥346,182	¥359,930	**¥271,475**	**$2,055,072**
Cost of Sales (Note 12)	270,968	285,146	**216,596**	**1,639,636**
Gross profit	75,214	74,784	**54,879**	**415,436**
Selling, General and Administrative Expenses	45,578	43,555	**41,172**	**311,673**
Operating income	29,636	31,229	**13,707**	**103,763**
Other Income (Expenses) (Note 13):				
Interest and dividend income	2,978	1,396	**1,313**	**9,939**
Interest expense	(1,092)	(675)	**(651)**	**(4,928)**
Loss on write-down or disposal of inventories	—	(3,243)	**—**	**—**
Gain on sales of marketable securities and short-term investments	52	66	**—**	**—**
(Loss) gain on sale or disposal of property and equipment	300	(419)	**(380)**	**(2,877)**
Loss on write-down of investments in subsidiaries (Note 8)	(25,943)	(22,944)	**—**	**—**
Loss on valuation of investment securities	(2)	(722)	**(4,295)**	**(32,513)**
Loss on valuation of investments in subsidiaries and affiliates	—	—	**(739)**	**(5,594)**
Loss on valuation of cash trust for investments	—	—	**(3,992)**	**(30,220)**
Gain on sales of investments in subsidiaries and affiliates	757	4,416	**—**	**—**
Gain on sales of investment securities	2,912	1,780	**510**	**3,861**
Loss on sale or disposal of operations in subsidiaries and affiliates	—	—	**(2,780)**	**(21,044)**
Net gain on foreign exchange	1,695	4,305	**1,155**	**8,743**
Provision for doubtful accounts	—	—	**(40,343)**	**(305,396)**
Amortization of discounts on bonds	(1,623)	(1,154)	**(687)**	**(5,201)**
Amortization of bond and note issue expenses	(977)	(977)	**(263)**	**(1,991)**
Income from cash trust for investments	1,998	—	**7**	**53**
Other, net	562	1,199	**2,302**	**17,425**
Total other income (expenses)	(18,383)	(16,972)	**(48,843)**	**(369,743)**
(Loss) income before income taxes	11,253	14,257	**(35,136)**	**(265,980)**
Income Taxes (Note 7)	5,949	8,685	**8,164**	**61,802**
Net (loss) income	¥ 5,304	¥ 5,572	**¥ (43,300)**	**$ (327,782)**

	Yen			U.S. dollars (Note 3)
	1996	1997	**1998**	**1998**
Per Share (Note 2 [14]):				
Net (loss) income—primary	¥52.8	¥55.4	**¥(430.3)**	**$(3.26)**
Net (loss) income—fully diluted(*1)	47.3	48.5	**—**	**—**
Cash dividends	38.0	38.0	**38.0**	**0.29**
Weighted average number of shares (thousands)	100,634	100,556	**100,633**	**100,633**

The accompanying notes are an integral part of these statements.

(*1) Fully diluted net loss per share was not disclosed for the year ended March 31, 1998, as net loss per share was calculated for the year after the adjustment for full dilution.

NON-CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

SEGA Enterprises, Ltd.
For the years ended March 31, 1996, 1997 and 1998

	Number of shares of common stock	Millions of yen					
		Common stock	Additional paid-in capital	Legal reserve	Voluntary reserves	Special tax-purpose reserves	(Deficit) Retained earnings
Balance at March 31, 1995	100,488,673	¥38,839	¥38,385	¥1,196	¥80,892	¥336	¥ 15,993
Net income for the year ended March 31, 1996	—	—	—	—	—	—	5,304
Cash dividends	—	—	—	—	—	—	(3,819)
Transfer to legal reserve	—	—	—	393	—	—	(393)
Bonuses to directors and corporate auditors	—	—	—	—	—	—	(112)
Reversal of special tax-purpose reserves (Note 2 [12])	—	—	—	—	—	(12)	12
Transfer to voluntary reserves	—	—	—	—	8,000	—	(8,000)
Proceeds from conversion of convertible bonds	145,045	315	315	—	—	—	—
Balance at March 31, 1996	100,633,718	39,154	38,700	1,589	88,892	324	8,985
Net income for the year ended March 31, 1997	—	—	—	—	—	—	5,572
Cash dividends	—	—	—	—	—	—	(3,824)
Transfer to legal reserve	—	—	—	392	—	—	(392)
Bonuses to directors and corporate auditors	—	—	—	—	—	—	(99)
Reversal of special tax-purpose reserves (Note 2 [12])	—	—	—	—	—	(11)	11
Transfer to voluntary reserves	—	—	—	—	1,000	—	(1,000)
Proceeds from conversion of convertible bonds	—	—	—	—	—	—	—
Balance at March 31, 1997	100,633,718	39,154	38,700	1,981	89,892	313	9,253
Net loss for the year ended March 31, 1998	**—**	**—**	**—**	**—**	**—**	**—**	**(43,300)**
Cash dividends	**—**	**—**	**—**	**—**	**—**	**—**	**(3,824)**
Transfer to legal reserve	**—**	**—**	**—**	**396**	**—**	**—**	**(396)**
Bonuses to directors and corporate auditors	**—**	**—**	**—**	**—**	**—**	**—**	**(133)**
Reversal of special tax-purpose reserves (Note 2 [12])	**—**	**—**	**—**	**—**	**—**	**(11)**	**11**
Transfer to voluntary reserves	**—**	**—**	**—**	**—**	**1,000**	**—**	**(1,000)**
Proceeds from conversion of convertible bonds	**—**	**—**	**—**	**—**	**—**	**—**	**—**
Balance at March 31, 1998	**100,633,718**	**¥39,154**	**¥38,700**	**¥2,377**	**¥90,892**	**¥302**	**¥(39,389)**

