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XEROX CORP  
Form 8-K  
July 24, 2003

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 8-K  
CURRENT REPORT

Pursuant to Section 13 or 15(d) of  
The Securities Exchange Act of 1934

Date of Report (date of earliest event reported):  
July 23, 2003

XEROX CORPORATION  
(Exact name of registrant as specified in its charter)

New York  
(State or other  
jurisdiction of  
incorporation)

1-4471  
(Commission File Number)

16-0468020  
(IRS Employer  
Identification No.)

800 Long Ridge Road  
P. O. Box 1600  
Stamford, Connecticut 06904-1600  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code:  
(203) 968-3000

Not Applicable  
(Former name or former address, if changed since last report)

References to "we," "our" or "us" refer to Xerox Corporation and its subsidiaries.

This Current Report on Form 8-K is being principally filed for the purpose of including a presentation of the condensed consolidating financial statements of our subsidiary guarantors included in Note 19 to our consolidated financial statements as of December 31, 2002 and 2001 and for each of the three years in the period ended December 31, 2002, in order to reflect a change in the composition of the subsidiaries which are guaranteeing our Senior Notes due 2009, as well as our Senior Notes due 2010 and 2013 that were issued in connection with the June 2003 recapitalization transactions.

Item 5. Other Events.

The information presented below supplements and updates Item 5 of the Current Report on Form 8-K, dated April 30, 2003, as well as Item 8 (Financial Statements and Supplementary Data) of Registrant's Annual Report on Form 10-K for the Year Ended December 31, 2002 for the change described above.

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The information presented below updates Item 8 of our 2002 Form 10-K.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Shareholders of Xerox Corporation:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, cash flows and common shareholders' equity present fairly, in all material respects, the financial position of Xerox Corporation and its subsidiaries at December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" on January 1, 2002.

PricewaterhouseCoopers LLP  
Stamford, Connecticut  
January 28, 2003, except for Notes 9, 15 and 20 which are as of April 30, 2003, March 27, 2003 and June 25, 2003, respectively

CONSOLIDATED STATEMENTS OF INCOME

|  |       |
|--|-------|
| Revenues                                       |       |
| Sales .....                                    | ..... |
| Service, outsourcing and rentals .....         | ..... |
| Finance income .....                           | ..... |
| Total Revenues .....                           | ..... |
| Costs and Expenses                             |       |
| Cost of sales .....                            | ..... |
| Cost of service, outsourcing and rentals ..... | ..... |
| Equipment financing interest .....             | ..... |
| Research and development expenses .....        | ..... |

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|   |  |
|---|--|
| Selling, administrative and general expenses .....  |  |
| Restructuring and asset impairment charges .....  |  |
| Gain on sale of half of interest in Fuji Xerox .....  |  |
| Gain on affiliate's sale of stock .....   |  |
| Gain on sale of China operations .....  |  |
| Other expenses, net .....   |  |
| <br>Total Costs and Expenses .....  |  |
| <br>Income (Loss) before Income Taxes (Benefits), Equity Income, Minorities'<br>Interests and Cumulative Effect of Change in Accounting Principle ..... |  |
| Income taxes (benefits) .....   |  |
| <br>Income (Loss) before Equity Income, Minorities' Interests and Cumulative Effect of<br>Change in Accounting Principle .....                          |  |
| Equity in net income of unconsolidated affiliates .....   |  |
| Minorities' interests in earnings of subsidiaries .....   |  |
| <br>Income (Loss) before Cumulative Effect of Change in Accounting Principle .....  |  |
| Cumulative effect of change in accounting principle .....   |  |
| <br>Net Income (Loss) .....   |  |
| Less: Preferred stock dividends, net .....  |  |
| <br>Income (Loss) available to common shareholders .....  |  |
| <br>Basic Earnings (Loss) per Share   |  |
| Income (Loss) before Cumulative Effect of Change in Accounting Principle .....  |  |
| <br>Net Earnings (Loss) per Share .....   |  |
| <br>Diluted Earnings (Loss) per Share   |  |
| Income (Loss) before Cumulative Effect of Change in Accounting Principle .....  |  |
| <br>Net Earnings (Loss) per Share .....   |  |

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

CONSOLIDATED BALANCE SHEETS

|   |  |
|---|--|
| Assets  |  |
| Cash and cash equivalents.....                  |  |
| Accounts receivable, net.....                   |  |
| Billed portion of finance receivables, net..... |  |
| Finance receivables, net.....                   |  |
| Inventories.....                                |  |
| Other current assets.....                       |  |

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Total Current Assets.....  
Finance receivables due after one year, net.....  
Equipment on operating leases, net.....  
Land, buildings and equipment, net.....  
Investments in affiliates, at equity.....  
Intangible assets, net.....  
Goodwill.....  
Deferred tax assets, long-term.....  
Other long-term assets.....

Total Assets.....

Liabilities and Equity  
Short-term debt and current portion of long-term debt.....  
Accounts payable.....  
Accrued compensation and benefits costs.....  
Unearned income.....  
Other current liabilities.....

Total Current Liabilities.....  
Long-term debt.....  
Pension liabilities.....  
Post-retirement medical benefits.....  
Other long-term liabilities.....

Total Liabilities.....  
Minorities' interests in equity of subsidiaries.....  
Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts  
holding solely subordinated debentures of the Company.....  
Preferred stock.....  
Deferred ESOP benefits.....  
Common stock, including additional paid in capital.....  
Retained earnings.....  
Accumulated other comprehensive loss.....

Total Liabilities and Equity.....

Shares of common stock issued and outstanding were (in thousands) 738,273 and 722,314 at December 31, 2002 and December 31, 2001, respectively.

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

Cash Flows from Operating Activities:

Ye  
---  
2002  
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|  |         |
|--|---------|
| Net income (loss)  | \$ 9    |
| Adjustments required to reconcile net income (loss) to cash flows from operating activities: |         |
| Depreciation and amortization.....   | 1,036   |
| Impairment of goodwill.....  | 46      |
| Provisions for receivables and inventory.....  | 67      |
| Restructuring and other charges.....   | (17)    |
| Deferred tax benefit.....  | (39)    |
| Cash payments for restructurings.....  | ( )     |
| Gain on early extinguishment of debt.....  | ( )     |
| Gains on sales of businesses and assets.....   | (2)     |
| Undistributed equity in income of affiliated companies.....                                  | 1       |
| Decrease in inventories.....   | (12)    |
| Increase in on-lease equipment.....  | 75      |
| Decrease (increase) in finance receivables.....  | (26)    |
| (Increase) decrease in accounts receivable and billed portion of finance receivables..       | -       |
| Proceeds from sale of accounts receivable, net   | 19      |
| Increase (decrease) in accounts payable and accrued compensation and benefits costs...       | (20)    |
| (Decrease) increase in income tax liabilities.....   | (25)    |
| (Decrease) increase in other current and long-term liabilities.....                          | 3       |
| Early termination of derivative contracts.....   | ( )     |
| Other, net.....  | -----   |
| Net cash provided by operating activities.....   | 1,87    |
| Cash Flows from Investing Activities:  |         |
| Cost of additions to land, buildings and equipment.....                                      | (14)    |
| Proceeds from sales of land, buildings and equipment.....                                    | 1       |
| Cost of additions to internal use software.....  | (5)     |
| Proceeds from divestitures.....  | 34      |
| Acquisitions, net of cash acquired.....  | ( )     |
| Funds released from (placed in) escrow and other restricted cash, net.....                   | 4       |
| Other, net.....  | ( )     |
| Net cash provided by (used in) investing activities.....                                     | -----   |
| Net cash provided by (used in) investing activities.....                                     | 19      |
| Cash Flows from Financing Activities:  |         |
| Cash proceeds from new secured financings.....   | 3,05    |
| Debt payments on secured financings.....   | (1,66)  |
| Other changes in debt, net.....  | (4,61)  |
| Proceeds from issuance of mandatorily redeemable preferred securities.....                   | -       |
| Dividends on common and preferred stock.....   | (6)     |
| Proceeds from issuances of common stock.....   | -       |
| Settlements of equity put options, net.....  | -       |
| Dividends to minority shareholders.....  | ( )     |
| Net cash (used in) provided by financing activities.....                                     | -----   |
| Net cash (used in) provided by financing activities.....                                     | (3,29)  |
| Effect of exchange rate changes on cash and cash equivalents.....                            | 11      |
| (Decrease) increase in cash and cash equivalents.....  | (1,10)  |
| Cash and cash equivalents at beginning of year.....  | 3,99    |
| Cash and cash equivalents at end of year.....  | \$ 2,88 |

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

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CONSOLIDATED STATEMENTS OF COMMON SHAREHOLDERS' EQUITY

|  | Common<br>Stock<br>Shares | Common<br>Stock<br>Amount | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>Loss |
|--|---------------------------|---------------------------|----------------------------------|----------------------|---|
| (In millions, except share data)                                   |                           |                           |                                  |                      |   |
| Balance at December 31, 1999 .....                                 | 665,156                   | \$ 667                    | \$ 1,600                         | \$ 1,910             |   |
| Net loss .....   |                           |                           |                                  | (273)                |   |
| Translation adjustments .....                                      |                           |                           |                                  |                      |   |
| Minimum pension liability, net of tax .....                        |                           |                           |                                  |                      |   |
| Unrealized loss on securities .....                                |                           |                           |                                  |                      |   |
| Comprehensive loss .....   |                           |                           |                                  |                      |   |
| Stock option and incentive plans .....                             | 940                       | 1                         | 32                               |                      |   |
| Xerox Canada exchangeable stock .....                              | 29                        |                           |                                  |                      |   |
| Convertible securities .....                                       | 2,451                     | 2                         | 28                               | (8)                  |   |
| Cash dividends declared:   |                           |                           |                                  |                      |   |
| Common stock (\$0.65 per share) .....                              |                           |                           |                                  | (434)                |   |
| Preferred stock (\$6.25 per<br>share), net of tax benefit .....    |                           |                           |                                  | (46)                 |   |
| Put options, net .....   |                           |                           | (100)                            |                      |   |
| Other .....  |                           |                           | 1                                | 1                    |   |
| Balance at December 31, 2000 .....                                 | 668,576                   | 670                       | 1,561                            | 1,150                |   |
| Net loss .....   |                           |                           |                                  | (94)                 |   |
| Translation adjustments .....                                      |                           |                           |                                  |                      |   |
| Minimum pension liability, net of tax .....                        |                           |                           |                                  |                      |   |
| Unrealized gain on securities .....                                |                           |                           |                                  |                      |   |
| FAS 133 transition adjustment .....                                |                           |                           |                                  |                      |   |
| Net unrealized gains on cash flow<br>hedges .....                  |                           |                           |                                  |                      |   |
| Comprehensive loss .....   |                           |                           |                                  |                      |   |
| Stock option and incentive plans .....                             | 546                       | 1                         | 5                                |                      |   |
| Xerox Canada exchangeable stock .....                              | 312                       |                           |                                  |                      |   |
| Convertible securities .....                                       | 5,865                     | 6                         | 36                               |                      |   |
| Cash dividends declared:   |                           |                           |                                  |                      |   |
| Common stock (\$0.05 per share) .....                              |                           |                           |                                  | (34)                 |   |
| Preferred stock (\$1.56 per<br>share), net of<br>tax benefit ..... |                           |                           |                                  | (12)                 |   |
| Put options, net .....   |                           |                           | 4                                |                      |   |
| Equity for debt exchanges .....                                    | 41,154                    | 41                        | 270                              |                      |   |
| Issuance of unregistered shares .....                              | 5,861                     | 6                         | 22                               |                      |   |
| Other .....  |                           |                           |                                  |                      | (2)   |
| Balance at December 31, 2001 .....                                 | 722,314                   | \$ 724                    | \$ 1,898                         | \$ 1,008             |   |
| Net income .....   |                           |                           |                                  | 91                   |   |
| Translation adjustments (2) .....                                  |                           |                           |                                  |                      |   |

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|  |         |        |          |          |
|--|---------|--------|----------|----------|
| Minimum pension liability, net of tax .....                      |         |        |          |          |
| Unrealized gain on securities .....                              |         |        |          |          |
| Net unrealized gains on cash flow<br>hedges .....                |         |        |          |          |
| Comprehensive income .....                                       |         |        |          |          |
| Stock option and incentive plans .....                           | 2,385   | 2      | 10       |          |
| Xerox Canada exchangeable stock                                  | 44      |        |          |          |
| Convertible securities .....                                     | 7,118   | 7      | 48       |          |
| Cash dividends declared:   |         |        |          |          |
| Preferred stock (\$10.94 per share),<br>net of tax benefit ..... |         |        |          | (73)     |
| Equity for debt exchanges .....                                  | 6,412   | 6      | 45       |          |
| Other .....  |         | (1)    |          | (1)      |
|  | -----   | -----  | -----    | -----    |
| Balance at December 31, 2002 .....                               | 738,273 | \$ 738 | \$ 2,001 | \$ 1,025 |
|  | =====   | =====  | =====    | =====    |

- (1) As of December 31, 2002, Accumulated Other Comprehensive Loss is composed of cumulative translation adjustments of \$(1,524), a minimum pension liability of \$(346) and cash flow hedging losses of \$(1).
- (2) Includes reclassification adjustments for foreign currency translation losses of \$59, that were realized in 2002 due to the sale of businesses. These amounts were included in accumulated other comprehensive loss in prior periods as unrealized losses. Refer to Note 4 for further discussion.

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in millions, except per-share data and unless otherwise indicated)

Note 1--Summary of Significant Accounting Policies

References herein to "we," "us" or "our" refer to Xerox Corporation and its subsidiaries unless the context specifically requires otherwise.

Description of Business and Basis of Presentation: We are The Document Company, and a leader in the global document market, developing, manufacturing, marketing, servicing and financing a complete range of document equipment, software, solutions and services.

Liquidity, Financial Flexibility and Funding Plans: We manage our worldwide liquidity using internal cash management practices, which are subject to (1) the statutes, regulations and practices of each of the local jurisdictions in which we operate, (2) the legal requirements of the agreements to which we are parties and (3) the policies and cooperation of the financial institutions we utilize to maintain such cash management practices. In 2000, our operational issues were exacerbated by significant competitive and industry changes, adverse economic conditions, and significant technology and acquisition spending. Together, these conditions negatively impacted our liquidity, which from 2000 to 2002 led to a series of credit rating downgrades, eventually to below investment grade. Consequently, our access to capital and derivative markets has been restricted. The downgrades also required us to cash-collateralize certain derivative and

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securitization arrangements to prevent them from terminating, and to immediately settle terminating derivative contracts. Further, we are required to maintain minimum cash balances in escrow on certain borrowings and letters of credit. In addition, as discussed in Note 15, the SEC would not allow us to publicly register any securities offerings while its investigation, which commenced in June 2000, was ongoing. This additional constraint essentially prevented us from raising funds from sources other than unregistered capital markets offerings and private lending or equity sources. Consequently, our credit ratings, which were already under pressure, came under greater pressure since credit rating agencies often include access to capital sources in their rating criteria.

While the conclusion of the SEC investigation in 2002 removed our previous inability to access public capital markets, we expect our ability to access unsecured credit sources to remain restricted as long as our credit ratings remain below investment grade, and we expect our incremental cost of borrowing to increase as a result of such credit ratings.

In June 2002, we entered into an Amended and Restated Credit Agreement (the "New Credit Facility") with a group of lenders, replacing our prior \$7 billion facility (the "Old Revolver"). At that time, we permanently repaid \$2.8 billion of the Old Revolver and subsequently paid \$710 on the New Credit Facility. At December 31, 2002, the New Credit Facility consisted of two tranches of term loans totaling \$2.0 billion and a \$1.5 billion revolving credit facility that includes a \$200 letter of credit subfacility. At December 31, 2002, \$3.5 billion was outstanding under the New Credit Facility. At December 31, 2002 we had no additional borrowing capacity under the New Credit Facility since the entire revolving facility was outstanding, including a \$10 letter of credit under the subfacility.

The New Credit Facility contains affirmative and negative covenants. The New Credit Facility contains financial covenants that the Old Revolver did not contain. Certain of the more significant covenants under the New Credit Facility are summarized below (this summary is not complete and is in all respects subject to the actual provisions of the New Credit Facility):

- . Excess cash of certain foreign subsidiaries and of Xerox Credit Corporation, a wholly-owned subsidiary, must be transferred to Xerox at the end of each fiscal quarter; for this purpose, "excess cash" generally means cash maintained by certain foreign subsidiaries taken as a whole in excess of their aggregate working capital and other needs in the ordinary course of business (net of sources of funds from third parties), including reasonably anticipated needs for repaying debt and other obligations and making investments in their businesses. In certain circumstances, we are not required to transfer cash to Xerox Corporation, the parent company, if the transfer cannot be made in a tax efficient manner or if it would be considered a breach of fiduciary duty by the directors of the foreign subsidiary;
- . Minimum EBITDA (a quarterly test that is based on rolling four quarters) ranging from \$1.0 to \$1.3 billion; for this purpose, "EBITDA" (Earnings before interest, taxes, depreciation and amortization) generally means EBITDA (excluding interest and financing income to the extent included in consolidated net income), less any amounts spent for software development that are capitalized;
- . Maximum leverage ratio (a quarterly test that is calculated as total adjusted debt divided by EBITDA) ranging from 4.3 to 6.0;
- . Maximum capital expenditures (annual test) of \$330 million per fiscal year plus up to \$75 million of any unused amount carried over from the previous year; for this purpose, "capital expenditures" generally mean the amounts included on our statement of cash flows as "additions to land, buildings



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and equipment, plus any capital lease obligations incurred;

- . Minimum consolidated net worth ranging from \$2.9 billion to \$3.1 billion; for this purpose, "consolidated net worth" generally means the sum of the amounts included on our balance sheet as "common shareholders' equity," "preferred stock," "company-obligated, mandatorily redeemable preferred securities of subsidiary trust holding solely subordinated debentures of the Company," except that the currency translation adjustment effects and the effects of compliance with FAS 133 occurring after December 31, 2001 are disregarded, the preferred securities (whether or not convertible) issued by us or by our subsidiaries which were outstanding on June 21, 2002 will always be included, and any capital stock or similar equity interest issued after June 21, 2002 which matures or generally becomes mandatorily redeemable for cash or puttable at holders' option prior to November 1, 2005 is always excluded; and
- . Limitations on: (i) issuance of debt and preferred stock; (ii) creation of liens; (iii) certain fundamental changes to corporate structure and nature of business, including mergers; (iv) investments and acquisitions; (v) asset transfers; (vi) hedging transactions other than in those in the ordinary course of business and certain types of synthetic equity or debt derivatives, and (vii) certain types of restricted payments relating to our, or our subsidiaries', equity interests, including payment of cash dividends on our common stock; (viii) certain types of early retirement of debt, and (ix) certain transactions with affiliates, including intercompany loans and asset transfers.

The New Credit Facility generally does not affect our ability to continue to monetize receivables under the agreements with GE and others. Although we cannot pay cash dividends on our common stock during the term of the New Credit Facility, we can pay cash dividends on our preferred stock, provided there is then no event of default. In addition to other defaults customary for facilities of this type, defaults on other debt, or bankruptcy, of Xerox Corporation, or certain of our subsidiaries, would constitute defaults under the New Credit Facility.

At December 31, 2002, we are in compliance with all aspects of the New Credit Facility including financial covenants and expect to be in compliance for at least the next twelve months. Failure to be in compliance with any material provision or covenant of the New Credit Facility could have a material adverse effect on our liquidity and operations.

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With \$2.9 billion of cash and cash equivalents on hand at December 31, 2002, we believe our liquidity (including operating and other cash flows we expect to generate) will be sufficient to meet operating cash flow requirements as they occur and to satisfy all scheduled debt maturities for at least the next twelve months. Our ability to maintain sufficient liquidity going forward is highly dependent on achieving expected operating results, including capturing the benefits from restructuring activities, and completing announced finance receivables securitizations. There is no assurance that these initiatives will be successful. Failure to successfully complete these initiatives could have a material adverse effect on our liquidity and our operations, and could require us to consider further measures, including deferring planned capital expenditures, reducing discretionary spending, selling additional assets and, if necessary, restructuring existing debt.

We also expect that our ability to fully access commercial paper and other

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unsecured public debt markets will depend upon improvements in our credit ratings, which in turn depend on our ability to demonstrate sustained profitability growth and operating cash generation and continued progress on our vendor financing initiatives. Until such time, we expect some bank credit lines to continue to be unavailable, and we intend to access other segments of the capital markets as business conditions allow, which could provide significant sources of additional funds until full access to the unsecured public debt markets is restored.

**Basis of Consolidation:** The consolidated financial statements include the accounts of Xerox Corporation and all of our controlled subsidiary companies. All significant intercompany accounts and transactions have been eliminated. Investments in business entities in which we do not have control, but we have the ability to exercise significant influence over operating and financial policies (generally 20 to 50 percent ownership), are accounted for using the equity method of accounting. Upon the sale of stock of a subsidiary, we recognize a gain or loss in our Consolidated Statements of Income equal to our proportionate share of the corresponding increase or decrease in that subsidiary's equity. Operating results of acquired businesses are included in the Consolidated Statements of Income from the date of acquisition. For further discussion of acquisitions, refer to Note 3.

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

**Income (Loss) before Income Taxes (Benefits), Equity Income, Minorities' Interests and Cumulative Effect of Change in Accounting Principle:** Throughout the Notes to the Consolidated Financial Statements, we refer to the effects of certain changes in estimates and other adjustments on Income (Loss) before Income Taxes (Benefits), Equity Income, Minorities' Interests and Cumulative Effect of Change in Accounting Principle. For convenience and ease of reference, that caption in our Consolidated Statements of Income is hereafter referred to as "pre-tax income (loss)."

**Use of Estimates:** The preparation of our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities, as well as the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions are used for, but not limited to: (i) allocation of revenues and fair values in multiple element arrangements; (ii) accounting for residual values; (iii) economic lives of leased assets; (iv) allowance for doubtful accounts; (v) retained interests associated with the sales of accounts or finance receivables; (vi) inventory valuation; (vii) restructuring and other related charges; (viii) asset impairments; (ix) depreciable lives of assets; (x) useful lives of intangible assets and goodwill (in 2002 goodwill is no longer amortized over an estimated useful life, see below for further discussion); (xi) pension and post-retirement benefit plans; (xii) income tax valuation allowances and (xiii) contingency and litigation reserves. Future events and their effects cannot be predicted with certainty; accordingly, our accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of our consolidated financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. Actual results could differ from those estimates.

The following table summarizes the more significant charges that require

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management estimates:

| (in millions)  | Year ended December 31, |        |       |
|--|-------------------------|--------|-------|
|  | 2002                    | 2001   | 2000  |
|  | -----                   | -----  | ----- |
| Restructuring provisions and asset impairments .....                 | \$ 670                  | \$ 715 | \$ 47 |
| Amortization and impairment of goodwill and intangible assets .....  | 99                      | 94     | 8     |
| Provisions for receivables .....                                     | 353                     | 506    | 61    |
| Provisions for obsolete and excess inventory .....                   | 115                     | 242    | 23    |
| Depreciation and obsolescence of equipment on operating leases ..... | 408                     | 657    | 62    |
| Depreciation of buildings and equipment .....                        | 341                     | 402    | 41    |
| Amortization of capitalized software .....                           | 249                     | 179    | 11    |
| Pension benefits - net periodic benefit cost .....                   | 168                     | 99     | 4     |
| Other post-retirement benefits - net periodic benefit cost .....     | 120                     | 130    | 10    |
| Deferred tax asset valuation allowance provisions .....              | 15                      | 247    | 1     |

Changes in Estimates: In the ordinary course of accounting for items discussed above, we make changes in estimates as appropriate, and as we become aware of circumstances surrounding those estimates. Such changes and refinements in estimation methodologies are reflected in reported results of operations in the period in which the changes are made and, if material, their effects are disclosed in the Notes to the Consolidated Financial Statements.

### New Accounting Standards and Accounting Changes:

Variable Interest Entities: In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an interpretation of ARB 51" ("FIN 46"). The primary objectives of FIN 46 are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("VIEs") and how to determine when and which business enterprise should consolidate the VIE. This new model for consolidation applies to an entity which either (1) the equity investors (if any) do not have a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. We do not expect the adoption of this standard to have any impact on our results of operations, financial position or liquidity.

Guarantees: In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others ("FIN 45")." This interpretation expands the disclosure requirements of guarantee obligations and requires the guarantor to recognize a liability for the fair value of the obligation assumed under a guarantee. In general, FIN 45 applies to contracts or indemnification agreements that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying instrument that is related to an asset, liability, or equity security of the guaranteed party. Other guarantees are subject to the disclosure requirements of FIN 45 but not to the recognition provisions and include, among others, a guarantee accounted for as a derivative instrument under SFAS 133, a parent's guarantee of debt owed to a third party by its subsidiary or vice versa, and a guarantee which is based on performance. The disclosure requirements of FIN 45 are effective as of December 31, 2002, and require information as to the nature of the guarantee, the maximum potential amount of future payments that the guarantor could be required to make under the guarantee, and the current amount of the liability, if any, for the guarantor's obligations under the guarantee. The recognition requirements of FIN 45 are to be applied prospectively to guarantees issued or modified after

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December 31, 2002. Significant guarantees that we have entered are disclosed in Note 15. We do not expect the requirements of FIN 45 to have a material impact on our results of operations, financial position or liquidity.

Stock-Based Compensation: In 2002, FASB issued Statement No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123" ("SFAS No. 148") which provides alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, this Statement amends APB Opinion No. 28, "Interim Financial Reporting," to require disclosure about those effects in interim financial information. We adopted SFAS No. 148 in the fourth quarter of 2002. Since we have not changed to a fair value method of stock-based compensation, the applicable portion of this statement only affects our disclosures.

We do not recognize compensation expense relating to employee stock options because we only grant options with an exercise price equal to the fair value of the stock on the effective date of grant. If we had elected to recognize compensation

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expense using a fair value approach, and therefore determined the compensation based on the value as determined by the modified Black-Scholes option pricing model, the pro forma net (loss) income and (loss) earnings per share would have been as follows:

|   |  |       |
|---|--|-------|
| Net income (loss)--as reported .....  |  | \$    |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax. .... |  | ----- |
| Net income (loss)--pro forma .....  |  | \$    |
|   |  | ===== |
| <br>  |  |       |
| Basic EPS--as reported .....  |  | \$    |
| Basic EPS--pro forma .....  |  | (     |
| Diluted EPS--as reported .....  |  | (     |
| Diluted EPS--pro forma .....  |  | (     |

As reflected in the pro forma amounts in the previous table, the fair value of each option granted in 2002, 2001 and 2000 was \$6.34, \$2.40 and \$7.50, respectively. The fair value of each option was estimated on the date of grant using the following weighted average assumptions:

|                           | 2002  | 2001  | 2000  |
|---------------------------|-------|-------|-------|
|                           | ----  | ----  | ----  |
| Risk-free interest rate   | 4.8%  | 5.1%  | 6.7%  |
| Expected life in years    | 6.5   | 6.5   | 7.1   |
| Expected price volatility | 61.5% | 51.4% | 37.0% |
| Expected dividend yield   | --    | 2.7%  | 3.7%  |

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**Costs Associated with Exit or Disposal Activities:** In 2002, the FASB issued Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS No. 146"). This standard requires companies to recognize costs associated with exit or disposal activities when they are incurred, rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, plant closing, or other exit or disposal activity. SFAS No. 146 is required to be applied prospectively to exit or disposal activities initiated after December 31, 2002, with earlier application encouraged. We adopted SFAS No. 146 in the fourth quarter of 2002. Refer to Note 2 for further discussion.

**Gains from Extinguishment of Debt:** On April 1, 2002, we adopted the provisions of Statement of Financial Accounting Standards No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" ("SFAS No. 145"). The portion of SFAS No. 145 that is applicable to us resulted in the reclassification of extraordinary gains on extinguishment of debt previously reported in the Consolidated Statements of Income as extraordinary items to Other expenses, net. The effect of this reclassification in the accompanying Consolidated Statements of Income was a decrease to Other expenses, net of \$63 and an increase to Income taxes of \$25, from amounts previously reported, for the year ended December 31, 2001.

**Impairment or Disposal of Long-Lived Assets:** In 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). SFAS No. 144 retains the previously existing accounting requirements related to the recognition and measurement of the impairment of long-lived assets to be held and used, while expanding the measurement requirements of long-lived assets to be disposed of by sale to include discontinued operations. It also expands on the previously existing reporting requirements for discontinued operations to include a component of an entity that either has been disposed of or is classified as held for sale. We adopted SFAS No. 144 on January 1, 2002. The adoption of this standard did not have a material effect on our financial position or results of operations.

**Asset Retirement Obligations:** In 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations." This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and associated asset retirement costs. We will adopt SFAS No. 143 on January 1, 2003 and do not expect this standard to have any effect on our financial position or results of operations.

**Business Combinations:** In 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS No. 141"), which requires the use of the purchase method of accounting for business combinations and prohibits the use of the pooling of interests method. We have not historically engaged in transactions that qualify for the

use of the pooling of interests method and therefore, this aspect of the new standard will not have an impact on our financial results. SFAS No. 141 also changes the definition of intangible assets acquired in a purchase business combination, providing specific criteria for the initial recognition and measurement of intangible assets apart from goodwill. As a result, the purchase price allocation of future business combinations may be different than the allocation that would have resulted under the previous rules. SFAS No. 141 also

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requires that upon adoption of Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" ("SFAS No. 142"), we reclassify the carrying amounts of certain intangible assets into or out of goodwill, based on certain criteria. Upon adoption of SFAS No. 142, we reclassified \$61 of intangible assets related to acquired workforce to goodwill that was required by this standard.

**Goodwill and Other Intangible Assets:** Goodwill represents the cost of acquired businesses in excess of the fair value of identifiable tangible and intangible net assets purchased, and prior to 2002 was amortized on a straight-line basis over periods ranging from 5 to 40 years. Other intangible assets represent the fair value of identifiable intangible assets acquired in purchase business combinations and include an acquired customer base, distribution network, technology and trademarks. Intangible assets are amortized on a straight-line basis over periods ranging from 7 to 25 years. We adopted SFAS No. 142 on January 1, 2002 and as a result, goodwill is no longer amortized.

SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets subsequent to their initial recognition. This statement recognizes that goodwill has an indefinite life and will no longer be subject to periodic amortization. However, goodwill is to be tested at least annually for impairment, using a fair value methodology, in lieu of amortization. The provisions of this standard also required that amortization of goodwill related to equity investments be discontinued, and that these goodwill amounts continue to be evaluated for impairment in accordance with Accounting Principles Board Opinion No. 18 "The Equity Method of Accounting for Investments in Common Stock."

SFAS No. 142 also requires performance of annual and transitional impairment tests on goodwill using a two-step approach. The first step is to identify a potential impairment and the second step is to measure the amount of any impairment loss. The first step requires a comparison of the carrying value of reporting units, as defined, to the fair value of these units. The standard requires that if a reporting unit's fair value is below its carrying value, a potential goodwill impairment exists and we would be required to complete the second step of the transitional impairment test to quantify the amount of the potential goodwill impairment charge. Based on the results of the first step of the transitional impairment test, we identified potential goodwill impairments in the reporting units included in our Developing Markets Operations ("DMO") operating segment. We subsequently completed the second step of the transitional goodwill impairment test, which required us to estimate the implied fair value of goodwill for each DMO reporting unit by allocating the fair value of each reporting unit to all of the reporting unit's assets and liabilities. The fair value of the reporting units giving rise to the transitional impairment loss was estimated using the present value of future expected cash flows. Because the carrying amount of each reporting unit's assets and liabilities (excluding goodwill) exceeded the fair value of each reporting unit, we recorded a goodwill impairment charge of \$63. This non-cash charge was recorded as a cumulative effect of change in accounting principle, in the accompanying Consolidated Statements of Income, as of January 1, 2002.

The following tables illustrate the pro-forma impact of the adoption of SFAS No. 142. Net Loss for the years ended December 31, 2001 and 2000, as adjusted for the exclusion of amortization expense, were as follows:

| For the Year Ended<br>December 31, |       |
|------------------------------------|-------|
| 2001                               | 2000  |
| -----                              | ----- |

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|  |         |          |
|--|---------|----------|
| Reported Net Loss .....                                  | \$ (94) | \$ (273) |
| Add: Amortization of goodwill, net of income taxes ..... | 59      | 58       |
|  | -----   | -----    |
| Adjusted Net Loss .....                                  | \$ (35) | \$ (215) |
|  | =====   | =====    |

Basic and Diluted Earnings per Share for the years ended December 31, 2001 and 2000, as adjusted for the exclusion of amortization expense, were as follows:

|  | For the Year Ended<br>December 31, |           |
|--|------------------------------------|-----------|
|  | 2001                               | 2000      |
|  | -----                              | -----     |
| Reported Net Loss per Share (Basic and Diluted) .....    | \$ (0.15)                          | \$ (0.48) |
| Add: Amortization of goodwill, net of income taxes ..... | 0.09                               | 0.09      |
|  | -----                              | -----     |
| Adjusted Net Loss per Share (Basic and Diluted) .....    | \$ (0.06)                          | \$ (0.39) |
|  | =====                              | =====     |

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Intangible assets totaled \$360 and \$457, net of accumulated amortization of \$98 and \$62 as of December 31, 2002 and 2001, respectively. All intangible assets relate to the Office operating segment and were comprised of the following as of December 31, 2002:

| As of December 31, 2002: | Amortization<br>Period | Gross<br>Carrying<br>Amount (1) | Accumulated<br>Amortization | Net Amount |
|--------------------------|------------------------|---------------------------------|-----------------------------|------------|
| -----                    | -----                  | -----                           | -----                       | -----      |
| Installed customer base  | 17.5 years             | \$ 209                          | \$ 33                       | \$ 176     |
| Distribution network     | 25 years               | 123                             | 15                          | 108        |
| Existing technology      | 7 years                | 103                             | 41                          | 62         |
| Trademarks               | 7 years                | 23                              | 9                           | 14         |
|                          |                        | -----                           | -----                       | -----      |
|                          |                        | \$ 458                          | \$ 98                       | \$ 360     |
|                          |                        | =====                           | =====                       | =====      |

(1) Balances exclude the amount of \$61 related to acquired workforce intangible asset, that was classified to goodwill as of January 1, 2002.

Amortization expense related to intangible assets was \$36, \$40 and \$55 for the years ended December 31, 2002, 2001 and 2000, respectively (including \$4 of amortization in 2001 on the acquired workforce prior to reclassification). Amortization expense related to these intangible assets is expected to remain approximately \$36 annually through 2007.

The following table presents the changes in the carrying amount of goodwill, by operating segment, for the year ended December 31, 2002:

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|   | Production | Office | DMO   | Other |
|---|------------|--------|-------|-------|
| Balance at January 1, 2002 (1)          | \$605      | \$710  | \$ 70 | \$121 |
| Foreign currency translation adjustment | 82         | 55     | (3)   | --    |
| Impairment charge                       | --         | --     | (63)  | --    |
| Divestitures                            | (4)        | --     | (1)   | --    |
| Other                                   | --         | (5)    | (3)   | --    |
|   | ----       | ----   | ----- | ----  |
| Balance at December 31, 2002            | \$683      | \$760  | \$ -- | \$121 |
|   | ====       | ====   | ===== | ====  |

(1) Balances include the amount of \$61 related to acquired workforce intangible asset, that was classified to goodwill as of January 1, 2002.

Derivatives and Hedging: Effective January 1, 2001, we adopted Statement of Financial Accounting Standards, No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), which requires companies to recognize all derivatives as assets or liabilities measured at their fair value, regardless of the purpose or intent of holding them. Gains or losses resulting from changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, depending on the type of hedge transaction. Changes in fair value for derivatives not designated as hedging instruments and the ineffective portions of hedges are recognized in earnings in the current period. The adoption of SFAS No. 133 resulted in a net cumulative after-tax loss of \$2 in the accompanying Consolidated Statement of Income and a net cumulative after-tax loss of \$19 in Accumulated Other Comprehensive Income which is included in the accompanying Consolidated Balance Sheet. Further, as a result of recognizing all derivatives at fair value, including the differences between the carrying values and fair values of related hedged assets, liabilities and firm commitments, we recognized a \$361 increase in assets and a \$382 increase in liabilities. Refer to Note 12 to the Consolidated Financial Statements for further discussion.

Revenue Recognition: In the normal course of business, we generate revenue through the sale and rental of equipment, service, and supplies and income associated with the financing of our equipment sales. Revenue is recognized when earned. More specifically, revenue related to sales of our products and services is recognized as follows:

Equipment: Revenues from the sale of equipment, including those from sales-type leases, are recognized at the time of sale or at the inception of the lease, as appropriate. For equipment sales that require us to install the product at the customer location, revenue is recognized when the equipment has been delivered to and installed at the customer location. Sales of customer installable and retail products are recognized upon shipment or receipt by the customer according to the customer's shipping terms. Revenues from equipment under other leases and similar arrangements are accounted for by the operating lease method and are recognized as earned over the lease term, which is generally on a straight-line basis.

Service: Service revenues are derived primarily from maintenance contracts on our equipment sold to customers and are recognized over the term of the contracts. A substantial portion of our products are sold with full service maintenance agreements for which the customer typically pays a base service fee plus a variable amount based on usage. As a



consequence, we do not have any significant product warranty obligations, including any obligations under customer satisfaction programs.

Supplies: Supplies revenue generally is recognized upon shipment or utilization by customer in accordance with sales terms.