	Thousands of U.S. dollars (Note 3)					
	Common stock	Additional paid-in capital	Legal reserve	Voluntary reserves	Special tax-purpose reserves	(Deficit) Retained earnings
Balance at March 31, 1997	$296,397	$292,960	$14,996	$680,484	$2,369	$ 70,045
Net loss for the year ended March 31, 1998	**—**	**—**	**—**	**—**	**—**	**(327,782)**
Cash dividends	**—**	**—**	**—**	**—**	**—**	**(28,947)**
Transfer to legal reserve	**—**	**—**	**2,998**	**—**	**—**	**(2,998)**
Bonuses to directors and corporate auditors	**—**	**—**	**—**	**—**	**—**	**(1,006)**
Reversal of special tax-purpose reserves (Note 2 [12])	**—**	**—**	**—**	**—**	**(83)**	**83**
Transfer to voluntary reserves	**—**	**—**	**—**	**7,571**	**—**	**(7,571)**
Proceeds from conversion of convertible bonds	**—**	**—**	**—**	**—**	**—**	**—**
Balance at March 31, 1998	**$296,397**	**$292,960**	**$17,994**	**$688,055**	**$2,286**	**$(298,176)**

The accompanying notes are an integral part of these statements.

NON-CONSOLIDATED STATEMENTS OF CASH FLOWS

SEGA Enterprises, Ltd.
For the years ended March 31, 1996, 1997 and 1998

	Millions of yen			Thousands of U.S. dollars (Note 3)
	1996	1997	**1998**	**1998**
Cash Flows from Operating Activities:				
Net (loss) income	¥ 5,304	¥ 5,572	**¥(43,300)**	**$(327,782)**
Adjustments to reconcile net (loss) income to net cash provided by operating activities:				
Depreciation	18,991	18,994	**19,279**	**145,942**
Amortization	4,151	3,920	**2,552**	**19,319**
Provision for retirement benefits for directors and corporate auditors	36	32	**(11)**	**(83)**
Loss on write-down or disposal of inventories	—	3,243	**—**	**—**
Loss (gain) on sale or disposal of property and equipment	(300)	419	**380**	**2,877**
Loss on write-down of investments in subsidiaries	25,943	22,944	**—**	**—**
Loss on valuation of investment securities	2	722	**4,295**	**32,513**
Loss on valuation of investments in subsidiaries and affiliates	—	—	**739**	**5,594**
Gain on sales of investments in subsidiaries and affiliates	(757)	(4,416)	**—**	**—**
Gain on sales of investment securities	(2,912)	(1,780)	**(510)**	**(3,861)**
Loss on sale or disposal of operations in subsidiaries and affiliates	—	—	**2,780**	**21,045**
Provision for doubtful accounts	—	—	**40,343**	**305,397**
Changes in assets and liabilities:				
Decrease (increase) in notes and accounts receivable	(17,504)	14,042	**10,873**	**82,309**
Decrease (increase) in inventories	(15,294)	4,836	**2,849**	**21,567**
(Increase) decrease in prepaid expenses and other current assets	(951)	1,759	**(479)**	**(3,626)**
Increase (decrease) in notes and accounts payable	14,999	(33,527)	**11,892**	**90,023**
(Decrease) increase in income taxes payable	(6,451)	6,135	**(2,045)**	**(15,481)**
(Decrease) increase in accrued expenses and other current liabilities	618	1,845	**(3,175)**	**(24,035)**
Other payments	(502)	619	**(270)**	**(2,044)**
Net cash provided by operating activities	25,373	45,359	**46,192**	**349,674**
Cash Flows from Investing Activities:				
Acquisition of property and equipment	(21,028)	(31,075)	**(23,054)**	**(174,519)**
Proceeds from sale of property and equipment	2,806	1,746	**1,638**	**12,400**
(Increase) decrease in investments in securities	19,824	(7,547)	**(1,925)**	**(14,572)**
(Increase) decrease in investments in subsidiaries and affiliates	(30,856)	3,294	**(47,114)**	**(356,654)**
Increase in other investments	(425)	(761)	**(2,963)**	**(22,430)**
Increase in fixed leasehold deposits	(372)	(96)	**(350)**	**(2,650)**
Additions to deferred charges and intangible assets	(1,932)	(1,600)	**(3,445)**	**(26,078)**
Net cash used in investing activities	(31,983)	(36,039)	**(77,213)**	**(584,503)**
Cash Flows from Financing Activities:				
Proceeds from borrowings of long-term debt	30,000	—	**—**	**—**
Decrease in short-term bank loans	(5,661)	—	**—**	**—**
Increase (decrease) in current portion of long-term debt	(19,816)	(30,620)	**19,897**	**150,621**
Decrease in long-term borrowings	—	—	**(19,897)**	**(150,621)**
Cash dividends	(3,819)	(3,824)	**(3,824)**	**(28,948)**
Net cash (used in) provided by financing activities	704	(34,444)	**(3,824)**	**(28,948)**
Changes in Cash and Cash Equivalents	(5,906)	(25,124)	**(34,845)**	**(263,777)**
Cash and Cash Equivalents at Beginning of Year	123,366	117,460	**92,336**	**698,987**
Cash and Cash Equivalents at End of Year	¥117,460	¥ 92,336	**¥ 57,491**	**$ 435,210**