Revenue Recognition Under Bundled Arrangements: We sell most of our products and services under bundled contract arrangements, which contain multiple deliverable elements. These contractual lease arrangements typically include equipment, service, supplies and financing components for which the customer pays a single negotiated price for all elements. These arrangements typically also include a variable component for page volumes in excess of contractual minimums, which are often expressed in terms of price per page, which we refer to as the "cost per copy." In a typical bundled arrangement, our customer is quoted a fixed minimum monthly payment for 1) the equipment, 2) the associated services and other executory costs and 3) the financing element. The fixed minimum monthly payments are multiplied by the number of months in the contract term to arrive at the total fixed minimum payments that the customer is obligated to make ("fixed payments") over the lease term. The payments associated with page volumes in excess of the minimums are contingent on whether or not such minimums are exceeded ("contingent payments"). The minimum contractual committed copy volumes are typically negotiated to equal the customer's estimated copy volume at lease inception. In applying our lease accounting methodology, we consider the fixed payments for purposes of allocating to the fair value elements of the contract. We do not consider the contingent payments for purposes of allocating to the elements of the contract or recognizing revenue on the sale of the equipment, given the inherent uncertainties as to whether such amounts will ever be received. Contingent payments are recognized as revenue in the period when the customer exceeds the minimum copy volumes specified in the contract.

When separate prices are listed in multiple element customer contracts, such prices may not be representative of the fair values of those elements, because the prices of the different components of the arrangement may be modified through customer negotiations, although the aggregate consideration may remain the same. Therefore, revenues under these arrangements are allocated based upon estimated fair values of each element. Our revenue allocation methodology first begins by determining the fair value of the service component, as well as other executory costs and any profit thereon and second, by determining the fair value of the equipment based on comparison of the equipment values in our accounting systems to a range of cash selling prices or, if applicable, other verifiable objective evidence of fair value. We perform extensive analyses of available verifiable objective evidence of equipment fair value based on cash selling prices during the applicable period. The cash selling prices are compared to the range of values included in our lease accounting systems. The range of cash selling prices must support the reasonableness of the lease selling prices, taking into account residual values that accrue to our benefit, in order for us to determine that such lease prices are indicative of fair value. Our interest rates are developed based upon a variety of factors including local prevailing rates in the marketplace and the customer's credit history, industry and credit class. These rates are recorded within our pricing systems. The resultant implicit interest rate, which is the same as our pricing interest rate, unless adjustment to equipment values is required, is then compared to fair market value rates to assess the reasonableness of the fair value allocations to the multiple elements.

Determination of Appropriate Revenue Recognition for Leases: Our accounting for leases involves specific determinations under Statement of Financial Accounting Standards No. 13 "Accounting for Leases" ("SFAS No. 13") which often involve

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complex provisions and significant judgments. The two primary criteria of SFAS No. 13 which we use to classify transactions as sales-type or operating leases are (1) a review of the lease term to determine if it is equal to or greater than 75 percent of the economic life of the equipment and (2) a review of the minimum lease payments to determine if they are equal to or greater than 90 percent of the fair market value of the equipment. Under our current product portfolio and business strategies, a non-cancelable lease of 45 months or more generally qualifies as a sale. Certain of our lease contracts are customized for larger customers, which results in complex terms and conditions and requires significant judgment in applying the above criteria. In addition to these, there are also other important criteria that are required to be assessed, including whether collectibility of the lease payments is reasonably predictable and whether there are important uncertainties related to costs that we have yet to incur with respect to the lease. In our opinion, our sales-type lease portfolios contain only normal credit and collection risks and have no important uncertainties with respect to future costs. Our leases in our Latin America operations have historically been recorded as operating leases since a majority of these leases are terminated significantly prior to the expiration of the contractual lease term. Specifically, because we generally do not collect the receivable from the initial transaction upon termination or during any subsequent lease term, the recoverability of the lease investment is deemed not to be predictable at lease inception. We continue to evaluate economic, business and political conditions in the Latin American region to determine if certain leases will qualify as sales type leases in future periods.

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The critical estimates and judgements that we consider with respect to our lease accounting, are the determination of the economic life and the fair value of equipment, including the residual value. Those estimates are based upon historical experience with all our products. For purposes of estimating the economic life, we consider the most objective measure of historical experience to be the original contract term, since most equipment is returned by lessees at or near the end of the contracted term. The estimated economic life of most of our products is five years since this represents the most frequent contractual lease term for our principal products and only a small percentage of our leases having original terms longer than five years. We believe that this is representative of the period during which the equipment is expected to be economically usable, with normal service, for the purpose for which it is intended. We continually evaluate the economic life of both existing and newly introduced products for purposes of this determination. Residual values are established at lease inception using estimates of fair value at the end of the lease term. Our residual values are established with due consideration to forecasted supply and demand for our various products, product retirement and future product launch plans, end of lease customer behavior, remanufacturing strategies, used equipment markets if any, competition and technological changes.

The vast majority of our leases that qualify as sales-type are non-cancelable and include cancellation penalties approximately equal to the full value of the leased equipment. Certain of our governmental contracts may have cancellation provisions or renewal clauses that are required by law, such as 1) those dependant on fiscal funding outside of a governmental unit's control, 2) those that can be cancelled if deemed in the taxpayer's best interest or 3) those that must be renewed each fiscal year, given limitations that may exist on entering multi- year contracts that are imposed by statute. In these circumstances and in accordance with the relevant accounting literature, we carefully evaluate these contracts to assess whether cancellation is remote or the renewal option is reasonably assured of exercise because of the existence of substantive economic penalties for the customer's failure to renew.

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Aside from the initial lease of equipment to our customers, we may enter subsequent transactions with the same customer whereby we extend the term. We evaluate the classification of lease extensions of sales-type leases using the originally determined economic life for each product. There may be instances where we have lease extensions for periods that are within the original economic life of the equipment. These are accounted for as sales-type leases only when the extensions occur in the last three months of the lease term and they otherwise meet the appropriate criteria of SFAS 13. All other lease extensions of this type are accounted for as direct financing leases. We generally account for lease extensions that go beyond the economic life as operating leases because of important uncertainties as to the amount of servicing and repair costs that we may incur.

**Cash and Cash Equivalents:** Cash and cash equivalents consist of cash on hand and investments with original maturities of three months or less.

**Restricted Cash and Investments:** Due to our credit ratings, many of our derivative contracts and several other material contracts require us to post cash collateral or maintain minimum cash balances in escrow. These cash amounts are reported in our Consolidated Balance Sheets within Other current assets or Other long-term assets, depending on when the cash will be contractually released. At December 31, 2002 and 2001, such restricted cash amounts were as follows:

|   |    |
|---|----|
| Escrow and cash collections related to the secured borrowings with GE - U.S. and Canada                 | \$ |
| Escrow related to distribution payments for the 2001 trust preferred securities                         |    |
| Collateral related to swaps and letters of credit   |    |
| Escrow and cash collections related to our asset-backed security transactions and other restricted cash |    |
| Total   | \$ |

Of these amounts, \$263 and \$235 were included in Other current assets and \$415 and \$351, were included in Other long-term assets, as of December 31, 2002 and 2001, respectively. The current amounts are expected to be available for our use within one year. The total increase in restricted cash during 2002 of \$92 is included in the Consolidated Statement of Cash Flows as a use of cash of \$104 in other, net of Operating Activities and a source of cash of \$12 in investing activities (of the total \$41).

**Securitizations and Transfers of Receivables:** From time to time, in the normal course of business, we may securitize or sell finance and accounts receivable with or without recourse and/or discounts. The receivables are removed from the Consolidated Balance Sheet at the time they are sold and the risk of loss has transferred to the purchaser. However, we maintain risk of loss on our retained interest in such receivables. Sales and transfers that do not meet the criteria for surrender of control or were sold to a consolidated special purpose entity (non-qualified special purpose entity) are accounted for as secured borrowings. When we sell receivables in securitizations of finance receivables or accounts receivable, we retain servicing rights, beneficial interests, and, in some cases, a cash reserve account, all of which are retained interests in the

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securitized receivables. The value assigned to the retained interests in securitized trade receivables is based on the relative fair values of the interest retained and sold in the securitization. We estimate fair value based on the present value of future expected cash flows using management's best estimates of the key assumptions, consisting of receivable amounts, anticipated credit losses and discount rates commensurate with the risks involved. Gains or losses on the sale of the receivables depend in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer.

**Provisions for Losses on Uncollectible Receivables:** The provisions for losses on uncollectible trade and finance receivables are determined principally on the basis of past collection experience applied to ongoing evaluations of our receivables and evaluations of the risks of repayment. Allowances for doubtful accounts on accounts receivable balances were \$282 and \$306, as of December 31, 2002 and 2001, respectively. Allowances for doubtful accounts on finance receivables were \$324 and \$368 at December 31, 2002 and 2001, respectively.

**Inventories:** Inventories are carried at the lower of average cost or realizable values.

**Land, Buildings and Equipment and Equipment on Operating Leases:** Land, buildings and equipment are recorded at cost. Buildings and equipment are depreciated over their estimated useful lives. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful life. Equipment on operating leases is depreciated to its estimated residual value over the term of the lease. Depreciation is computed using principally the straight-line method. Significant improvements are capitalized and maintenance and repairs are expensed. Refer to Notes 6 and 7 for further discussion.

**Internal Use Software:** We capitalize direct costs incurred during the application development stage and the implementation stage for developing, purchasing or otherwise acquiring software for internal use. These costs are amortized over the estimated useful lives of the software, generally three to five years. All costs incurred during the preliminary project stage, including project scoping, identification and testing of alternatives, are expensed as incurred. During 2002 we wrote off \$106 of permanently impaired internal-use capitalized software. Refer to Note 7 for further discussion.

**Impairment of Long-Lived Assets:** We review the recoverability of our long-lived assets, including buildings, equipment, internal-use software and other intangible assets, when events or changes in circumstances occur that indicate that the carrying value of the asset may not be recoverable. The assessment of possible impairment is based on our ability to recover the carrying value of the asset from the expected future pre-tax cash flows (undiscounted and without interest charges) of the related operations. If these cash flows are less than the carrying value of such asset, an impairment loss is recognized for the difference between estimated fair value and carrying value. The measurement of impairment requires management to make estimates of these cash flows related to long-lived assets, as well as other fair value determinations.

**Research and Development Expenses:** Research and development costs are expensed as incurred.

**Pension and Post-Retirement Benefit Obligations:** We sponsor pension plans in various forms and in various countries covering substantially all employees who meet certain eligibility requirements. Post-retirement benefit plans cover primarily U.S. employees for retirement medical costs. As required by existing accounting rules, we employ a delayed recognition feature in measuring the costs

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and obligations of pension and post-retirement benefit plans. This allows for changes in the benefit obligations and changes in the value of assets set aside to meet those obligations, to be recognized, not as they occur, but systematically and gradually over subsequent periods. All changes are ultimately recognized, except to the extent they may be offset by subsequent changes. At any point, changes that have been identified and quantified await subsequent accounting recognition as net cost components and as liabilities or assets.

Several statistical and other factors that attempt to anticipate future events are used in calculating the expense, liability and asset values related to our pension and post-retirement benefit plans. These factors include assumptions we make about the discount rate, expected return on plan assets, rate of increase in healthcare costs, the rate of future compensation increases, and mortality, among others. Actual returns on plan assets are not immediately recognized in our income statement, due to the aforementioned delayed recognition feature that we follow in accounting for pensions. In calculating the expected return on the plan asset component of our net periodic pension cost, we apply our estimate of the long term rate of return to the plan assets that support our pension obligations, after deducting assets that are specifically allocated to Transitional Retirement Accounts (which are accounted for based on specific plan terms).

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For purposes of determining the expected return on plan assets, we utilize a calculated value approach in determining the value of the pension plan assets, as opposed to a fair market value approach. The primary difference between the two methods relates to, systematic recognition of changes in fair value over time (generally two years) versus immediate recognition of changes in fair value. Our expected rate of return on plan assets is then applied to the calculated asset value to determine the amount of the expected return on plan assets to be used in the determination of the net periodic pension cost. The calculated value approach reduces the volatility in net periodic pension cost that results from using the fair market value approach.

The difference between the actual return on plan assets and the expected return on plan assets is added to, or subtracted from, any cumulative differences that arose in prior years. This amount is a component of the unrecognized net actuarial (gain) loss and is subject to amortization to net periodic pension cost over the remaining service lives of the employees participating in the pension plan.

An additional significant assumption affecting our pension and post-retirement benefit obligations and the net periodic pension and other post-retirement benefit cost is the rate that we use to discount our future anticipated benefit obligations. In estimating this rate, we consider rates of return on high quality fixed-income investments currently available, and expected to be available, during the period to maturity of the pension benefits.

Foreign Currency Translation: The functional currency for most foreign operations is the local currency. Net assets are translated at current rates of exchange, and income, expense and cash flow items are translated at the average exchange rate for the year. The translation adjustments are recorded in Accumulated Other Comprehensive Income. The U.S. dollar is used as the functional currency for certain subsidiaries that conduct their business in U.S. dollars or operate in hyperinflationary economies. A combination of current and historical exchange rates is used in remeasuring the local currency transactions of these subsidiaries, and the resulting exchange adjustments are included in income. Aggregate foreign currency losses were \$77 in 2002 and gains were \$29 and \$103 in 2001 and 2000, respectively, and are included in Other expenses, net

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in the accompanying Consolidated Statements of Income. Effective January 1, 2002, we changed the functional currency of our Argentina operation from the U.S. dollar to the Peso as a result of operational changes made subsequent to the government's new economic plan.

### Note 2--Restructuring Programs

Since early 2000, we have engaged in a series of restructuring programs related to downsizing our employee base, exiting certain businesses, outsourcing certain internal functions and engaging in other actions designed to reduce our cost structure. We accomplished these objectives through the undertaking of restructuring initiatives, two of which, the SOHO Disengagement and the March 2000 Restructuring, are now substantially completed. The execution of the Turnaround Program and the Fourth Quarter 2002 Restructuring Program and related payments of obligations continued through December 31, 2002. As management continues to evaluate the business, there may be supplemental charges for new plan initiatives as well as changes in estimates to amounts previously recorded, as payments are made or actions are completed. Asset impairment charges were incurred in connection with these restructuring actions for those assets made obsolete or redundant as a result of the plans. The restructuring and asset impairment charges in the Consolidated Statements of Income totaled \$670, \$715 and \$475 in 2002, 2001 and 2000, respectively.

The restructuring initiatives and a summary of the impacts on our financial statements were as follows:

| RESTRUCTURING ACTION                        | INITIATION OF PLAN |
|---|--------------------|
| . Fourth Quarter 2002 Restructuring Program | November 2002      |
| . Turnaround Program                        | October 2000       |
| . SOHO Disengagement                        | June 2001          |
| . March 2000 Restructuring                  | March 2000         |

Detailed information about each of the above restructuring programs and the applicable accounting rules we applied are outlined below.

Fourth Quarter 2002 Restructuring Program. As more fully discussed in Note 1, on October 1, 2002, we adopted the provisions of SFAS No. 146. During the fourth quarter of 2002, we announced a worldwide restructuring program and subsequently recorded a provision of \$402. The fair value of the initial liability was determined by discounting the future cash outflows using our credit-adjusted risk-free borrowing rate of 5.9 percent. The provision consisted of \$312 for

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severance and related costs (including \$32 for special termination benefits and pension curtailment charges) and \$45 of costs associated with lease terminations and future rental obligations net of estimated future sublease rents. We also recorded \$45 for asset impairments associated with the exit activities. Of the total asset impairment charge, \$32 relates to the recognition of currency translation adjustment losses on our investment that were recognized in conjunction with the shutdown of a foreign subsidiary. The remaining asset impairment related to the write-off of leasehold improvements in exited facilities. The total included in Restructuring and asset impairment charges in the Consolidated Statements of Income for the Fourth Quarter 2002 Restructuring Program was \$402.

Key initiatives of this restructuring include the following:

- .. Streamlining manufacturing and administrative operations;
- .. Transitioning to an indirect sales and service model for our Office segment

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- in Europe;
- .. Implementing an average ten percent reduction in the number of middle and upper managers across all our businesses in the United States;
- .. Outsourcing work in areas not related to our core business operations and where there is an economic advantage. This includes the outsourcing of certain service functions and moving towards an indirect sales model where it was deemed cost beneficial to do so.
- .. Implementing a wide-ranging series of initiatives across Developing Markets Operations ("DMO") geographies to improve productivity and reduce costs; and
- .. Integrating Xerox Engineering Systems ("XES") into our North American and European operations from its previous stand-alone structure.

The severance and other employee separation costs are related to the elimination of approximately 4,700 positions worldwide. Approximately 55 percent, 31 percent, 11 percent and 3 percent of the positions related to the U.S., Europe, Latin America and Canada, respectively. As of December 31, 2002, approximately 1,700 of the 4,700 affected employees had been separated under the program, and a majority of the remainder are expected to be separated in the first quarter of 2003.

SFAS No. 146 requires recognition and measurement of a liability for lease and other contract termination costs. For those lease contracts that are not terminated, a liability must be recorded when the entity ceases using the leased property. This liability is based on remaining rentals over the lease term, net of estimated sublease rentals that can be reasonably obtained for the property, regardless of whether the entity intends to enter a sublease. The sublease rates are based on estimated market rental rates. External factors, such as appraisals, recent rental activities in local markets, history of subleases in the same or similar space and other factors are all considered when estimating sublease rentals. Our estimated lease costs of \$45 for properties exited as part of the Fourth Quarter 2002 Restructuring Program are net of future sublease rentals of \$19.

The lease termination and asset impairment charge related primarily to the exiting and consolidation of office facilities, distribution centers and warehouses worldwide. The majority of the U.S. consolidation resulted in a provision of \$36, and was for facilities located in California and other smaller locations. The remaining provision of \$9 related to the consolidation of certain European facilities as a result of the reduction in personnel. The Fourth Quarter Restructuring Program reserve balance at December 31, 2002 of \$286 is expected to be substantially utilized in 2003. As mentioned above, we recorded \$32 in special termination benefits and pension curtailment charges representing enhanced retirement benefits given to early retirees and the recognition of previously unrecognized pension and other benefit costs that will be paid to such employees. In addition to these pension related costs, we also incur others such as pension settlements. A pension settlement occurs when we make lump-sum cash payments to plan participants in exchange for their rights to receive pension benefits in the future. We are required to recognize a loss, if at the time of the settlement, the assets attributable to those participants included unrecognized losses. We expect that many of the terminated employees will subsequently elect to receive lump-sum cash payments in 2003. In accordance with pension accounting rules, we are not permitted to recognize such gains or losses, until such settlement occurs. We expect 2003 restructuring charges of approximately \$115, \$90 of which are expected to relate to pension settlements in the Production and Office segments. Such amounts could change based on the actual level of participants who elect to receive the lump sum distributions and the pension asset values as of such date. The balance of the planned 2003 restructuring charges relate to additional severance and cost reduction actions associated with our Xerox Engineering Services ("XES") business in the Other segment.

The following table summarizes the restructuring activity for the Fourth Quarter

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2002 Restructuring Program for the year ended December 31, 2002:

|                              | Severance and related<br>costs | Lease Cancellation<br>and Other Costs | Total  |
|------------------------------|--------------------------------|---------------------------------------|--------|
| Provision, net of accretion  | 312                            | 45                                    | 357    |
| Charges against reserve/(1)/ | (71)                           | -                                     | (71)   |
|                              | -----                          | -----                                 | -----  |
| Balance December 31, 2002    | \$ 241                         | 45                                    | \$ 286 |
|                              | =====                          | =====                                 | =====  |

(1) Includes the impact of currency translation adjustments of \$3.

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Restructuring and asset impairment charges of \$402 for the Fourth Quarter 2002 Restructuring Program were comprised of \$145 in our Production segment, \$102 in our Office segment, \$55 in our DMO segment and \$100 in our Other segment.

Turnaround Program. The Turnaround Program began in October to reduce costs, improve operations, transition customer equipment financing to third party vendors and sell certain assets.

In the fourth quarter of 2000, we provided \$105, consisting of \$71 for severance and related costs and \$34 for asset impairments associated with the disposition of Delphax, which supplied high-speed election beam digital printing systems. Over half of these charges related to our Production operating segment, with the remainder relating to our Office, DMO and Other operating segments. During 2001, we provided an additional \$403 of restructuring and asset impairment charges, net of reversals of \$26. The reversals related to actual employee separation costs being lower than we originally anticipated. This was largely due to employee attrition, prior to fulfilling the services required before severance became payable as well as certain employees that were subsequently redeployed within our other businesses as a result of unrelated attrition in these other businesses. Of the amounts provided, \$339 was for severance and other employee separation costs (including \$21 for pension curtailment charges), \$36 was for lease cancellation and other exit costs and \$28 was for asset impairments. The majority of these charges related to our Production and Office operating segments. The lease termination and other exit costs and asset impairments related primarily to manufacturing operations. Included in 2001 restructuring charges are \$24, primarily for severance and other employee separation costs, related to the outsourcing of certain Office operating segment manufacturing to Flextronics, as discussed in Note 4.

As of December 31, 2001, we had \$223 of Turnaround Program restructuring reserves remaining, primarily related to employee severance as a result of our downsizing efforts. During the year ended December 31, 2002, we provided an additional \$253 (including special termination benefits and pension curtailments of \$27), net of \$33 reversals. The reversals are related to employee attrition prior to severance payments, lower costs of outplacement programs and other costs. These provisions were primarily for severance and other employee separation costs affecting our Production and Office operating segments, as well as a minor amount of lease termination and other costs. The 2002 charge related to the elimination of redundant resources and the consolidation of activities into other existing operations, bringing the total eliminated positions, since the inception of the Turnaround Program, to approximately 11,200. As of December 31, 2002, substantially all the 11,200 affected employees had separated under



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the program. The Turnaround Program reserve balance at December 31, 2002 was \$131, which is expected to be substantially utilized in the first half of 2003. The total net costs included in Restructuring and asset impairment charges in the Consolidated Statements of Income for the Turnaround Program were \$253, \$403 and \$105 in 2002, 2001 and 2000, respectively.

The following table summarizes the restructuring activity for the Turnaround Program for the two years ended December 31, 2002:

|                                | Severance and<br>related costs | Lease<br>Cancellation<br>and Other Costs | Total |
|--------------------------------|--------------------------------|--|-------|
|                                |                                |  |       |
| Turnaround Program             |                                |  |       |
| Restructuring Costs:           |                                |  |       |
| Balance December 31, 2000/(1)/ | \$ 71                          | \$ --                                    | \$ 71 |
| Provision                      | 364                            | 37                                       | 401   |
| Reversal                       | (25)                           | (1)                                      | (26)  |
| Charges/(2)/                   | (219)                          | (4)                                      | (223) |
|                                | -----                          | -----                                    | ----- |
| Balance December 31, 2001      | 191                            | 32                                       | 223   |
|                                | -----                          | -----                                    | ----- |
| Provision                      | 261                            | 25                                       | 286   |
| Reversal                       | (28)                           | (5)                                      | (33)  |
| Charges/(2)/                   | (320)                          | (25)                                     | (345) |
|                                | -----                          | -----                                    | ----- |
| Balance December 31, 2002      | \$ 104                         | \$ 27                                    | \$131 |
|                                | =====                          | =====                                    | ===== |

/(1)/ There were no charges against reserves for the Turnaround Program in 2000.

/(2)/ Includes the impact of currency translation adjustments of \$12 and (\$8) for the years ended December 31, 2002 and 2001, respectively.

SOHO Disengagement. In 2001, we began a separate restructuring program associated with the disengagement from our worldwide small office/ home office ("SOHO") business. In connection with exiting this business in 2001, we recorded a provision of \$239, net of reversals of \$26. Reversals were primarily related to a higher than anticipated number of

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employees re-deployed and better than expected experience in certain contract terminations. The charge included provisions for the elimination of approximately 1,200 positions worldwide by the end of 2001, the closing of facilities and the write down of certain assets to net realizable value. The restructuring provision associated with this action included \$164 for asset impairments, \$49 for lease terminations, purchase commitments and other exit costs, and \$26 for severance and employee separation costs. An additional provision of \$34 related to excess inventory was recorded as a charge to Cost of Sales in our Consolidated Statements of Income.

During the fourth quarter 2001, we depleted our inventory of personal inkjet and xerographic printers, copiers, facsimile machines and multifunction devices which were sold primarily through retail channels to small offices, home offices and personal users (consumers). We continue to provide service, support and supplies, including the manufacturing of such supplies, for customers who currently own these products during a phase-down period to meet customer needs.

During 2002, we recorded a charge of \$10 primarily for asset impairment charges for a change in the estimated recoverability of the Ireland SOHO facility. The

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total net costs included in Restructuring and asset impairment charges in the Consolidated Statements of Income for the SOHO disengagement were \$10 and \$239 in 2002 and 2001, respectively. Charges against the reserve were \$17 and \$52 in 2002 and 2001, respectively. The SOHO disengagement program had been substantially completed as of December 31, 2002, with \$6 of reserves remaining for severance and lease cancellation costs.

March 2000 Restructuring. In March 2000, we announced details of a worldwide restructuring program and recorded charges of \$489 which included severance and employee separation costs of \$424 related to the elimination of 5,200 positions worldwide, asset impairments of \$30 and other exit costs of \$35. An additional provision of \$84 related to excess inventory primarily resulting from the planned consolidation of certain warehousing operations was recorded as a charge to Cost of sales. In late 2000, as a result of weakening business conditions, poor operating results and a change in focus of our new senior management team toward increasing liquidity, we re-evaluated the remaining plan elements. As a result of this re-evaluation, we reversed \$120 of the original charge. The amount reversed consisted of \$97 related to severance costs associated with approximately 1,000 positions and \$23 related to other costs. The most significant reversals related to an aggregated \$72 for the abandonment of our plans to outsource warehouse facilities in North America, as well as the outsourcing of a product manufacturing line. As 2000 progressed and the Turnaround Program was announced, new senior management determined that the costs required to complete the planned actions for both of these initiatives and the estimated payback periods were not in line with their objectives. Based on the changes in facts and circumstances, we determined that the reserve should be reversed. The remaining \$48 of reversals related to attrition, as well as management's assessment of remaining employee terminations, in light of the newly announced Turnaround Program, which involved \$71 of new severance charges in the fourth quarter of 2000. During 2001, we recorded additional provisions of \$83 which included \$68 for severance and related costs, asset impairments of \$13 and other exit costs of \$2 for instances when the actual cost of certain initiatives exceeded the amount estimated at the time of the original charge. We also recorded reversals of \$17 associated with the cancellation of certain service and manufacturing initiatives. We provided an additional \$5 in 2002 to complete certain severance-related actions. We recorded asset impairments of \$13 and \$30 in 2001 and 2000, respectively. The total net costs included in Restructuring and asset impairment charges in the Consolidated Statements of Income for the March 2000 Restructuring were \$5, \$66 and \$369 in 2002, 2001 and 2000, respectively. Charges against the reserve were \$17, \$204 and \$176 in 2002, 2001 and 2000, respectively. As of December 31, 2002, the March 2000 Restructuring Program had been completed.

1998 Restructuring. During 2001, we recorded additional provisions for changes in estimates of \$15 and reversals of \$8, primarily as a result of changes in certain manufacturing initiatives. The total net costs included in Restructuring and asset impairment charges in the Consolidated Statements of Income for the 1998 Restructuring was \$7 and \$1 in 2001 and 2000, respectively. Charges against the reserve were \$24, \$76 and \$247 in 2002, 2001 and 2000, respectively. As of December 31, 2002, the 1998 Restructuring Program had been completed.

Reconciliation of Restructuring Charges to Statements of Cash Flows. The following is a reconciliation of charges to the restructuring reserves for all restructuring actions to the amounts reported in the Consolidated Statement of Cash Flows as Cash payments for restructurings:

|  | 2002    | 2001    | 2000    |
|--|---------|---------|---------|
|  | ----    | ----    | ----    |
| Charges to reserve, all programs                       | \$(474) | \$(555) | \$(423) |
| Non-cash items:  |         |         |         |
| Special termination benefits and pension curtailment   | 59      | 21      | --      |
| Effects of foreign currency and other non-cash charges | 23      | 50      | 36      |

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|                                  |         |         |         |
|----------------------------------|---------|---------|---------|
|                                  | -----   | -----   | -----   |
| Cash payments for restructurings | \$(392) | \$(484) | \$(387) |
|                                  | =====   | =====   | =====   |

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### Note 3--Acquisitions

CPID Division of Tektronix, Inc.: In January 2000, we and Fuji Xerox completed the acquisition of the Color Printing and Imaging Division of Tektronix, Inc. ("CPID"). CPID manufactures and sells color printers, ink and related products, and supplies. The original aggregate consideration paid of \$925 in cash, including \$73 paid directly by Fuji Xerox, was subject to purchase price adjustments pending the finalization of net asset values. During 2001, we were reimbursed \$18 in cash upon finalization of these values which was recorded as a reduction to goodwill in the accompanying Consolidated Balance Sheets. The acquisition was accounted for in accordance with the purchase method of accounting.

The excess of cash paid over the fair value of net assets acquired was allocated to identifiable intangible assets and goodwill using a discounted cash flow approach. The value of the identifiable intangible assets included \$27 for purchased in-process research and development that was expensed in 2000. The charge represented the fair value of certain acquired research and development projects that were determined not to have reached technological feasibility as of the date of the acquisition, and was determined based on a methodology that utilized the projected after-tax cash flows of the products expected to result from in-process research and development activities and the stage of completion of the individual projects. Other identifiable intangible assets acquired were exclusive of intangible assets acquired by Fuji Xerox, and included the installed customer base, the distribution network, the existing technology, the workforce (which was transferred to goodwill upon adopting SFAS No. 142) and trademarks. These identifiable assets are included in Intangibles assets, net in the accompanying Consolidated Balance Sheets.

The other identifiable intangible assets acquired are being amortized on a straight-line basis over the estimated useful lives which range from 7 to 25 years. During 2001, certain intangible asset useful lives were revised. As a result of these revisions, we recorded an additional \$9 in amortization expense during 2001. The goodwill recorded in connection with this transaction was being amortized on a straight-line basis (over 25 years) through December 31, 2001. On January 1, 2002, we adopted the provisions of SFAS No. 142 and the amortization of goodwill was discontinued. Refer to Note 1 for further discussion of the adoption of SFAS No. 142.

In connection with this acquisition, we recorded approximately \$45 for anticipated costs associated with exiting certain activities of the acquired operations. These activities included: (i) the consolidation of duplicate distribution facilities; (ii) the rationalization of the service organization and (iii) the exiting of certain lines of the CPID business. The costs associated with these activities included inventory write-offs, severance charges, contract cancellation costs and fixed asset impairment charges. During 2001, we revised our originally planned initiatives related to the acquired European service organization and our estimate of the costs to complete the exit from our distribution facilities in Europe. These changes, along with certain other changes, resulted in the reversal of \$9 of the originally recorded reserves, with a corresponding reduction in goodwill.

### Note 4--Divestitures and Other Sales

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Nigeria: In December 2002, we sold our remaining investment in Nigeria for a nominal amount and recognized a loss of \$35, primarily representing cumulative translation adjustment losses which were previously unrealized.

Licensing Agreement: In September 2002, we signed a license agreement with a third party, related to a nonexclusive license for the use of certain of our existing patents. In October 2002, we received proceeds of \$50 and granted the license. We have no continuing obligation or other commitments to the third party and recorded the income associated with this transaction as revenue in Service, outsourcing and rentals in the accompanying Consolidated Statement of Income.

Katun Corporation: In July 2002, we sold our 22 percent investment in Katun Corporation, a supplier of aftermarket copier/printer parts and supplies, for net proceeds of \$67. This sale resulted in a pre-tax gain of \$12, which is included in Other expenses, net, in the accompanying Consolidated Statements of Income. After-tax, the sale was essentially break-even, as the taxable basis of Katun was lower than our carrying value on the sale date resulting in a high rate of income tax.

Italy Leasing Business: In April 2002, we sold our leasing business in Italy to a company now owned by General Electric ("GE") for \$200 in cash plus the assumption of \$20 of debt. This sale is part of an agreement under which GE, as successor, will provide ongoing, exclusive equipment financing to our customers in Italy. The total pre-tax loss on this transaction, which is included in Other expenses, net, in the accompanying Consolidated Statements of Income, was \$27 primarily related to recognition of cumulative translation adjustment losses and final sale contingency settlements.

Prudential Insurance Company Common Stock: In the first quarter of 2002, we sold common stock of Prudential Insurance Company, associated with that company's demutualization. In connection with this sale, we recognized a pre-tax gain of \$19 that is included in Other Expenses, net, in the accompanying Consolidated Statements of Income.

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Delphax: In December 2001, we sold Delphax Systems and Delphax Systems, Inc. ("Delphax") to Check Technology Canada LTD and Check Technology Corporation for \$16. The transaction was essentially break-even. Delphax designs, manufactures and supplies high-speed electron beam imaging digital printing systems and related parts, supplies and services.

Nordic Leasing Business: In April 2001, we sold our leasing businesses in four Nordic countries to a company now owned by GE, for \$352 in cash and retained interests in certain finance receivables for total proceeds of approximately \$370 which approximated book value. These sales are part of an agreement under which that company will provide ongoing, exclusive equipment financing to our customers in those countries.

Fuji Xerox Interest: In March 2001, we sold half of our ownership interest in Fuji Xerox to Fuji Photo Film Co., Ltd ("Fuji Film") for \$1.3 billion in cash. In connection with the sale, we recorded a pre-tax gain of \$773. Under the agreement, Fuji Film's ownership interest in Fuji Xerox increased from 50 percent to 75 percent. Our ownership interest decreased to 25 percent and we retain significant rights as a minority shareholder. We have product distribution and technology agreements that ensure that both parties have access to each other's portfolio of patents, technology and products. Fuji Xerox continues to provide products to us as well as collaborate with us on R&D.

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Xerox China: In December 2000, we sold our China operations to Fuji Xerox for \$550. In connection with the sale, Fuji Xerox also assumed \$118 of indebtedness. We recorded a pre-tax gain of \$200 in connection with this transaction. Prior to the sale, our China operations had revenue of \$262 in 2000, which is included in the accompanying Consolidated Statement of Income. While Fuji Xerox is our affiliate, we believe the negotiations for this transaction were similar to those that would have been entered into with an unaffiliated third party, both in terms of price and conditions. Both parties were represented by separate legal counsel.

Commodity Paper Product Line: In June 2000, we entered an agreement with Georgia Pacific, to sell our U.S. and Canadian commodity paper product line and customer list and recorded a pre-tax gain of \$40 which is included in Other expenses, net, which represented the proceeds from the sale. We also granted a ten-year exclusive license related to the use of the Xerox brand name on future paper sales in exchange for a fair value royalty agreement. In conjunction with the sale, we also became an agent of Georgia Pacific for which we earn a market-based commission on sales of commodity paper. Subsequently, in January 2003, we discontinued the agency relationship without penalty, and resumed direct commodity paper sales.

ContentGuard: In April 2000, we sold a 25 percent ownership interest in our wholly-owned subsidiary, ContentGuard, to Microsoft, Inc. for \$50 and recognized a pre-tax gain of \$23, which is included in Other expenses, net in the accompanying Consolidated Statements of Income. An additional pre-tax gain of \$27 was deferred, pending the achievement of certain performance criteria. In May 2002, we repaid Microsoft \$25, as the performance criteria had not been achieved. In connection with the sale, ContentGuard also received \$40 from Microsoft for a non-exclusive license of its patents and other intellectual property and a \$25 advance against future royalty income from Microsoft on sales of products incorporating ContentGuard's technology. The license payment is being amortized over the ten-year life of the license agreement due to continuing obligations we have, related to our majority ownership of ContentGuard. The royalty advance will be recognized in income as earned. These amounts are not refundable.

Flextronics Manufacturing Outsourcings: In the fourth quarter of 2001, we entered into purchase and supply agreements with Flextronics, a global electronics manufacturing services company. Under the agreements, Flextronics purchased related inventory, property and equipment. Pursuant to the purchase agreement, we sold our operations in Toronto, Canada; Aguascalientes, Mexico, Penang, Malaysia, Venray, The Netherlands and Resende, Brazil to Flextronics in a series of transactions, which were completed in 2002. In total, approximately 4,100 Xerox employees in certain of these operations transferred to Flextronics. Total proceeds from the sales in 2002 and 2001 were \$167, plus the assumption of certain liabilities, representing a premium over book value. The premium is being amortized over the life of the supply contract.

Under the supply agreement, Flextronics manufactures and supplies equipment and components, including electronic components, for the Office segment of our business. This represents approximately 50 percent of our overall worldwide manufacturing operations. The initial term of the Flextronics supply agreement is five years subject to our right to extend for two years. Thereafter it will automatically be renewed for one-year periods, unless either party elects to terminate the agreement. We have agreed to purchase from Flextronics most of our requirements for certain products in specified product families. We also must purchase certain electronic components from Flextronics, so long as Flextronics meets certain pricing requirements. Flextronics must acquire inventory in anticipation of meeting our forecasted requirements and must maintain sufficient manufacturing capacity to satisfy such forecasted requirements. Under certain circumstances, we may become obligated to repurchase inventory that remains unused for more than 180 days, becomes obsolete or upon termination of the

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supply agreement. Our remaining manufacturing operations are primarily located in Rochester, NY for our high end production products and consumables and Wilsonville, OR for consumable supplies and components for the Office segment products.