The accompanying notes are an integral part of these statements.

1. BASIS OF PRESENTING THE NON-CONSOLIDATED FINANCIAL STATEMENTS

(1) Accounting Principles

The accompanying non-consolidated financial statements have been prepared from accounts and records maintained by SEGA Enterprises, Ltd. (the "Company"), in accordance with the provisions set out in the Commercial Code of Japan and in conformity with accounting principles generally accepted in Japan.

Relevant notes have been added, and certain reclassifications of account balances as disclosed in the non-consolidated financial statements in Japan have been made so as to present them in a form which is more familiar to readers outside Japan.

(2) Significant Shareholders

The Company is an affiliate of CSK Corporation, Japan, which owned 20,148 thousand shares of common stock of the Company at March 31, 1997 and 1998, representing 20.02% of shares outstanding at such dates. In addition, the chairman of the Company, Mr. Isao Okawa, and the vice chairman of the Company, Mr. Hayao Nakayama, personally owned 2.16% and 3.14%, respectively, of the issued shares of the Company as of March 31, 1998.

There have been no material transactions and account balances outstanding, other than the shareholdings, between the Company and CSK Corporation.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(1) Inventories

Inventories are stated at cost, determined by the moving-average method. When the net realizable value of certain classes of inventories is substantially lower than the carrying value (cost) and such decline of value is considered to be permanent, appropriate write-downs are recorded on such items.

(2) Valuation of Securities

Securities with quoted market values are valued at the lower of cost or market on an individual basis, cost being determined by the moving-average method. Other securities are valued at cost, which is determined by the moving-average method.

(3) Cash and Cash Equivalents

Cash equivalents include time deposits and short-term investments in conformity with generally accepted Japanese accounting practices.

(4) Investments in Subsidiaries and Affiliates

Investments in subsidiaries (majority-owned companies) and affiliates (20% to 50% owned companies) are valued at cost. The equity method of accounting for investments in the common stock of subsidiaries and affiliates has not been followed by the Company in the non-consolidated financial statements under Japanese accounting practices.

(5) Property and Equipment

Depreciation is computed by the declining-balance method at rates based on the estimated useful lives of assets, as prescribed by the Japanese income tax laws. The range of useful lives is principally from 3 to 65 years for buildings and structures; from 2 to 20 years for machinery, equipment, furniture and tools; and from 2 to 5 years for amusement machines and facilities.

The cost of property and equipment retired or otherwise disposed of and accumulated depreciation in respect thereof are eliminated from the related accounts, and the resulting gain or loss is reflected in income.

(6) Consumption Tax

Until March 31, 1997, the consumption tax had been imposed at the flat rate of 3% on all domestic consumption of goods and services (with certain exemptions). On April 1, 1997, the rate was increased to 5%.

The consumption tax imposed on the Company's sales to customers is withheld by the Company at the time of sale and is paid to the national government subsequently. The consumption tax withheld upon sale is not included in the amount of "net sales" in the accompanying non-consolidated statements of income but is recorded as a liability, "consumption tax withheld." The balances of "consumption tax withheld" and "consumption tax paid" (an asset item), which is borne by the Company on the purchases of products, merchandise and services from vendors, are not included in the amounts of costs and expenses but are offset, and the net balance is included in "Other current assets" or "Other current liabilities" of the non-consolidated balance sheets at March 31, 1997 and 1998.