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Note 5--Receivables, Net

Finance Receivables: Finance receivables result from installment arrangements and sales-type leases arising from the marketing of our equipment. These receivables are typically collateralized by a security interest in the underlying assets. The components of Finance receivables, net at December 31, 2002 and 2001 follow:

|  | 2002      | 2001      |
|--|-----------|-----------|
| Gross receivables                                      | \$ 10,685 | \$ 11,685 |
| Unearned income  | (1,628)   | (1,628)   |
| Unguaranteed residual values                           | 272       | 272       |
| Allowance for doubtful accounts                        | (324)     | (324)     |
|  | -----     | -----     |
| Finance receivables, net                               | 9,005     | 9,005     |
| Less: Billed portion of finance receivables, net       | (564)     | (564)     |
| Current portion of finance receivables not billed, net | (3,088)   | (3,088)   |
|  | -----     | -----     |
| Amounts due after one year, net                        | \$ 5,353  | \$ 5,353  |
|  | =====     | =====     |

Contractual maturities of our gross finance receivables subsequent to December 31, 2002 follow (including those already billed of \$564):

| 2003     | 2004     | 2005     | 2006   | 2007   | Thereafter |
|----------|----------|----------|--------|--------|------------|
| ----     | ----     | ----     | ----   | ----   | -----      |
| \$ 4,359 | \$ 2,869 | \$ 2,031 | \$ 982 | \$ 349 | \$ 95      |

Our experience has shown that a portion of these finance receivables will be prepaid prior to maturity. Accordingly, the preceding schedule of contractual maturities should not be considered a forecast of future cash collections. In addition, our strategy of exiting, in some geographies, the business of direct financing of customers' purchases may result in further acceleration of the collection of these receivables as a result of associated asset sales or securitizations.

Vendor Financing Initiatives: In 2001, we announced several Framework Agreements with GE, under which GE would become our primary equipment-financing provider in the U.S., Canada, Germany and France. In connection therewith, in October 2002, we completed an eight-year agreement in the U.S. (the "New U.S. Vendor Financing Agreement"), under which GE Vendor Financial Services, a subsidiary of GE, became the primary equipment financing provider in the U.S., through monthly securitizations of our new lease originations. In addition to the \$2.5 billion already funded by GE prior to this agreement, which is secured by portions of

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our current lease receivables in the U.S., the New U.S. Vendor Financing Agreement calls for GE to provide funding in the U.S. on new lease originations, of up to an additional \$5 billion outstanding at anytime, during the eight year term, subject to normal customer acceptance criteria. The \$5 billion limit may be increased to \$8 billion, subject to agreement between the parties. The new agreement contains mutually agreed renewal options for successive two-year periods.

Under the agreement, GE is expected to securitize approximately 70 percent of new U.S. lease originations at over-collateralization rates, which will vary over time, but are expected to be approximately 10 percent of the net receivables balance. The securitizations will be subject to interest rates calculated at each monthly loan occurrence at yield rates consistent with average rates for similar market based transactions. Refer to Note 11 for further information on interest rates. Consistent with the loans already received from GE, the funding received under this new agreement will be recorded as secured borrowings and the associated receivables will be included in our Consolidated Balance Sheet. GE's commitment to fund under this new agreement is not subject to our credit ratings. There are no credit rating defaults that could impair future funding under this agreement. This agreement contains cross default provisions related to certain financial covenants contained in the New Credit Facility and other significant debt facilities. Any default would impair our ability to receive subsequent funding until the default was cured or waived but does not accelerate previous borrowings. As of December 31, 2002, we were in compliance with all covenants and expect to be in compliance for at least the next twelve months.

In 2002 and 2001, we received financing totaling \$1,845 million and \$1,175 million, respectively, from GE, secured by lease receivables in the U.S. Net fees of \$9 million and \$7 million have been capitalized as debt issue costs during the years ended December 31, 2002 and 2001, respectively. In connection with these transactions, \$150 million is in escrow, as security for our continuing obligations under the transferred contracts. At December 31, 2002, the remaining balance was \$2,323 million and is included in debt in our Consolidated Balance Sheet.

In May 2002, we launched the Xerox Capital Services ("XCS") venture with GE, under which XCS now manages our customer administration and leasing activities in the U.S., including various financing programs, credit approval, order processing, billing and collections. We account for XCS as a consolidated entity since we are responsible to fund all of its

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operations, and, further, all events of termination result in GE receiving back their entire equity investment and total ownership reverting to us.

**France Secured Borrowings:** In December 2002, we received \$362, net of escrow requirements, in financing from Merrill Lynch Capital Markets Bank Limited and Merrill Lynch International Bank Limited (subsidiaries of Merrill Lynch) secured by some of our lease receivables in France. At December 31, 2002, the remaining balance is \$377 and is included in debt in our Consolidated Balance Sheet.

**The Netherlands Secured Borrowings:** Beginning in the second half of 2002, we received a series of financings from our unconsolidated joint venture with De Lage Landen International BV (DLL) secured by some of our lease receivables in The Netherlands. At December 31, 2002, the remaining balance is \$112 and is included in debt in our Consolidated Balance Sheet.

**Germany Secured Borrowings:** In May 2002, we entered into an agreement to

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transfer part of our financing operations in Germany to GE. In conjunction with this transaction, we received loans from GE secured by lease receivables in Germany. Initial cash proceeds of \$79 were net of \$15 of escrow requirements. As part of the transaction we transferred leasing employees to a GE entity which will also finance certain new leasing business in the future. We currently consolidate this joint venture since we retain substantive rights related to the borrowings. At December 31, 2002, the remaining balance, which includes additional proceeds received since May 2002, is \$95 and is included in debt in our Consolidated Balance Sheet.

United Kingdom Secured Borrowings: During 2002 and 2001, we received \$268 and \$885, respectively, in financing from GE Capital Equipment Finance Limited (a subsidiary of GE), secured by our portfolios of lease receivables in the United Kingdom. At December 31, 2002, the remaining balance of \$529 is included in debt in our Consolidated Balance Sheets.

Canada Secured Borrowings: In 2002, we received \$443 of financing from GE, secured by lease receivables in Canada. Cash proceeds of \$428 were net of \$8 of escrow requirements and \$7 of fees. At December 31, 2002, the remaining balance is \$319 and is included in debt in our Consolidated Balance Sheet.

U.S. Asset-backed Securities Transaction: In July 2001, we transferred U.S. lease contracts to a consolidated trust, which in turn sold \$513 of floating-rate asset-backed notes (notes). We received cash proceeds of \$480, net of \$3 of expenses and fees. An additional \$30 of proceeds are being held in reserve by the trust until the notes are repaid, which is currently estimated to be in or around August 2003. Since the trust is consolidated in our financial statements, we effectively recorded the proceeds received as a secured borrowing. At December 31, 2002, the remaining balance was \$139 and is included as debt in our Consolidated Balance Sheet.

In 2000, we transferred domestic lease contracts to a special purpose entity ("SPE") as part of a financing transaction, for gross proceeds of \$411. The proceeds received were accounted for as a secured borrowing. At December 31, 2002, the remaining balance was \$7 and is included in debt in our Consolidated Balance Sheet.

As of December 31, 2002, \$4,218 of Finance receivables and \$219 of Billed finance receivables are held as collateral in various trusts and SPEs, as security for the borrowings noted above. Total outstanding debt being secured by these receivables at December 31, 2002 was \$3,900. The SPEs are consolidated in our financial statements due to their holding non-financial assets and other conditions which preclude sale accounting. Although the transferred assets are included in our total assets, we received an opinion from outside legal counsel that the trusts and SPEs to which the assets were transferred were deemed bankruptcy remote. As a result, the assets of the trust are not available to satisfy any of our other obligations.

Accounts Receivable: In 2000, we established two revolving accounts receivable securitization facilities in the U.S. and Canada aggregating \$330. The facilities enabled us to sell, on an ongoing basis, undivided interests in a portion of our accounts receivable in exchange for cash.

In May 2002, a credit rating agency downgrade caused a termination event under our U.S. trade receivable securitization facility. The undivided interest sold under the U.S. trade receivable securitization facility amounted to \$290 at December 31, 2001 and was accounted for as a sale of receivables. We continued to sell receivables into the U.S trade receivable securitization facility pending renegotiation of the facility as a result of this termination event. In October 2002, the facility was terminated and no additional receivables were sold to the facility. As a result, in October the counter-party received \$231 of collections from the pool of the then-existing receivables within the facility,



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which represented their remaining undivided interest balance. No new receivables were purchased by the counterparty and we have no further obligations as such facility has been terminated.

The Canadian accounts receivable facility, also accounted for as a sale of receivables, had undivided interests of \$36 at December 31, 2001. It was impacted by a downgrade in our credit rating in February 2002, which led to a similar termination event. The Canadian accounts receivable facility was not renegotiated and the balance of the undivided interests was fully settled through collections in the first quarter of 2002.

Note 6--Inventories and Equipment on Operating Leases, Net

The components of inventories at December 31, 2002 and 2001 were as follows:

|                         | 2002    | 2001    |
|-------------------------|---------|---------|
|                         | ----    | ----    |
| Finished goods .....    | \$ 961  | \$ 960  |
| Work in process .....   | 66      | 97      |
| Raw materials .....     | 195     | 307     |
|                         | -----   | -----   |
| Total inventories ..... | \$1,222 | \$1,364 |
|                         | =====   | =====   |

Equipment on operating leases and similar arrangements consists of our equipment rented to customers and depreciated to estimated salvage value at the end of the lease term. The transfer of equipment on operating leases from our inventories is presented in our Consolidated Statements of Cash Flows in the operating activities section as a non-cash adjustment. Equipment on operating leases and the related accumulated depreciation at December 31, 2002 and 2001 were as follows:

|  | 2002     | 2001     |
|--|----------|----------|
|  | ----     | ----     |
| Equipment on operating leases .....      | \$ 2,002 | \$ 2,433 |
| Less: Accumulated depreciation .....     | (1,543)  | (1,629)  |
|  | -----    | -----    |
| Equipment on operating leases, net ..... | \$ 459   | \$ 804   |
|  | =====    | =====    |

Depreciable lives generally vary from three to four years consistent with our planned and historical usage of the equipment subject to operating leases. Depreciation and obsolescence expense was \$408, \$657 and \$626 for the years ended December 31, 2002, 2001 and 2000, respectively. Our equipment operating lease terms vary, generally from 12 to 36 months. Scheduled minimum future rental revenues on operating leases with original terms of one year or longer are:

| 2003  | 2004  | 2005 | 2006 | Thereafter |
|-------|-------|------|------|------------|
| ----  | ----  | ---- | ---- | -----      |
| \$472 | \$126 | \$57 | \$20 | \$3        |

Total contingent rentals on operating leases, consisting principally of usage charges in excess of minimum contracted amounts, for the years ended December 31, 2002, 2001 and 2000 amounted to \$187, \$235 and \$286, respectively.

Note 7--Land, Buildings and Equipment, Net

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The components of land, buildings and equipment, net at December 31, 2002 and 2001 were as follows:

|  | Estimated<br>Useful Lives<br>(Years)<br>----- | 2002<br>----- |
|--|---|---------------|
| Land                                     |   | \$ 54         |
| Buildings and building equipment .....   | 25 to 50                                      | 1,077         |
| Leasehold improvements .....             | Lease term                                    | 412           |
| Plant machinery .....                    | 5 to 12                                       | 1,551         |
| Office furniture and equipment .....     | 3 to 15                                       | 1,057         |
| Other .....                              | 4 to 20                                       | 107           |
| Construction in progress .....           |   | 129           |
|  |   | -----         |
| Subtotal .....                           |   | 4,387         |
| Less: accumulated depreciation .....     |   | (2,630)       |
|  |   | -----         |
| Land, buildings and equipment, net ..... |   | \$ 1,757      |
|  |   | =====         |

Depreciation expense was \$341, \$402, and \$417 for the years ended December 31, 2002, 2001 and 2000, respectively. We lease certain land, buildings and equipment, substantially all of which are accounted for as operating leases. Total rent expense under operating leases for the years ended December 31, 2002, 2001 and 2000 amounted to \$299, \$332, and \$344,

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respectively. Future minimum operating lease commitments that have remaining non-cancelable lease terms in excess of one year at December 31, 2002 follow:

| 2003<br>---- | 2004<br>---- | 2005<br>---- | 2006<br>---- | 2007<br>---- | Thereafter<br>----- |
|--------------|--------------|--------------|--------------|--------------|---------------------|
| \$238        | \$202        | \$157        | \$124        | \$71         | \$346               |

In certain circumstances, we sublease space not currently required in operations. Future minimum sublease income under leases with non-cancelable terms in excess of one year amounted to \$45 at December 31, 2002.

Capitalized direct costs associated with developing, purchasing or otherwise acquiring software for internal use are included in Other long-term assets in our Consolidated Balance Sheet. These costs are amortized on a straight-line basis over the expected useful life of the software, beginning when the software is implemented. The software useful lives generally vary from 3 to 5 years. Capitalized software balances, net of accumulated amortization, were \$341 and \$479 at December 31, 2002 and 2001, respectively. Amortization expense, including impairment charges, was \$215, \$132 and \$86 for the years ended December 31, 2002, 2001 and 2000, respectively.

In 2001, we extended our information technology contract with Electronic Data Systems Corp. ("EDS") for five years through June 30, 2009. Services to be

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provided under this contract include support of global mainframe system processing, application maintenance, desktop and helpdesk support, voice and data network management and server management. There are no minimum payments due EDS under the contract. Payments to EDS, which are recorded in SAG, were \$357, \$445 and \$555 for the years ended December 31, 2002, 2001 and 2000, respectively.

### Note 8--Investments in Affiliates, at Equity

Investments in corporate joint ventures and other companies in which we generally have a 20 to 50 percent ownership interest at December 31, 2002 and 2001 were as follows:

|                                     | 2002  | 2001  |
|-------------------------------------|-------|-------|
|                                     | ----  | ----  |
| Fuji Xerox/(1)/                     | \$563 | \$532 |
| Other investments                   | 65    | 100   |
|                                     | ----  | ----  |
| Investments in affiliates at equity | \$628 | \$632 |
|                                     | ===== | ===== |

/(1)/ Our investment in Fuji Xerox of \$563 at December 31, 2002, differs from our implied 25 percent interest in the underlying net assets, or \$627, due primarily to our deferral of gains resulting from sales of assets by us to Fuji Xerox, partially offset by goodwill we allocated to the Fuji Xerox investment at the time we acquired our remaining 20 percent of Xerox Limited from The Rank Group (plc). We cannot recognize such gains related to our portion of ownership interest in Fuji Xerox.

Fuji Xerox is headquartered in Tokyo and operates in Japan and other areas of the Pacific Rim, Australia and New Zealand. As discussed in Note 4, we sold half our interest in Fuji Xerox to Fuji Photo Film Co., Ltd. in March 2001.

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Condensed financial data of Fuji Xerox for its last three years follow:

|   | 2002/(1)/ | 2001/(1)/ | 2000     |
|---|-----------|-----------|----------|
|   | ----      | ----      | ----     |
| <b>Summary of Operations:</b>               |           |           |          |
| Revenues                                    | \$ 7,539  | \$ 7,684  | \$ 8,398 |
| Costs and expenses                          | 7,181     | 7,316     | 8,076    |
|   | -----     | -----     | -----    |
| Income before income taxes                  | 358       | 368       | 322      |
| Income taxes                                | 134       | 167       | 146      |
| Minorities interests                        | 36        | 35        | 36       |
|   | -----     | -----     | -----    |
| Net Income                                  | \$ 188    | \$ 166    | \$ 140   |
|   | =====     | =====     | =====    |
| <b>Balance Sheet Data</b>                   |           |           |          |
| <b>Assets</b>                               |           |           |          |
| Current assets                              | \$ 2,976  | \$ 2,783  |          |
| Non-current assets                          | 3,862     | 3,455     |          |
|   | -----     | -----     |          |
| Total Assets                                | \$ 6,838  | \$ 6,238  |          |
|   | =====     | =====     |          |
| <b>Liabilities and Shareholders' Equity</b> |           |           |          |

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|   |          |          |
|---|----------|----------|
| Current Liabilities                             | \$ 2,152 | \$ 2,242 |
| Long-term debt                                  | 868      | 796      |
| Other non-current liabilities                   | 1,084    | 632      |
| Minorities' interests in equity of subsidiaries | 227      | 201      |
| Shareholders' equity                            | 2,507    | 2,367    |
|   | -----    | -----    |
| Total liabilities and shareholders' equity      | \$ 6,838 | \$ 6,238 |
|   | =====    | =====    |

(1) Fuji Xerox changed its fiscal year end in 2001 from December 31 to March 31. The 2002 and 2001 condensed financial data consists of the last three months of Fuji Xerox's fiscal year 2002 and 2001 and the first nine months in fiscal year 2003 and 2002, respectively.

We have a technology agreement with Fuji Xerox whereby we receive royalty payments and rights to access their patent portfolio in exchange for access to our patent portfolio. We have arrangements with Fuji Xerox whereby we purchase inventory from and sell inventory to Fuji Xerox. Pricing of the transactions under these arrangements is based upon negotiations conducted at arm's length. Certain of these inventory purchases and sales are the result of mutual research and development arrangements. Our purchase commitments with Fuji Xerox are in the normal course of business and typically have a lead time of three months. Purchases from and sales to Fuji Xerox for the three years ended December 31, 2002 were as follows:

|           | 2002  | 2001  | 2000  |
|-----------|-------|-------|-------|
|           | ----  | ----  | ----  |
| Sales     | \$113 | \$132 | \$178 |
| Purchases | \$727 | \$598 | \$812 |

### Note 9--Segment Reporting

Our reportable segments are aligned with how we manage our business and view the markets we serve. Our 2003 reportable segments are as follows: Production, Office, DMO, and Other. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. As discussed below, our operating segment financial information for 2002 and 2001 has been restated to reflect changes in operating segment structure made through 2003.

The Production segment includes black and white products over 91 pages per minute and color products over 41 pages per minute. Products include the DocuTech, DocuPrint, and DocuColor families as well as older technology light-lens products. These products are sold, predominantly through direct sales channels in North America and Europe, to Fortune 1000, graphic arts, government, education and other public sector customers.

The Office segment includes black and white products up to 90 pages per minute and color printers and multi-function devices up to 40 pages per minute. Products include our family of Document Centre digital multifunction products, color laser, solid ink and monochrome laser desktop printers, digital and light-lens copiers and facsimile products. These products are sold, through direct and indirect sales channels in North America and Europe, to global, national and mid-size commercial customers as well as government, education and other public sector customers.

The DMO segment includes our operations in Latin America, the Middle East, India, Eurasia, Russia and Africa. This segment includes sales of products that are typical to the aforementioned segments, however management serves and evaluates these markets on an aggregate geographic, rather than product, basis.

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The segment classified as Other includes several units, none of which met the thresholds for separate segment reporting. This group primarily includes Xerox Supplies Group ("XSG") (predominately paper), SOHO, Xerox Engineering Systems ("XES"), Xerox Technology Enterprises ("XTE"), and consulting services, royalty and license revenues. XES is a business that sells equipment used for special engineering

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applications, XConnect is a network service business aimed at optimizing office efficiency and providing solutions and XTE consists of a collection of high technology start-up entities. The SOHO segment includes inkjet printers and personal copiers sold through indirect channels in North America and Europe. The Other segment profit (loss) includes the profit (loss) from the previously mentioned sources, equity income received from Fuji Xerox and certain costs which have not been allocated to the businesses including non-financing and other corporate costs.

Operating segment information for 2002 and 2001 has been adjusted to reflect changes in our operating segment structure that were made in 2003 and 2002. The changes made during 2003 relate to the following: (1) reclassification of our mid-range color products (11-40 pages per minute) from the Production segment to the Office segment to align our segment reporting with the marketplace; (2) reclassification of Small Office/Home Office ("SOHO"), a business we exited in 2001 (previously reported as its own segment) to the Other segment as it no longer met the quantitative thresholds for separate reporting related to assets, revenues and profitability and its results are no longer regularly reviewed by our chief operating decision maker; and (3) adjustment of corporate expense and other allocations to reflect the aforementioned changes, and changes associated with internal reorganizations made in 2002 as well as decisions concerning the direct applicability of certain overhead expenses to the segments. The adjustments increased (decreased) full year 2002 revenues as follows: Production--\$(1,113) million, Office--\$921 million, and Other--\$192 million. The full year 2002 segment profit was increased (decreased) as follows: Production--\$(163 million), Office--\$128 million, DMO--\$38 million, and Other--\$(3 million). The adjustments increased (decreased) full year 2001 revenues as follows: Production--\$(1,172 million), Office--\$1,091 million, DMO--\$(1 million), and Other--\$82 million. The full year 2001 segment profit was increased (decreased) as follows: Production--\$(82 million), Office--\$86 million, DMO--\$60 million, and Other--\$(64 million). The operating segment information for 2000 has not been restated, as it was impracticable to do so. Therefore, we have presented 2002 and 2001 on the 2003 basis and 2002, 2001 and 2000 on the old basis.

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Operating segment selected financial information, using the 2003 basis of presentation as discussed above, for the years ended December 31, 2002 and 2001 was as follows:

|                                   | Production | Office   | DMO      | Oth   |
|-----------------------------------|------------|----------|----------|-------|
|                                   | -----      | -----    | -----    | ----- |
| 2002                              |            |          |          |       |
| Information about profit or loss: |            |          |          |       |
| Revenues                          | \$ 4,128   | \$ 6,940 | \$ 1,742 | \$ 2, |

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|  |          |          |          |       |
|--|----------|----------|----------|-------|
| Finance income                                     | 394      | 601      | 16       |       |
|  | -----    | -----    | -----    | ----- |
| Total segment revenues                             | \$ 4,522 | \$ 7,541 | \$ 1,758 | \$ 2, |
|  | =====    | =====    | =====    | ===== |
| Interest expense/(1)/                              | \$ 157   | \$ 223   | \$ 17    | \$    |
| Segment profit (loss)/(2) (3)/                     | 450      | 621      | 91       | (     |
| Equity in net income of unconsolidated affiliates  | --       | --       | 5        |       |
| Information about assets:                          |          |          |          |       |
| Investments in affiliates, at equity               | 9        | 8        | 22       |       |
| Total assets                                       | 8,856    | 13,113   | 1,121    | 2,    |
| Cost of additions to land, buildings and equipment | 51       | 75       | 6        |       |

|  | Production | Office   | DMO      | Oth   |
|--|------------|----------|----------|-------|
|  | -----      | -----    | -----    | ----- |
| 2001   |            |          |          |       |
| Information about profit or loss:                  |            |          |          |       |
| Revenues from external customers                   | \$ 4,288   | \$ 7,356 | \$ 2,000 | \$ 2, |
| Finance income                                     | 439        | 661      | 26       |       |
|  | -----      | -----    | -----    | ----- |
| Total segment revenues                             | \$ 4,727   | \$ 8,017 | \$ 2,026 | \$ 2, |
|  | =====      | =====    | =====    | ===== |
| Interest expense/(1)/                              | \$ 217     | \$ 304   | \$ 48    | \$    |
| Segment profit (loss)/(2) (3)/                     | 372        | 427      | (97)     | (     |
| Equity in net income of unconsolidated affiliates  | --         | --       | 4        |       |
| Information about assets:                          |            |          |          |       |
| Investments in affiliates, at equity               | 7          | 6        | 12       |       |
| Total assets                                       | 9,453      | 13,842   | 1,679    | 2,    |
| Cost of additions to land, buildings and equipment | 75         | 110      | 13       |       |

(1) Interest expense includes equipment financing interest as well as non-financing interest, which is a component of Other expenses, net.

(2) Other segment profit (loss) includes net corporate expenses of \$217 and \$66 for the years ended December 31, 2002 and 2001, respectively.

(3) Depreciation and amortization expense is recorded in cost of sales, research and development expenses and selling, administrative and general expenses and is included in the segment profit (loss) above. This information is not identified and reported separately to our chief operating decision-maker. These expenses are recorded by our operating units in the accounting records based on individual assessments as to how the related assets are used. The separate identification of this information for purposes of segment disclosure is impracticable, as it is not readily available and the cost to develop it would be excessive.

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Operating segment selected financial information, using the old basis of presentation, as discussed above, for the years ended December 31, 2002, 2001 and 2000 was as follows:

|                                   | Production | Office   | DMO      |
|-----------------------------------|------------|----------|----------|
|                                   | -----      | -----    | -----    |
| 2002                              |            |          |          |
| Information about profit or loss: |            |          |          |
| Revenues from external customers  | \$ 5,130   | \$ 5,995 | \$ 1,742 |
| Finance income                    | 505        | 490      | 16       |

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|   |          |          |          |
|---|----------|----------|----------|
| Intercompany revenues                                       | --       | 135      | --       |
|   | -----    | -----    | -----    |
| Total segment revenues                                      | \$ 5,635 | \$ 6,620 | \$ 1,758 |
|   | -----    | -----    | -----    |
| Interest expense(1)   | \$ 198   | \$ 182   | \$ 17    |
| Segment profit (loss) (2) (3)                               | 613      | 493      | 53       |
| Equity in net income of unconsolidated affiliates           | --       | --       | 5        |
| Information about assets                                    |          |          |          |
| Investments in affiliates, at equity                        | 9        | 8        | 22       |
| Total assets  | 10,756   | 11,213   | 1,121    |
| Cost of additions to land, buildings and equipment          | 62       | 64       | 6        |
| 2001  |          |          |          |
| Information about profit or loss                            |          |          |          |
| Revenues from external customers                            | \$ 5,336 | \$ 6,340 | \$ 2,001 |
| Finance income  | 563      | 536      | 26       |
| Intercompany revenues                                       | --       | 50       | --       |
|   | -----    | -----    | -----    |
| Total segment revenues                                      | \$ 5,899 | \$ 6,926 | \$ 2,027 |
|   | -----    | -----    | -----    |
| Interest expense(1)   | \$ 274   | \$ 247   | \$ 48    |
| Segment profit (loss) (2) (3)                               | 454      | 341      | (157)    |
| Equity in net income of unconsolidated affiliates           | --       | --       | 4        |
| Information about assets                                    |          |          |          |
| Investments in affiliates, at equity                        | 7        | 6        | 12       |
| Total assets  | 11,214   | 11,905   | 1,671    |
| Cost of additions to land, buildings and equipment          | 60       | 74       | 32       |
| 2000  |          |          |          |
| Information about profit or loss                            |          |          |          |
| Revenues from external customers                            | \$ 5,749 | \$ 6,518 | \$ 2,573 |
| Finance income  | 583      | 528      | 46       |
| Intercompany revenues                                       | --       | 14       | --       |
|   | -----    | -----    | -----    |
| Total segment revenues                                      | \$ 6,332 | \$ 7,060 | \$ 2,619 |
|   | -----    | -----    | -----    |
| Interest expense(1)   | \$ 275   | \$ 235   | \$ 103   |
| Segment profit (loss) (2) (3)                               | 463      | (180)    | (93)     |
| Equity in net income (loss) of unconsolidated affiliates(4) | (2)      | (2)      | 4        |
| Information about assets                                    |          |          |          |
| Investments in affiliates, at equity                        | 7        | 6        | 13       |
| Total assets  | 11,158   | 11,362   | 2,240    |
| Cost of additions to land, buildings and equipment          | 132      | 122      | 88       |

- (1) Interest expense includes equipment financing interest as well as non-financing interest, which is a component of Other expenses, net.
- (2) Other segment profit (loss) includes net corporate expenses of \$227, \$35 and \$116 for the years ended December 31, 2002, 2001 and 2000, respectively.
- (3) Depreciation and amortization expense is recorded in cost of sales, research and development expenses and selling, administrative and general expenses and is included in the segment profit (loss) above. This information is not identified and reported separately to our chief operating decision-maker. These expenses are recorded by our operating units in the accounting records based on individual assessments as to how the related assets are used. The separate identification of this information for purposes of segment disclosure is impracticable, as it is

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not readily available and the cost to develop it would be excessive.

(4) Excludes our \$37 share of a restructuring charge recorded by Fuji Xerox.

The following is a reconciliation of segment profit to total company pre-tax income (loss):

|  | Years ended December 31, |        |          |
|--|--------------------------|--------|----------|
|  | 2002                     | 2001   | 2000     |
|  | ----                     | ----   | ----     |
| Total segment profit                                       | \$ 978                   | \$ 368 | \$ 122   |
| Unallocated items:   |                          |        |          |
| Restructuring and asset impairment charges                 | (670)                    | (715)  | (475)    |
| Gain on early extinguishment of debt                       | --                       | 63     | --       |
| Restructuring related inventory write-down charges         | (2)                      | (42)   | (84)     |
| In process research and development charges                | --                       | --     | (27)     |
| Gains on sales of Fuji Xerox interest and China Operations | --                       | 773    | 200      |
| Allocated item:  |                          |        |          |
| Equity in net income of unconsolidated affiliates          | (54)                     | (53)   | (103)    |
|  | -----                    | -----  | -----    |
| Pre-tax income (loss)                                      | \$ 252                   | \$ 394 | \$ (367) |
|  | -----                    | -----  | -----    |

Geographic area data follow:

|               | Revenues  |           |           | Long-Lived Assets (1) |          |          |
|---------------|-----------|-----------|-----------|-----------------------|----------|----------|
|               | 2002      | 2001      | 2000      | 2002                  | 2001     | 2000     |
|               | ----      | ----      | ----      | ----                  | ----     | ----     |
| United States | \$ 9,897  | \$ 10,034 | \$ 10,706 | \$ 1,524              | \$ 1,880 | \$ 2,423 |
| Europe        | 4,425     | 5,039     | 5,511     | 718                   | 767      | 940      |
| Other Areas   | 1,527     | 1,935     | 2,534     | 379                   | 706      | 1,052    |
|               | -----     | -----     | -----     | -----                 | -----    | -----    |
| Total         | \$ 15,849 | \$ 17,008 | \$ 18,751 | \$ 2,621              | \$ 3,353 | \$ 4,415 |
|               | =====     | =====     | =====     | =====                 | =====    | =====    |

(1) Long-lived assets are comprised of (i) land, buildings and equipment, net, (ii) on-lease equipment, net, and (iii) internal and external-use capitalized software costs, net.

### Note 10--Net Investment in Discontinued Operations

Our net investment in discontinued operations is included in the Consolidated Balance Sheets in Other long-term assets and totaled \$728 and \$749 at December 31, 2002 and 2001, respectively. Our net investment is primarily related to the disengagement from our former insurance holding company, Talegen Holdings, Inc. ("Talegen").

Reinsurance Obligation: Xerox Financial Services, Inc. ("XFSI"), a wholly owned subsidiary, continues to provide aggregate excess of loss reinsurance coverage (the Reinsurance Agreements) to two of the former Talegen units, Crum and Forster Inc. ("C&F") and The Resolution Group, Inc. ("TRG") through Ridge Reinsurance Limited ("Ridge Re"), a wholly-owned subsidiary of XFSI. The



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coverage limits for these two remaining Reinsurance Agreements total \$578, which is exclusive of \$234 in C&F coverage that Ridge Re reinsured during the fourth quarter of 1998.

We, and XFSI, have guaranteed that Ridge Re will meet all its financial obligations under the two remaining Reinsurance Agreements. Although unlikely, XFSI may be required, under certain circumstances, to purchase, over time, additional redeemable preferred shares of Ridge Re, up to a maximum of \$301.

During 2001, we replaced \$660 of letters of credit, which supported Ridge Re ceded reinsurance obligations, with trusts which included the then existing Ridge Re investment portfolio of approximately \$405 plus \$255 in cash. During 2002, Ridge Re repaid \$20 of this cash to us and expects to repay the remaining \$235 during 2003 at the time of the expected novation of the C&F reinsurance contract to another insurance company. These trusts are required to provide security with respect to aggregate excess of loss reinsurance obligations under the two remaining Reinsurance Agreements. At December 31, 2002 and 2001, the balance of the investments in the trusts, consisting of U.S. government, government agency and high quality corporate bonds, was \$759 and \$684, respectively.

Our remaining net investment in Ridge Re was \$325 and \$319 at December 31, 2002 and 2001, respectively. Based on Ridge Re's current projections of investment returns and reinsurance payment obligations, we expect to fully recover our remaining investment. The projected reinsurance payments are based on actuarial estimates.

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Performance-Based Instrument: In connection with the sale of TRG in 1997, we received a \$462 performance-based instrument as partial consideration. Cash distributions are paid on the instrument, based on 72.5 percent of TRG's available cash flow as defined in the sale agreement. For the years ended December 31, 2002 and 2001, we have received cash distributions of \$24 and \$28, respectively. The recovery of this instrument is dependent upon the sufficiency of TRG's available cash flows. Based on current cash flow projections, we expect to fully recover the \$410 remaining balance of this instrument.

During 2002, the ultimate parent of TRG sought approval from us to affect a change in business structure of the entities it holds by combining an insurance subsidiary of TRG with one of its other insurers. In order to obtain our approval and enhance the cash flow capabilities of TRG, the ultimate parent of TRG has entered into a subscription agreement with TRG to purchase an established number of shares of this instrument each year from TRG beginning in 2003 and continuing through 2017.

Note 11--Debt

Short-Term Debt: Short-term borrowings at December 31, 2002 and 2001 were as follows:

|                     | Weighted<br>Average Interest<br>Rates at<br>December 31, 2002 | Weighted<br>Average Interest<br>Rates at<br>December 31, 2001 |
|---------------------|---|---|
|                     | -----   | -----   |
| Notes payable ..... | 6.22%   | 11.07%  |

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|  |       |     |
|--|-------|-----|
| Euro secured borrowing .....               | 3.27% | --% |
| Total short-term debt .....                |       |     |
| Current maturities of long-term debt ..... |       |     |
| Total .....                                |       |     |

Debt Classification: At December 31, 2002, our debt has been classified in the Consolidated Balance Sheet based on the contractual maturity dates of the underlying debt instruments or as of the earliest put date available to the debt holders. At December 31, 2001, our debt was classified in the same manner, except that \$3.5 billion of the aggregate \$7.0 billion Revolving credit agreement, which was due in 2002, was classified as long-term because subsequent to December 31, 2001, but prior to the issuance of the financial statements, we refinanced that debt on a long-term basis under the New Credit Facility.

We defer costs associated with debt issuance over the applicable term or to the first redemption date, in the case of convertible debt or debt with a put feature. Total deferred debt issuance costs included in Other long-term assets were \$133 and \$33 as of December 31, 2002 and 2001, respectively. These costs are amortized as interest expense in our Consolidated Statement of Income.

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Long-Term Debt: Long-term debt by final contractual maturity date at December 31, 2002 and 2001 was as follows:

|   | Weighted<br>Average Interest<br>Rates at<br>12/31/02<br>----- |
|---|---|
| U.S. Operations<br>-----                  |   |
| Xerox Corporation (parent company)        |   |
| Guaranteed ESOP notes due 2001-2003 ..... | -----   |
| Notes due 2002 .....                      | -----   |
| Notes due 2003 .....                      | 5.62%   |
| Notes due 2004 .....                      | 7.15  |
| Euro notes due 2004 .....                 | 3.50  |
| Notes due 2006 .....                      | 7.25  |
| Notes due 2007 .....                      | 7.38  |
| Notes due 2008 .....                      | 1.41  |
| Senior Notes due 2009                     | 9.75  |
| Euro Senior Notes due 2009 .....          | 9.75  |
| Notes due 2011 .....                      | 7.01  |
| Notes due 2014 .....                      | 9.00  |
| Notes due 2016 .....                      | 7.20  |
| Convertible notes due 2018/(1)/ .....     | 3.63  |
| New Credit Facility .....                 | 6.15  |
| Other debt due 2001-2018 .....            | 6.97  |
| Subtotal .....                            |   |
| Xerox Credit Corporation                  |   |

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|  |       |
|--|-------|
| Notes due 2002 .....                   | ----- |
| Yen notes due 2002 .....               | ----- |
| Notes due 2003 .....                   | 6.61  |
| Yen notes due 2005 .....               | 1.50  |
| Yen notes due 2007 .....               | 2.00  |
| Notes due 2008 .....                   | 6.45  |
| Notes due 2012 .....                   | 7.11  |
| Notes due 2013 .....                   | 6.50  |
| Notes due 2014 .....                   | 6.06  |
| Notes due 2018 .....                   | 7.00  |
| Revolving credit agreement .....       | ----- |
| Subtotal .....                         |       |
| Other US Operations/(2,3)/             |       |
| Secured borrowings due 2002-2006 ..... | 5.03  |
| Secured borrowings due 2001-2003 ..... | 3.25  |
| Subtotal .....                         |       |
| Total U.S. operations .....            |       |

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| International Operations                                   | Weighted<br>Average Interest<br>Rates at<br>12/31/02<br>----- |
|--|---|
| Xerox Capital (Europe) plc:                                |   |
| Euros due 2001-2008 .....                                  | 5.25%   |
| Japanese yen due 2001-2005 .....                           | 1.30  |
| U.S. dollars due 2001-2008 .....                           | 5.89  |
| Revolving credit agreement (U.S. dollars) .....            | --  |
| Subtotal .....   |   |
| Other International Operations:                            |   |
| Pound Sterling secured borrowings/(3)/ due 2001-2003 ..... | 6.24  |
| Euro secured borrowings... ..                              | 7.78  |
| Canadian dollars secured borrowings due 2003-2005 .....    | 5.63  |
| Revolving credit agreement .....                           | 6.45  |
| Other debt due 2001-2008 .....                             | 10.07   |
| Subtotal .....   |   |
| Total international operations .....                       |   |
| Subtotal .....   |   |
| Less current maturities .....                              |   |

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Total long-term debt .....