(7) Leases

Finance leases other than those which are deemed to transfer the ownership of the leased assets to lessees are accounted for by the method that is applicable to ordinary operating leases.

(8) Amortization

Amortization of deferred charges and intangible assets is computed by the straight-line method, principally over seven years.

New share issue expenses and debt security issue expenses are charged to income as incurred.

"Bond discount" arising from the issue of the zero-coupon convertible discount bonds (see Note 9), is recorded as a deferred charge and is amortized to expenses on a straight-line basis over the period up to the maturity of the bonds. When the discount bonds are converted into common stock of the Company, appropriate amortization is made in proportion to the balance of converted bonds.

Bond and note issue expenses are deferred and amortized on a straight-line basis over a three-year period.

(9) Foreign Currency Translation

Cash and short-term receivables and payables denominated in foreign currencies are translated into yen at the current exchange rates prevailing at the respective balance sheet dates. Resulting translation gains or losses are included in the determination of net income for the fiscal year.

Long-term receivables denominated in foreign currencies, including investments in overseas subsidiaries, are generally translated at the historical rates prevailing at the transaction dates.

Accounts denominated in foreign currencies which are hedged by forward exchange contracts are translated into yen at the contracted rates of exchange.

(10) Income Taxes

Income taxes are provided for based on the amount required by the tax returns for the fiscal year. No tax effect is recorded for timing differences in the recognition of certain expenses between tax and financial reporting.

(11) Allowance for Doubtful Accounts

Allowance for doubtful accounts is provided for on the basis of the amount allowed for deduction by the tax laws. In addition, the amount deemed necessary to cover uncollectible receivables is provided when appropriate.

(12) Special Tax-Purpose Reserves

The Company has provided for special tax-purpose reserves which have resulted in the deferral of income tax payments in accordance with the provisions of the Special Taxation Measures Law of Japan. The provisions for and reversals of the special tax-purpose reserves are made through appropriation of retained earnings and are deducted from or added back to the taxable income of the fiscal year to which the appropriation relates.

The reserves of the Company are in respect of the postponement of income tax payments by reason of export sales and deferred capital gains arising from qualified asset replacements.

(13) Appropriation of Retained Earnings

Under the Japanese Commercial Code and the Articles of Incorporation of the Company, the plan for appropriation of retained earnings (including year-end cash dividend payments) proposed by the Board of Directors should be approved by the shareholders’ meeting which must be held within three months after the end of each fiscal year. The appropriation of retained earnings reflected in the accompanying non-consolidated financial statements represents the results of such appropriations which are applicable to the immediately preceding fiscal year but were approved by the shareholders’ meeting and disposed of during that year. Year-end dividends are paid to shareholders on the shareholders‘ register at the end of each fiscal year.

(14) Net (Loss) Income and Dividends per Share

Net (loss) income per share of common stock is based upon the weighted average number of shares of common stock outstanding during each fiscal year. Net income per share is computed to reflect the dilutive effect on net income assuming potential issues of new shares of common stock upon conversion of convertible debt securities and exercise of warrants outstanding with the related reduction of interest expenses.

Cash dividends per share shown for each year in the non-consolidated statements of income represent dividends declared as applicable to the respective period.

(15) Common Stock and Additional Paid-in Capital

Under the provisions of the Commercial Code of Japan, it is required that at least 50% of the issue price of new shares be transferred to the “Common stock” account, provided 50% of the issue price is greater than the par value of common stock. In accordance with such requirements, 50% of the proceeds from new share issues sold in public offerings at market price is transferred to the “Common stock” account and the remaining 50% is credited to the “Additional paid-in capital” account.

3. UNITED STATES DOLLAR AMOUNTS

The Company maintains its accounting records in yen. The dollar amounts included in the non-consolidated financial statements and notes thereto represent the arithmetical results of translating yen to dollars on the basis of ¥132.10=US$1. The inclusion of such dollar amounts is solely for convenience and is not intended to imply that yen amounts have been or could be converted, realized or settled in dollars at ¥132.10=US$1 or at any other rate.

4. INVENTORIES

Inventories as of March 31, 1997 and 1998, consisted of:

	Millions of yen		Thousands of U.S. dollars
	1997	1998	1998
Merchandise	¥ 3,333	**¥ 3,141**	**$ 23,777**
Products	15,066	**12,152**	**91,991**
Materials	16,088	**14,427**	**109,213**
Work in process	3,546	**4,901**	**37,100**
Supplies	1,767	**2,331**	**17,646**
	¥39,800	**¥36,952**	**$279,727**

5. SHORT-TERM INVESTMENTS AND INVESTMENTS IN SECURITIES

Short-term investments (current portfolio) and investments in securities (non-current portfolio) of the Company at March 31, 1997 and 1998, consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	1997	1998	1998
Short-term investments:			
Cash trust for investments	¥10,000	**¥ 6,007**	**$ 45,473**
Mortgage-backed notes	3,000	**—**	**—**
Lease-backed notes	—	**4,000**	**30,280**
Other securities	3,225	**4,496**	**34,035**
	¥16,225	**¥14,503**	**$109,788**
Investments in securities:			
Listed corporate shares	¥ 9,036	**¥ 8,209**	**$ 62,142**
Unlisted corporate shares	4,950	**5,818**	**44,042**
Other securities	4,571	**2,671**	**20,220**
	18,557	**16,698**	**126,404**
Shares and convertible bonds issued by CSK Corporation	2,129	**2,129**	**16,117**
	¥20,686	**¥18,827**	**$142,521**

Market value of listed corporate shares (except for CSK Corporation's shares) included in current and non-current portfolios as of March 31, 1997 and 1998, is summarized as follows:

	Millions of yen		Thousands of U.S. dollars
	1997	1998	1998
Market value of listed corporate shares in:			
Non-current portfolio	¥10,141	**¥8,654**	**$65,511**

6. FIXED LEASEHOLD DEPOSITS

The Company conducts amusement center operations on property leased from lessors on a long-term cancelable basis.

Japanese lessors require large amounts of leasehold deposits relative to the amount of annual lease rental payments. Such leasehold deposits do not bear interest and are generally returnable only when the lease is terminated. Such leasehold deposits are shown in the non-consolidated balance sheets as "Fixed leasehold deposits."

7. INCOME TAXES

Income taxes in Japan applicable to the Company for the years ended March 31, 1996, 1997 and 1998, consisted of corporate income tax (national), enterprise tax (local) and resident income taxes (local) at the approximate rates indicated below:

	Rates on taxable income		
	1996	1997	**1998**
Standard rates:			
Corporate income tax	37.5%	37.5%	**37.5%**
Enterprise tax	12.6	12.6	**12.6**
Resident income taxes	7.8	7.8	**7.8**
	57.9%	57.9%	**57.9%**
Statutory tax rate in effect to reflect the deductibility of enterprise tax when paid	51.4%	51.4%	**51.4%**

Unlike other income taxes, enterprise tax is deductible for tax purposes when it is paid. Although the enterprise tax is presented as a part of selling, general and administrative expenses in the basic financial statements disclosed in conformity with the accounting practices in Japan, a reclassification has been made to present income taxes in their entirety in the accompanying non-consolidated statements of income.

Income tax expenses as shown in the accompanying non-consolidated statements of income differ from the amounts computed by applying the aforementioned statutory tax rates to income before income taxes. Such differences arise partly from entertainment expenses, which are not allowable tax deductions. In addition, the differences arise because no tax effects have been recognized on certain timing differences between financial accounting and tax reporting primarily in relation to accrued enterprise tax not deductible until paid, write-down of inventories not deductible until actually disposed of, reserve for doubtful accounts provided in excess of the limit of deduction established by the tax laws and other factors.

8. INVESTMENTS IN AND ADVANCES TO SUBSIDIARIES AND AFFILIATES

Investments in and advances to subsidiaries and affiliates as of March 31, 1997 and 1998, were as follows:

	Percentage of ownership	Millions of yen 1997	Millions of yen 1998	Thousands of U.S. dollars 1998
Subsidiaries:				
SEGA Europe Ltd.	100.0	¥14,122	**¥15,014**	**$113,656**
SIMS Co., Ltd.	100.0	101	**101**	**765**
S-AI Electronics Co., Ltd.	100.0	100	**100**	**757**
SEGA Amusements Taiwan Ltd.	51.0	475	**475**	**3,596**
SEGA Ozisoft Pty. Ltd.(*1)	—	617	**—**	**—**
SEGA Singapore Pte. Ltd.	100.0	103	**103**	**780**
SEGA International Finance B.V.	100.0	11	**11**	**83**
Nextech Co., Ltd.	100.0	70	**100**	**757**
SEGA Huahan Culture Entertainment Co., Ltd.	80.0	240	**240**	**1,817**
SEGA Yonezawa Co., Ltd.(*2)	100.0	301	**—**	**—**
SEGA United Co., Ltd.(*3)	—	138	**—**	**—**
SEGA Enterprises (Australia) Pty. Ltd.	86.0	661	**2,014**	**15,246**
SEGA Enterprises, Inc. (U.S.A.)	100.0	8,605	**8,605**	**65,140**
Cross Products Ltd.	100.0	257	**257**	**1,945**
SEGA Distribution Australia Pty. Ltd.	100.0	—	**365**	**2,763**
SEGA Food Works Co., Ltd.	51.0	—	**5**	**38**
S.G.S. Co., Ltd.(*5)	65.0	—	**65**	**492**
SEGA of America, Inc.				
Advances	—	—	**40,000**	**302,801**
Other	—	60	**120**	**908**
Affiliates:				
Linguaphone Japan Ltd.(*4)	24.6	350	**—**	**—**
Light Printing Co., Ltd.	33.4	1,470	**1,470**	**11,128**
SEGA Digital Communication Co., Ltd.	35.0	140	**140**	**1,060**
SEGA Music Networks Co., Ltd.				
Investment in capital stock	50.0	200	**200**	**1,514**
Advances	—	869	**1,246**	**9,432**
SG MEDIA Co., Ltd.	20.0	60	**60**	**454**
S.G.S. Co., Ltd.(*5)	—	50	**—**	**—**
SEGA Logistics Service Co., Ltd.	50.0	100	**100**	**757**
Virtual Game Center Corporation(*6)	—	47	**—**	**—**
Super Merge Corporation Sdn. Bhd.	20.0	437	**437**	**3,308**
Hyundai Sega Entertainment Co., Ltd.	25.0	173	**173**	**1,310**
SEGA Muse Ltd.	46.9	—	**255**	**1,930**
Lotte SEGA Co., Ltd.	50.0	—	**709**	**5,367**
Amusement World of Vietnam Corporation	30.0	—	**38**	**288**
SEGA Lease Co., Ltd.				
Investment in capital stock	29.0	—	**30**	**227**
Advances	—	—	**838**	**6,344**
Atlus Dream Entertainment Co., Ltd.	20.0	—	**76**	**575**
Other	—	20	**25**	**190**
		¥29,777	**¥73,372**	**$555,428**