- /(1)/ This debt contains a put option that may be exercisable in 2003 (see below).
- /(2)/ Includes debt of special purpose entities that are consolidated in our financial statements.
- /(3)/ Refer to Note 5 for further discussion of secured borrowings.

Consolidated Long-Term Debt Maturities: Scheduled payments due on long-term debt for the next five years and thereafter follow:

| 2003<br>---- | 2004<br>---- | 2005<br>---- | 2006<br>---- | 2007<br>---- | Thereafter<br>---- |
|--------------|--------------|--------------|--------------|--------------|--------------------|
| \$ 3,980     | \$ 3,909     | \$ 4,016     | \$ 56        | \$ 296       | \$                 |

Certain of our debt agreements allow us to redeem outstanding debt prior to scheduled maturity, although the New Credit Facility generally prohibits early repayment of debt. The actual decision as to early redemption, when and if possible, will be made at the time the early redemption option becomes exercisable and will be based on liquidity, prevailing economic and business conditions, and the relative costs of new borrowing.

Convertible Debt due 2018: In 1998, we issued convertible subordinated debentures for net proceeds of \$575. The original scheduled amount due at maturity in April 2018 was \$1,012 which corresponded to an effective interest rate of 3.625 percent per annum, including 1.003 percent payable in cash semiannually beginning in October 1998. These debentures are convertible at any time at the option of the holder into 7.808 shares of our common stock per 1,000 dollars principal amount at maturity of the debentures. This debt contains a put option which requires us to purchase any debenture, at the option of the holder, on April 21, 2003, for a price of 649 dollars per 1,000 dollars principal amount at maturity of the debentures. We may elect to settle the obligation in cash, shares of common stock, or any combination thereof. During 2002, we retired \$32 of this convertible debt through the exchange of approximately 4 million shares of common stock valued at \$31. During 2001, we retired \$58 of this convertible debt through the exchange of approximately 6 million shares of common stock valued at \$49. As a result of these retirements, the amount due at December 31, 2002 is \$556 and is projected to accrete to \$863 upon maturity in April 2018.

Debt-for-Equity Exchanges: During 2002, we exchanged an aggregate of \$52 of debt through the exchange of 6.4 million shares of common stock valued at \$51 using the fair market value at the date of exchange. A gain of \$1 was recorded in connection with these transactions. During 2001, we retired \$374 of long-term debt through the exchange of 41 million shares of common stock valued at \$311. A gain of \$63 was recorded in connection with these transactions. The gains were recorded in Other expenses, net in our Consolidated Statements of Income. The shares were valued using the daily volume-weighted average price of our common stock over a specified number of days prior to the exchange, based on contractual terms.

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Lines of Credit: As of December 31, 2001, we had \$7 billion of loans outstanding under a fully-drawn revolving credit agreement (Old Revolver) due October 22, 2002, which we entered into in 1997 with a group of lenders.

In June 2002, we entered into an Amended and Restated Credit Agreement (the "New Credit Facility") with a group of lenders, replacing our prior \$7 billion facility (the "Old Revolver"). At that time, we permanently repaid \$2.8 billion of the Old Revolver and subsequently paid \$710 on the New Credit Facility. At December 31, 2002, the New Credit Facility consisted of two tranches of term loans totaling \$2.0 billion and a \$1.5 billion revolving credit facility that includes a \$200 letter of credit subfacility. At December 31, 2002, \$3.5 billion was outstanding under the New Credit Facility. At December 31, 2002 we had no additional borrowing capacity under the New Credit Facility since the entire revolving facility was outstanding, including a \$10 letter of credit under the subfacility. Xerox, the parent company, is currently, and expects to remain, the borrower of all the loans. The Revolving Facility is available, without sub-limit, to Xerox and to certain subsidiaries including Xerox Canada Capital Limited, Xerox Capital Europe plc, and other foreign subsidiaries as defined.

We could be required to repay portions of the loans earlier than their scheduled maturities with specified percentages of any proceeds we receive from capital market debt issuances, equity issuances or asset sales during the term of the New Credit Facility, except that the revolving loan commitment cannot be reduced below \$1 billion as a result of such prepayments. Additionally, all loans under the New Credit Facility become due and payable upon the occurrence of a change in control.

The New Credit Facility loans bear interest at LIBOR plus 4.50 percent, except that a \$500 term-loan tranche bears interest at LIBOR plus a spread that varies between 4.00 percent and 4.50 percent, depending on the amount secured.

In connection with the New Credit Facility we incurred fees and other expenses of \$120 which have been capitalized and are being amortized over its term on a basis consistent with the scheduled repayments in relation to the total amount of the loan facility.

Subject to certain limits, all obligations under the New Credit Facility are currently secured by liens on substantially all domestic assets of Xerox Corporation and substantially all our U.S. subsidiaries (other than Xerox Credit Corporation) and are guaranteed by substantially all our U.S. subsidiaries. In addition, revolving loans outstanding from time to time to Xerox Capital (Europe) plc (XCE) (none at December 31, 2002) are also secured by all XCE's assets and are guaranteed on an unsecured basis by certain foreign subsidiaries that directly or indirectly own all the outstanding stock of XCE. Revolving loans outstanding from time to time to Xerox Canada Capital Limited (XCCL) (\$50 at December 31, 2002) are secured by all XCCL's assets and are guaranteed on an unsecured basis by our material Canadian subsidiaries, as defined.

The New Credit Facility contains affirmative and negative covenants which are more fully discussed in Note 1.

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At December 31, 2002, we are in compliance with all aspects of the New Credit Facility including financial covenants and expect to be in compliance for at least the next twelve months. Failure to be in compliance with any material provision or covenant of the New Credit Facility could have a material adverse effect on our liquidity and operations.

We are required to make scheduled amortization payments of \$202.5 on each of

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March 31, 2003 and September 30, 2003, and \$302.5 on each of March 31, 2004 and September 30, 2004. In addition, mandatory prepayments are required from a portion of any proceeds we receive from certain asset transfers or debt or equity issuances, as those terms are defined in the New Credit Facility. Any such prepayments would be credited toward the scheduled amortization payments in direct order of maturity.

Senior Notes. In January 2002, we completed an unregistered offering in the U.S. (\$600) and Europe ((euro)225) of 9.75 percent senior notes due in 2009 ("Senior Notes") and received net cash proceeds of \$746, which included \$559 and (euro)209. The senior notes were issued at a 4.833 percent discount and pay interest semiannually on January 15 and July 15. In March 2002, we filed a registration statement to exchange senior registered notes for these unregistered senior notes. This registration statement has not yet been declared effective. The terms of the debt include increases in the interest rate to the extent the registration is delayed. Such increases will be up to 0.50 percent and will be effective until the registration effectiveness is complete. As of January 17, 2003, the interest rate increased to 10.0 percent. Fees of \$16 million incurred in connection with this offering have been capitalized as debt issue costs and are being amortized over the term of the notes. These Senior Notes are guaranteed by certain of our U.S. subsidiaries and contain several affirmative and negative covenants similar to those in the New Credit Facility, but taken as a whole are less restrictive than those in the New Credit Facility. We were in compliance with these covenants at December 31, 2002.

Guarantees. At December 31, 2002, we have guaranteed \$1.9 billion of indebtedness of our foreign wholly-owned subsidiaries. This debt is included in our Consolidated Balance Sheet as of such date.

Interest. Interest paid by us on our short- and long-term debt amounted to \$772, \$1,074, and \$1,050 for the years ended December 31, 2002, 2001 and 2000, respectively.

Interest expense and interest income consisted of:

|                          | Year Ended<br>December 31, |         |          |
|--------------------------|----------------------------|---------|----------|
|                          | 2002                       | 2001    | 2000     |
| Interest expense / (1) / | \$ 751                     | \$ 937  | \$ 1,090 |
| Interest income / (2) /  | (1,077)                    | (1,230) | (1,239)  |

/ (1) / Includes Equipment financing interest, as well as non-financing interest expense that is included in Other expenses, net in the Consolidated Statements of Income.

/ (2) / Includes Finance income, as well as other interest income that is included in Other expenses, net in the Consolidated Statements of Income.

Equipment financing interest is determined based on a combination of actual interest expense incurred on financing debt, as well as our estimated cost of funds, applied against the estimated level of debt required to support our financed receivables. The estimate is based on an assumed ratio of debt as compared to our finance receivables. This ratio ranges from 80-90% of our average finance receivables. This methodology has been consistently applied for all periods presented.

A summary of the Other cash changes in debt, net as shown on the consolidated statements of cash flows for the three years ended December 31, 2002 follows:

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|  | 2002<br>---- | 2001<br>---- | 2000<br>---- |
|--|--------------|--------------|--------------|
| Cash payments on notes payable, net            | \$ (33)      | \$ (141)     | \$ (1,277)   |
| Cash proceeds from long-term debt, net / (1) / | 1,053        | 89           | 10,131       |
| Cash payments on long-term debt                | (5,639)      | (2,396)      | (5,816)      |
|  | -----        | -----        | -----        |
| Total other cash changes in debt, net          | \$ (4,619)   | \$ (2,448)   | \$ 3,038     |
|  | =====        | =====        | =====        |

/(1)/ Includes payment of debt issuance costs.

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Note 12--Financial Instruments

We are exposed to market risk from changes in foreign currency exchange rates and interest rates that could affect our results of operations and financial condition. Our current below investment-grade credit ratings effectively constrain our ability to fully use derivative contracts as part of our risk management strategy described below, especially with respect to interest rate management. Accordingly, our results of operations are exposed to increased volatility. As further discussed in Note 1, we adopted SFAS No. 133, as of January 1, 2001. The adoption of SFAS No. 133 has increased the volatility of reported earnings and other comprehensive income. In general, the amount of volatility will vary with the level of derivative and hedging activities and the market volatility during any period.

We have historically entered into certain derivative contracts, including interest rate swap agreements, foreign currency swap agreements, forward exchange contracts and purchased foreign currency options, to manage interest rate and foreign currency exposures. The fair market values of all our derivative contracts change with fluctuations in interest rates and/or currency rates and are designed so that any change in their values is offset by changes in the values of the underlying exposures. Our derivative instruments are held solely to hedge economic exposures; we do not enter into derivative instrument transactions for trading or other speculative purposes and we employ long-standing policies prescribing that derivative instruments are only to be used to achieve a very limited set of objectives.

Our primary foreign currency market exposures include the Japanese Yen, Euro, Brazilian Real, British Pound Sterling and Canadian Dollar. Historically, for each of our legal entities, we have generally hedged foreign currency denominated assets and liabilities, primarily through the use of derivative contracts. Despite our current credit ratings, we have been able to restore significant economic hedging activities with currency-related derivative contracts during 2002. Although we are still unable to hedge all our currency exposures, we are currently utilizing the re-established capacity primarily to hedge currency exposures related to our foreign-currency denominated debt.

We typically enter into simple unleveraged derivative transactions. Our policy is to use only counterparties with an investment-grade or better credit rating and to monitor market risk and exposure for each counterparty. We also utilize arrangements allowing us to net gains and losses on separate contracts with all counterparties to further mitigate the credit risk associated with our financial instruments. Based upon our ongoing evaluation of the replacement cost of our derivative transactions and counterparty credit-worthiness, we consider the risk

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of a material default by a counterparty to be remote.

Due to our credit ratings, many of our derivative contracts and several other material contracts at December 31, 2002 require us to post cash collateral or maintain minimum cash balances in escrow. These cash amounts are reported in our Consolidated Balance Sheets as within Other current assets or Other long-term assets, depending on when the cash will be contractually released. Such restricted cash amounts totaled \$77 at December 31, 2002.

**Interest Rate Risk Management:** Virtually all customer-financing assets earn fixed rates of interest, while a significant portion of our debt bears interest at variable rates. Historically we have attempted to manage our interest rate risk by "match-funding" the financing assets and related debt, including through the use of interest rate swap agreements. However, as our credit ratings declined, our ability to continue this practice became constrained.

At December 31, 2002, we had \$7.0 billion of variable rate debt, including the \$3.5 billion outstanding under the New Credit Facility and the notional value of our pay-variable interest-rate swaps. The notional value of our offsetting pay-fixed interest-rate swaps was \$1.2 billion.

Our loans related to vendor financing, from parties including GE, are secured by customer-financing assets and are designed to mature ratably with our collection of principal payments on the financing assets which secure them. Additionally, the interest rates on all these loans are fixed. As a result, the vendor financing loan programs we have implemented create natural match-funding of the financing assets to the related loans. As we implement additional vendor financing opportunities and continue to repay existing debt, the portion of our financing assets which is match-funded against related secured debt will increase.

**Single Currency Interest Rate Swaps:** At December 31, 2002 and 2001 we had outstanding single currency interest rate swap agreements with aggregate notional amounts of \$3,820 and \$4,415, respectively. The net asset fair values at December 31, 2002 and 2001 were \$121 and \$52, respectively.

**Foreign Currency Interest Rate Swaps:** In cases where we issue foreign currency-denominated debt, we enter into cross-currency interest rate swap agreements if possible, whereby we swap the proceeds and related interest payments with a counterparty. In return, we receive and effectively denominate the debt in local functional currencies.

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At December 31, 2002 and 2001, we had outstanding cross-currency interest rate swap agreements with aggregate notional amounts of \$879 and \$1,481, respectively. The net asset fair values at December 31, 2002 and 2001 were \$21 and \$17, respectively. Of the outstanding agreements at December 31, 2002, the largest single currency hedged was the Japanese yen. Contracts denominated in Japanese yen, Pound sterling and Euros accounted for over 95 percent of our cross-currency interest rate swap agreements.

The aggregate notional amounts of interest rate swaps by maturity date and type at December 31, 2002 follow:

| Single Currency Swaps | 2003 | 2004 | 2005 | 2006 | Thereafter | T   |
|-----------------------|------|------|------|------|------------|-----|
| -----                 | ---- | ---- | ---- | ---- | -----      | --- |



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|                            |        |         |        |       |         |     |
|----------------------------|--------|---------|--------|-------|---------|-----|
| Pay fixed/receive variable | \$ 139 | \$ 275  | \$ 172 | \$ 22 | \$ 250  | \$  |
| Pay variable/receive fixed | 825    | 1,287   | --     | --    | 850     | 2   |
|                            | -----  | -----   | -----  | ----- | -----   | --- |
| Total                      | \$ 964 | \$1,562 | \$ 172 | \$ 22 | \$1,100 | \$3 |
|                            | =====  | =====   | =====  | ===== | =====   | === |
| Interest rate paid         | 0.79%  | 3.19%   | 6.61%  | 6.02% | 5.37%   |     |
| Interest rate received     | 2.30   | 5.00    | 2.23   | 2.84  | 7.45    |     |

|                            |        |       |       |        |            |     |
|----------------------------|--------|-------|-------|--------|------------|-----|
| Cross Currency Swaps       | 2003   | 2004  | 2005  | 2006   | Thereafter | T   |
|                            | ----   | ----  | ----  | ----   | -----      | --- |
|                            | -----  | ----- | ----- | -----  | -----      | --- |
| Pay fixed/receive variable | \$ 257 | \$ 87 | \$ 8  | \$ --  | \$ --      | \$  |
| Pay variable/receive fixed | --     | --    | --    | 406    | 122        |     |
|                            | -----  | ----- | ----- | -----  | -----      | --- |
| Total                      | \$ 257 | \$ 87 | \$ 8  | \$ 406 | \$ 122     | \$  |
|                            | =====  | ===== | ===== | =====  | =====      | === |
| Interest rate paid         | 5.02%  | 5.97% | 6.85% | 2.53%  | 2.93%      |     |
| Interest rate received     | 1.42   | 1.42  | 1.42  | 1.50   | 2.00       |     |

The majority of the variable portions of our swaps pay interest based on spreads against LIBOR or the European Interbank Rate.

Derivatives Marked-to-Market Results: While our existing portfolio of interest rate derivative instruments is intended to economically hedge interest rate risks to the extent possible, differences between the contract terms of our derivatives and the underlying related debt reduce our ability to obtain hedge accounting in accordance with SFAS No. 133. This results in mark-to-market valuation of the majority of our derivatives directly through earnings, which accordingly leads to increased earnings volatility. During 2002 and 2001, we recorded net gains of \$12 and net losses of \$2, respectively, from the mark-to-market valuation of interest rate derivatives for which we did not apply hedge accounting.

Fair Value Hedges: During 2002, pay variable/receive fixed interest rate swaps with a notional amount of \$600 and associated with the Senior Notes due in 2009, were designated and accounted for as fair value hedges. The swaps were structured to hedge the fair value of the debt by converting it from a fixed rate instrument to a variable based instrument. Since the hedging relationship qualified under SFAS No. 133, no ineffective portion was recorded to earnings during 2002. During 2001, certain Japanese yen/U.S. dollar cross-currency interest rate swaps with a notional amount of 65 billion yen were designated and accounted for as fair value hedges. The net ineffective portion recorded to earnings during 2001 was a loss of \$7 and is included in Other expenses, net in the accompanying Consolidated Statements of Income. All components of each derivatives gain or loss were included in the assessment of hedge effectiveness. Hedge accounting was discontinued in the fourth quarter 2001 after the swaps were terminated and moved to a different counterparty, because the new swaps did not satisfy certain SFAS No. 133 requirements.

Foreign Exchange Risk Management:

Currency Derivatives: We utilize forward exchange contracts and purchased option contracts to hedge against the potentially adverse impacts of foreign currency fluctuations on foreign currency denominated assets and liabilities. Changes in the value of these currency derivatives are recorded in earnings together with the offsetting foreign exchange gains and losses on the underlying assets and liabilities.

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We also utilize currency derivatives to hedge anticipated transactions, primarily forecasted purchases of foreign-sourced inventory and foreign currency lease, interest and other payments. These contracts generally mature in six months or less. Although these contracts are intended to economically hedge foreign currency risks to the extent possible, differences between the contract terms of our derivatives and the underlying forecasted exposures reduce our ability to obtain hedge accounting in accordance with SFAS No. 133. Accordingly, the changes in value for a majority of these derivatives are recorded directly through earnings.

During 2002, 2001 and 2000, we recorded aggregate exchange losses of \$77 and gains of \$29 and \$103, respectively. This reflects the changes in the values of all our foreign currency derivatives, for which we did not apply hedge accounting, together with exchange gains and losses on foreign currency underlying assets and liabilities.