(*1) During the year ended March 31, 1998, the Company sold all its capital stock in SEGA Ozisoft Pty. Ltd. in the amount of ¥617 million. The Company's percentage of ownership was reduced to zero and the Company had no ownership interest in SEGA Ozisoft Pty. Ltd. as of March 31, 1998.
Therefore, SEGA Ozisoft Pty. Ltd. is neither a subsidiary nor an affiliate as of March 31, 1998.
(*2) During the year ended March 31, 1998, the Company increased the capital stock of SEGA Yonezawa Co., Ltd. by ¥20 million upon the merger with SEGA Tech Co., Ltd. However, the Company subsequently wrote off the investment in capital stock of SEGA Yonezawa Co., Ltd. in the amount of ¥321 million. The loss recognized as a result of the write-off is ¥321 million, which is included in "Loss on valuation of investments in subsidiaries and affiliates" in the accompanying non-consolidated statements of income.
(*3) In January 1998, SEGA United Co., Ltd. was extinguished by the combination with Mumin, combiner, converted its ownership interests to combiner.
After the combination, the combiner altered its name SEGA Muse Ltd.
(*4) During the year ended March 31, 1998, the Company wrote off the investment in capital stock of Linguaphone Japan Ltd. in the amount of ¥350 million. The loss recognized as a result of the write-off is ¥350 million, which is included in "Loss on valuation of investments in subsidiaries and affiliates" in the accompanying non-consolidated statements of income.
(*5) During the year ended March 31, 1998, the Company acquired additional capital stock of S.G.S. Co., Ltd. in the amount of ¥15 million. Therefore, the increase in percentage of ownership changed S.G.S. Co., Ltd. from an affiliate to a subsidiary.
(*6) During the year ended March 31, 1998, the Company liquidated the investments in capital stock of Virtual Game Center Corporation in the amount of ¥47 million. The loss recognized as a result of the write-off is ¥47 million, which is included in "Loss on valuation of investments in subsidiaries and affiliates" in the accompanying non-consolidated statements of income.

9. LONG-TERM DEBT

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

	Millions of yen		Thousands of U.S. dollars
	1997	**1998**	**1998**
Zero-coupon convertible discount bonds due 1999	¥ 19,897	**¥ 19,897**	**$ 150,621**
0.55% convertible bonds due 2000	94,339	**94,339**	**714,149**
Zero-coupon convertible bonds due 1999	29,371	**29,371**	**222,339**
Other long-term debt	1,319	**1,213**	**9,182**
	144,926	**144,820**	**1,096,291**
Less portion due within one year	—	**19,897**	**150,621**
	¥144,926	**¥124,923**	**$ 945,670**

The zero-coupon convertible discount bonds due March 31, 1999, were issued on January 30, 1992, in the principal amount of ¥20,000 million at a discount of ¥25 per par value of ¥100. The bonds are convertible into shares of common stock of the Company at the current conversion price of ¥8,548.10 per share.

The 0.55% convertible bonds due September 29, 2000, were issued on June 24, 1994, in the principal amount of ¥100,000 million. The bonds are convertible into shares of common stock of the Company at the current conversion price of ¥7,913.00 per share.

The zero-coupon convertible bonds due September 7, 1999, were issued on September 7, 1995, in the principal amount of ¥30,000 million. The bonds are convertible into shares of common stock of the Company at the current conversion price of ¥4,336.00 per share.

10. RETIREMENT PLAN AND SEVERANCE INDEMNITIES

The employees of the Company are generally entitled to receive lump-sum payments or pension payments upon retirement under the Company's retirement benefit plan. The amounts of such retirement benefits are determined by reference to the latest rate of pay, length of service and whether the retirement is voluntary or involuntary.

In November 1993, together with the SEGA Group Companies, the Company transferred 100% of the retirement benefits to a separate contributory pension program which was established as a pension trust fund, pursuant to the welfare pension insurance laws in Japan, whereby the pension fund has been substituted for a portion of the government pension program.

As a result, the balance of the "Accrued employees' retirement benefits," which became no longer necessary due to the change, is being amortized to income over a period for which the past service costs of the pension plan are being amortized.

As of March 31, 1998, the past service costs amounted to ¥1,739 million ($13,164 thousand), which are amortized over 20 years.

With respect to directors and corporate auditors, while the Company has no legal obligation, as is customary practice in Japan, the Company makes lump-sum payments to a director or corporate auditor upon retirement with the approval of a general meeting of shareholders. The amounts are determined on a basis similar to that used for employees' payments. The Company has provided a reserve for such payments to directors and corporate auditors on an accrual basis.

11. LEGAL RESERVE AND APPROPRIATION OF RETAINED EARNINGS

The Commercial Code of Japan states that an amount equal to at least 10% of cash distributions (cash dividends and bonuses to officers, etc.) paid out of retained earnings should be appropriated to the legal reserve until such reserve equals 25% of the amount of common stock. This reserve may be transferred to common stock by a resolution of the Board of Directors or used to reduce a deficit by a resolution of a shareholders' meeting, but is not available for dividend payments.

The Company's Board of Directors, with subsequent approval by shareholders, has made annual appropriations of retained earnings for various purposes, the accumulated balance of which is presented as "Voluntary reserves" in the accompanying financial statements. Any disposition of such appropriations shall be at the discretion of the Board of Directors and shareholders.

12. ANALYSIS OF NET SALES AND COST OF SALES

The breakdown of the Company's net sales and cost of sales for the years ended March 31, 1996, 1997 and 1998, is as follows:

	Millions of yen			Thousands of U.S. dollars
	1996	1997	**1998**	**1998**
Net sales:				
Product sales	¥251,095	¥250,010	**¥139,555**	**$1,056,435**
Merchandise sales	3,405	12,626	**36,710**	**277,895**
	254,500	262,636	**176,265**	**1,334,330**
Revenues from amusement center operations	82,136	88,191	**90,958**	**688,554**
Royalties on game software	9,546	9,103	**4,252**	**32,188**
	¥346,182	¥359,930	**¥271,475**	**$2,055,072**
Cost of sales:				
Cost of products and merchandise sold	¥219,052	¥227,033	**¥151,372**	**$1,145,889**
Cost of amusement center operations	51,916	58,113	**65,224**	**493,747**
	¥270,968	¥285,146	**¥216,596**	**$1,639,636**

13. RELATED PARTY TRANSACTIONS

The Company's transactions with its subsidiaries and affiliates for the years ended March 31, 1996, 1997 and 1998, are summarized as follows:

	Millions of yen			Thousands of U.S. dollars
	1996	1997	**1998**	**1998**
Sales to subsidiaries and affiliates (products)	¥120,661	¥147,608	**¥82,085**	**$621,385**
Sales to subsidiaries and affiliates (merchandise)	52	101	**120**	**908**
Revenues from amusement center operations	257	54	**46**	**348**
Royalty income	2,442	900	**1,068**	**8,085**
Interest income	232	51	**83**	**628**
Gain on sales of investments in subsidiaries and affiliates	757	4,416	**—**	**—**

14. LEASE COMMITMENTS AND CONTINGENT LIABILITIES

Finance lease contracts without ownership transfer as of and for the years ended March 31, 1997 and 1998, is summarized as follows:

Calculated amounts relevant to acquisition cost, accumulated depreciation and book value of leased properties as of March 31, 1997 and 1998, are summarized as follows:

	Millions of yen		Thousands of U.S. dollars
	1997	**1998**	**1998**
Amusement machines:			
Acquisition cost	¥3,271	**¥3,164**	**$23,951**
Accumulated depreciation	(1,474)	**(2,031)**	**(15,375)**
Book value	¥1,797	**¥1,133**	**$ 8,576**
Buildings:			
Acquisition cost	¥3,332	**¥3,517**	**$26,623**
Accumulated depreciation	(803)	**(1,280)**	**(9,689)**
Book value	¥2,529	**¥2,237**	**$16,934**
Others:			
Acquisition cost	¥4,341	**¥3,691**	**$27,940**
Accumulated depreciation	(2,249)	**(1,758)**	**(13,308)**
Book value	¥2,092	**¥1,933**	**$14,632**

The amount of outstanding future lease payments due at March 31, 1998, which included the portion of interest thereon, is summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Future lease payments:		
Within one year	¥2,057	$15,572
More than one year	3,538	26,783
	¥5,595	$42,355

Lease payment and the calculated amounts relevant to depreciation and interest expense for the leased properties for the year ended March 31, 1998, are summarized as follows:

	Millions of yen	Thousands of U.S. dollars
Lease payment	¥2,478	$18,759
Depreciation	2,185	16,540
Interest expense	324	2,453
	¥4,987	$37,752

The Company was contingently liable for guarantee of obligations as of March 31, 1998, as follows:

	Millions of yen	Thousands of U.S. dollars
Lease rental obligations under lease contracts made by		
SEGA Enterprises, Inc. (U.S.A.)	¥ 7,085	$ 53,634
SEGA Gameworks, L.L.C.	875	6,624
Cross Products Ltd.	157	1,188
Guarantee of obligation as collateral of bank loan made by		
Atlus Dream Entertainment Co., Ltd.	297	2,248
Guarantee commitment to collateral of bank loan made by		
SEGA Enterprises (Australia) Pty. Ltd.	5,053	38,251
	¥13,467	$101,945

15. LEGAL PROCEEDINGS

In August 1997, in the United States, 3Dfx Co., Ltd., which developed the 3-D Accelerator, filed a suit in the Santa Clara High Court, California, for compensatory damages against the Company and SEGA of America, Inc., due to the development contract regarding graphic chips for Dreamcast, the next-generation machines.

The companies are engaged in the legal proceedings of the trial of evidence disclosure at the status quo.

16. SUBSEQUENT EVENT

Appropriations of Retained Earnings

The appropriations of retained earnings in respect of the year ended March 31, 1998, proposed by the Board of Directors and approved by the General Meeting of Shareholders held on June 26, 1998, are as follows:

	Millions of yen	Thousands of U.S. dollars
Deficit as of March 31, 1998	¥(39,389)	$(298,176)
Reversal of special tax-purpose reserves	11	83
Reversal of voluntary reserves	45,000	340,651
	5,622	42,558
Appropriations:		
Cash dividends (¥38 per share)	2,315	17,524
Transfer to legal reserve	231	1,749
Total appropriations	2,546	19,273
Retained earnings to be carried forward	¥ 3,076	$ 23,285

17. STOCK OPTION PLAN

At the General Meeting of Shareholders held on June 26, 1998, shareholders of the Company approved a stock option plan for directors and employees. Under the plan, 130,000 shares and 322,000 shares of common stock of the Company may be granted to 9 directors and 177 employees, respectively. All options to be granted will be exercisable at an exercise price of 105% of the average market price for the month immediately preceding the date of grant over a period from July 1, 1999 through June 30, 2002. The purchase price will be subject to subsequent stock splits or issue of the Company's stock at less than the then-current market price.

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS ON THE NON-CONSOLIDATED FINANCIAL STATEMENTS

To: The Board of Directors of
SEGA Enterprises, Ltd.

We have audited the non-consolidated balance sheets of SEGA Enterprises, Ltd. as of March 31, 1997 and 1998, and the related non-consolidated statements of income, shareholders' equity, and cash flows for the years ended March 31, 1996, 1997 and 1998, all expressed in Japanese yen. These non-consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these non-consolidated financial statements based on our audit.

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

In our opinion, the non-consolidated financial statements referred to above present fairly, in all material respects, the non-consolidated financial position of SEGA Enterprises, Ltd. as of March 31, 1997 and 1998, and the results of its operations and cash flows for the years ended March 31, 1996, 1997 and 1998, in conformity with generally accepted accounting principles in Japan applied on a consistent basis.

June 26, 1998
Tokyo, Japan

Chuo Audit Corporation

Chuo Audit Corporation
Independent Certified Public Accountants

BOARD OF DIRECTORS

(As of June 26, 1998)

Representative Director and Chairman
Isao Okawa

Representative Director and Vice Chairman
Hayao Nakayama

Representative Director and President
Shoichiro Irimajiri

Representative Director and Executive Vice President
Hisashi Suzuki

Representative Director and Executive Vice President
Sadahiko Hirose

Director
Yoshiji Fukushima

Director
Yasushi Akimoto

Director
Tsuguhiko Kadokawa

Director
Yukio Sonoyama

SEGA ENTERPRISES, LTD.

Head Office

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Tel: (03) 5736-7111

Branch Offices

Sapporo, Kansai, Kyushu

Date of Incorporation

June 3, 1960

Paid-in Capital

¥39,154 million

Number of Employees

3,982

PRINCIPAL SUBSIDIARIES

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