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At December 31, 2002 and 2001, we had outstanding forward exchange and purchased option contracts with gross notional values of \$3,319 and \$3,900, respectively. The net asset (liability) fair values of our currency derivatives at December 31, 2002 and 2001 were \$(50) and \$8, respectively. The following is a summary of the primary hedging positions held as of December 31, 2002:

| Currency Hedged (Buy/Sell) | Gross<br>Notional<br>Value | Fair Value<br>Asset/<br>(Liability) |
|----------------------------|----------------------------|-------------------------------------|
| US Dollar/Euro             | \$ 791                     | \$ (45)                             |
| Euro/Pound Sterling        | 730                        | 5                                   |
| Yen/US Dollar              | 584                        | 4                                   |
| Pound Sterling/Euro        | 360                        | (7)                                 |
| Canadian Dollar/Euro       | 109                        | (14)                                |
| US Dollar/Brazil Real      | 104                        | 6                                   |
| US Dollar/Canadian Dollar  | 90                         | 1                                   |
| Yen/Pound Sterling         | 89                         | 2                                   |
| All Other                  | 462                        | (2)                                 |
|                            | -----                      | -----                               |
| Total                      | \$ 3,319                   | \$ (50)                             |
|                            | =====                      | =====                               |

Accumulated Other Comprehensive Income ("AOCI"): The following is a summary of changes in AOCI resulting from the application of SFAS No. 133 during 2002 and 2001:

| For the Year Ended December 31, 2002 | Opening<br>Balance | Transition<br>Gains (Losses) | Net<br>Gains (Losses) | Reco<br>Stat<br>Ope |
|--------------------------------------|--------------------|------------------------------|-----------------------|---------------------|
| Variable Interest Paid               | \$ (15)            | \$ --                        | \$ --                 | \$                  |
| Foreign Currency Interest Payments   | (2)                | --                           | (1)                   |                     |
|                                      | -----              | -----                        | -----                 |                     |
| Pre-tax Subtotal                     | (17)               | --                           | (1)                   |                     |
|                                      | -----              | -----                        | -----                 |                     |
| Tax Expense                          | 8                  | --                           | --                    |                     |
| Fuji Xerox, net                      | 2                  | --                           | --                    |                     |
|                                      | -----              | -----                        | -----                 |                     |

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|                                      |        |         |        |       |
|--------------------------------------|--------|---------|--------|-------|
| Total                                | \$ (7) | \$ --   | \$ (1) | \$    |
|                                      | =====  | =====   | =====  | ===== |
| For the Year Ended December 31, 2001 |        |         |        |       |
| -----                                |        |         |        |       |
| Variable Interest Paid               | \$ --  | \$ (35) | \$ --  | \$    |
| Inventory Purchases                  | --     | --      | (5)    |       |
| Foreign Currency Interest Payments   | --     | --      | (4)    |       |
|                                      | -----  | -----   | -----  |       |
| Pre-tax Subtotal                     | --     | (35)    | (9)    |       |
|                                      | -----  | -----   | -----  |       |
| Tax Expense                          | --     | 14      | 4      |       |
| Fuji Xerox, net                      | --     | 2       | --     |       |
|                                      | -----  | -----   | -----  |       |
| Total                                | \$ --  | \$ (19) | \$ (5) | \$    |
|                                      | =====  | =====   | =====  | ===== |

\* Includes reclassification of \$7 in 2002 and \$12 in 2001 of the after-tax transition loss of \$19.

During 2002 and 2001, certain forward contracts used to hedge Euro denominated interest payments were designated and accounted for as cash flow hedges. Accordingly, the change in value of these derivatives is included in the rollforward of AOCI above. No amount of ineffectiveness was recorded to the Consolidated Statements of Income during 2002 or 2001 for our designated cash flow hedges and all components of each derivatives gain or loss are included in the assessment of hedge effectiveness. The amount reclassified to earnings during 2001 and 2002 represents the recognition of deferred gains or losses along with the underlying hedged transactions.

Net Investment Hedges: We also utilize derivative instruments and non-derivative financial instruments to hedge against the potentially adverse impacts of foreign currency fluctuations on certain of our investments in foreign entities. During 2001, \$18 of net after-tax gains related to hedges of our net investments in Xerox Brazil and Fuji Xerox were recorded in the cumulative translation adjustments account. The amounts recorded during 2002 were less than \$1.

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Fair Value of Financial Instruments. The estimated fair values of our financial instruments at December 31, 2002 and 2001 follow:

|                                 | 2002     |          | 2001     |
|---------------------------------|----------|----------|----------|
|                                 | Carrying | Fair     | Carrying |
|                                 | Amount   | Value    | Amount   |
|                                 | -----    | -----    | -----    |
| Cash and cash equivalents ..... | \$ 2,887 | \$ 2,887 | \$ 3,990 |
| Accounts receivable, net .....  | 2,072    | 2,072    | 1,896    |
| Short-term debt .....           | 4,377    | 3,837    | 6,637    |
| Long-term debt .....            | 9,794    | 9,268    | 10,107   |

The fair value amounts for Cash and cash equivalents and Accounts receivable, net approximate carrying amounts due to the short maturities of these

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instruments.

The fair value of Short and Long-term debt was estimated based on quoted market prices for these or similar issues or on the current rates offered to us for debt of similar maturities. The difference between the fair value and the carrying value represents the theoretical net premium or discount we would pay or receive to retire all debt at such date. We have no plans to retire significant portions of our debt prior to scheduled maturity.

Note 13--Employee Benefit Plans

We sponsor numerous pension and other post-retirement benefit plans, primarily retiree health, in our U.S. and international operations. Information regarding our benefit plans is presented below:

|  | Pension Benefits |          | Oth        |
|--|------------------|----------|------------|
|  | 2002             | 2001     | 2002       |
|  | -----            | -----    | -----      |
| Change in Benefit Obligation                                   |                  |          |            |
| Benefit obligation, January 1 .....                            | \$ 7,606         | \$ 8,255 | \$ 1,481   |
| Service cost .....   | 180              | 174      | 26         |
| Interest cost .....  | (210)            | (184)    | 96         |
| Plan participants' contributions .....                         | 18               | 19       | 3          |
| Plan amendments .....  | (31)             | --       | (139)      |
| Actuarial loss .....   | 736              | 76       | 191        |
| Currency exchange rate changes .....                           | 327              | (99)     | --         |
| Divestitures .....   | (1)              | --       | --         |
| Curtailments .....   | 2                | 34       | 8          |
| Special termination benefits .....                             | 39               | --       | 2          |
| Benefits paid/settlements .....                                | (735)            | (669)    | (105)      |
|  | -----            | -----    | -----      |
| Benefit obligation, December 31 .....                          | \$ 7,931         | \$ 7,606 | \$ 1,563   |
| Change in Plan Assets  |                  |          |            |
| Fair value of plan assets, January 1 .....                     | \$ 7,040         | \$ 8,626 | \$ --      |
| Actual return on plan assets .....                             | (768)            | (843)    | --         |
| Employer contribution .....                                    | 138              | 42       | 102        |
| Plan participants' contributions .....                         | 18               | 19       | 3          |
| Currency exchange rate changes .....                           | 271              | (135)    | --         |
| Divestitures .....   | (1)              | --       | --         |
| Benefits paid .....  | (735)            | (669)    | (105)      |
|  | -----            | -----    | -----      |
| Fair value of plan assets, December 31 .....                   | \$ 5,963         | \$ 7,040 | \$ --      |
|  | -----            | -----    | -----      |
| Funded status (including under-funded and non-funded plans) .. | (1,968)          | (566)    | (1,563)    |
| Unamortized transition assets .....                            | --               | (1)      | --         |
| Unrecognized prior service cost .....                          | (27)             | 8        | (134)      |
| Unrecognized net actuarial (gain) loss .....                   | 1,843            | 434      | 445        |
|  | -----            | -----    | -----      |
| Net amount recognized .....                                    | \$ (152)         | \$ (125) | \$ (1,252) |
|  | =====            | =====    | =====      |

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|   | Pension Benefits |          |
|---|------------------|----------|
|   | 2002             | 2001     |
|   | ----             | ----     |
| Amounts recognized in the Consolidated Balance Sheets consist of:     |                  |          |
| Prepaid benefit cost .....  | \$ 656           | \$ 597   |
| Accrued benefit liability .....                                       | (1,277)          | (785)    |
| Intangible asset .....  | 7                | 7        |
| Accumulated other comprehensive income .....                          | 462              | 56       |
|   | -----            | -----    |
| Net amount recognized .....   | \$ (152)         | \$ (125) |
|   | =====            | =====    |
| Under-funded or non-funded plans                                      |                  |          |
| Aggregate benefit obligation .....                                    | \$7,865          | \$5,778  |
| Aggregate fair value of plan assets .....                             | \$5,878          | \$5,039  |
| Plans with under-funded or non-funded accumulated benefit obligations |                  |          |
| Aggregate accumulated benefit obligation .....                        | \$5,188          | \$4,604  |
| Aggregate fair value of plan assets .....                             | \$4,008          | \$4,157  |

|  | Pension Benefits |      |      |      |
|--|------------------|------|------|------|
|  | 2002             | 2001 | 2000 | 200  |
|  | ----             | ---- | ---- | ---- |
| Weighted average assumptions as of December 31 |                  |      |      |      |
| Discount rate .....                            | 6.2%             | 6.8% | 7.0% | 6.5  |
| Expected return on plan assets .....           | 8.8              | 8.9  | 8.9  |      |
| Rate of compensation increase .....            | 3.9              | 3.8  | 3.8  |      |

Our domestic retirement defined benefit plans provide employees a benefit at the greater of (i) the benefit calculated under a highest average pay and years of service formula, (ii) the benefit calculated under a formula that provides for the accumulation of salary and interest credits during an employee's work life, or (iii) the individual account balance from the Company's prior defined contribution plan (Transitional Retirement Account or TRA).

|   | Pension Benefits |       |       |       |
|---|------------------|-------|-------|-------|
|   | 2002             | 2001  | 2000  | 200   |
|   | ----             | ----  | ----  | ----  |
| Components of Net Periodic Benefit Cost             |                  |       |       |       |
| Defined benefit plans                               |                  |       |       |       |
| Service cost .....                                  | \$180            | \$174 | \$167 | \$ 26 |
| Interest cost/(1)/ .....                            | (210)            | (184) | 453   | 96    |
| Expected return on plan assets/(2)/.....            | 134              | 81    | (522) | --    |
| Recognized net actuarial loss .....                 | 7                | 7     | 4     | 3     |
| Amortization of prior service cost .....            | 3                | 9     | 4     | (5    |
| Recognized net transition asset .....               | (1)              | (14)  | (16)  | --    |
| Recognized curtailment/settlement loss (gain) ..... | 55               | 26    | (46)  | --    |
|   | -----            | ----- | ----- | ----- |
| Net periodic benefit cost .....                     | 168              | 99    | 44    | 120   |
| Special termination benefits                        | 27               | --    | --    | 2     |
| Defined contribution plans .....                    | 10               | 21    | 14    | --    |

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|             |                         |                         |                         |                         |
|-------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Total ..... | -----<br>\$205<br>===== | -----<br>\$120<br>===== | -----<br>\$ 58<br>===== | -----<br>\$122<br>===== |
|-------------|-------------------------|-------------------------|-------------------------|-------------------------|

/(1)/ Interest cost includes interest expense on non-TRA obligations of \$238, \$216 and \$225 and interest (income) expense directly allocated to TRA participant accounts of \$(448), \$(400) and \$228 for the years ended December 31, 2002, 2001 and 2000, respectively.

/(2)/ Expected return on plan assets includes expected investment income on non-TRA assets of \$314, \$319 and \$294 and actual investment (losses) income on TRA assets of \$(448), \$(400) and \$228 for the years ended December 31, 2002, 2001 and 2000, respectively.

During 2002, we incurred special termination benefits and recognized curtailment/settlement losses as a result of restructuring programs. Accordingly, the special termination benefit cost of \$29, and \$18 of the total recognized settlement/curtailment loss amount of \$55 is included as a restructuring charge in our Consolidated Statements of Income.

Pension plan assets consist of both defined benefit plan assets and assets legally restricted to the TRA accounts. The combined investment results for these plans, along with the results for our other defined benefit plans, are shown above in the actual return on plan assets caption. To the extent that investment results relate to TRA, such results are charged directly to these accounts as a component of interest cost.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. For measurement purposes, a 13.8 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 2003, decreasing gradually to 5.2 percent in 2008 and thereafter.

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A one-percentage-point change in assumed health care cost trend rates would have the following effects:

|  | One-percentage-<br>point increase<br>----- |
|--|--|
| Effect on total service and interest cost components ..... | \$ 5                                       |
| Effect on post-retirement benefit obligation .....         | \$64                                       |

Employee Stock Ownership Plan ("ESOP") Benefits.: In 1989, we established an ESOP and sold to it 10 million shares of Series B Convertible Preferred Stock ("Convertible Preferred") of the Company for a purchase price of \$785. Each ESOP share is presently convertible into six common shares of our common stock (the "Convertible Preferred"). The Convertible Preferred has a \$1 par value and a guaranteed minimum value of \$78.25 per share and accrues annual dividends of \$6.25 per share, which are cumulative if earned. When the ESOP was established, the ESOP borrowed the purchase price from a group of lenders. The ESOP debt was included in our Consolidated Balance Sheets as debt because we guaranteed the ESOP borrowings. A corresponding and offsetting amount was classified as Deferred ESOP benefits and represented our commitment to future compensation

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expense related to the ESOP benefits as well as an offset to the preferred shares included in equity. In the second quarter of 2002, we repaid the outstanding balance of ESOP debt of \$135. We recorded an intercompany receivable from the ESOP trust, in connection with our repayment of the ESOP debt, which eliminates in consolidation. Accordingly, the repayment of the ESOP debt effectively represents a retirement of third party debt and therefore such debt is no longer included in our Consolidated Balance Sheets. The repayment of debt did not affect the recognition of compensation expense associated with the ESOP; however, interest expense was lower in 2002.

In connection with our decision in 2001 to eliminate the quarterly dividends on our common stock, dividends on the Convertible Preferred were suspended in July 2001. The ESOP requires pre-determined debt service obligations for each period to be funded by a combination of dividends and employee contributions over the term of the plan. The dividends do not affect our Consolidated Statements of Income, while the contributions are recorded as expense in such statements. As a result of the suspension of dividends, we were required, under the terms of the plan, to increase our contributions to the ESOP trust in order to meet the pre-determined amount of debt service obligations. In addition, since the dividend requirement on the Convertible Preferred is cumulative, dividends continued to accumulate in arrears until dividends were reinstated. As of the end of the third quarter of 2002, the cumulative dividend amounted to \$67, including \$11 representing the third quarter 2002 dividend requirement. In September 2002, the payment of Cumulative Preferred dividends was reinstated by our Board of Directors and \$67 of Convertible Preferred dividends were declared. This resulted in a reversal of the previously accrued incremental compensation expense of \$67 (\$32 of which related to 2001). During the fourth quarter of 2002, dividends of \$11 were declared. These were paid in January 2003. There was no corresponding earnings per share improvement in 2002 since the EPS calculation requires deduction of dividends declared from reported net income in arriving at net income available to common shareholders.

Information relating to the ESOP trust for the three years ended December 31, 2002 follows:

|   | 2002 | 2001  | 2000  |
|---|------|-------|-------|
|   | ---- | ----  | ----  |
| Interest on ESOP Borrowings .....                       | \$ 5 | \$ 15 | \$ 15 |
| Dividends declared on Convertible Preferred Stock ..... | 78   | 13    | 13    |
| Cash contribution to the ESOP .....                     | 31   | 88    | 88    |
| Compensation expense .....                              | 10   | 89    | 89    |

We recognize ESOP costs based on the amount committed to be contributed to the ESOP plus related trustee, finance and other charges.

Note 14--Income and Other Taxes

Income (loss) before income taxes for the three years ended December 31, 2002 was as follows:

|                              | 2002   | 2001     | 2000 |
|------------------------------|--------|----------|------|
|                              | ----   | ----     | ---- |
| Domestic income (loss) ..... | \$ 167 | \$ (126) | \$ 7 |
| Foreign income (loss) .....  | 85     | 520      | (44) |

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|   |        |        |         |
|---|--------|--------|---------|
| Income (loss) before income taxes ..... | \$ 252 | \$ 394 | \$ (36) |
|   | =====  | =====  | =====   |

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Provisions (benefits) for income taxes for the three years ended December 31, 2002 were as follows:

|                      | 2002  | 2001  | 2000    |
|----------------------|-------|-------|---------|
|                      | ----  | ----  | ----    |
| Federal income taxes |       |       |         |
| Current .....        | \$ 86 | \$ 31 | \$ (18) |
| Deferred .....       | (35)  | (117) | (95)    |
| Foreign income taxes |       |       |         |
| Current .....        | 145   | 474   | 73      |
| Deferred .....       | (141) | 114   | (45)    |
| State income taxes   |       |       |         |
| Current .....        | 7     | 2     | 5       |
| Deferred .....       | (2)   | (7)   | 10      |
| Income taxes .....   | \$ 60 | \$497 | \$ (70) |
|                      | ===== | ===== | =====   |

A reconciliation of the U.S. federal statutory income tax rate to the effective income tax rate for the three years ended December 31, 2002 follows:

|   | 2002   | 2001   |
|---|--------|--------|
|   | ----   | ----   |
| U.S. federal statutory income tax rate .....                | 35.0%  | 35.0%  |
| Foreign earnings taxed at different rates .....             | 22.3   | 41.0   |
| Sale of partial ownership interest in Fuji Xerox .....      | --     | 29.5   |
| Goodwill amortization .....                                 | --     | 2.6    |
| Tax-exempt income .....                                     | (3.8)  | (3.3)  |
| State taxes, net of federal benefit .....                   | 1.3    | (0.8)  |
| Audit resolutions and other examination items - net .....   | (22.1) | (35.6) |
| Dividends on Employee Stock Ownership Plan shares .....     | (9.3)  | (1.0)  |
| Effect of tax law change .....                              | (6.3)  | (2.7)  |
| Change in valuation allowance for deferred tax assets ..... | 5.8    | 62.9   |
| Other .....   | 0.9    | (1.5)  |
| Effective income tax rate .....                             | 23.8%  | 126.1% |
|   | =====  | =====  |

The difference between the 2002 effective tax rate of 23.8 percent and the U.S. federal statutory income tax rate relates primarily to the recognition of tax benefits from the favorable resolution of a foreign tax audit, tax law changes as well as the retroactive declaration of ESOP dividends. Such benefits are offset, in part, by tax expense recorded for the ongoing examination in India, the sale of our interest in Katun Corporation as well as recurring losses in certain jurisdictions where we are not providing tax benefits.



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The difference between the 2001 effective tax rate of 126.1 percent and the U.S. federal statutory income tax rate relates primarily to the recognition of deferred tax asset valuation allowances resulting from our recoverability assessments, the taxes incurred in connection with the sale of our partial interest in Fuji Xerox and recurring losses in low tax jurisdictions. The gain for tax purposes on the sale of Fuji Xerox was disproportionate to the gain for book purposes as a result of a lower tax basis in the investment. Other items favorably impacting the tax rate included a tax audit resolution and additional tax benefits arising from prior period restructuring provisions.

The difference between the 2000 effective tax rate of 19.1 percent and the U.S. federal statutory income tax rate relates primarily to recurring losses in low tax jurisdictions, the recognition of deferred tax asset valuation allowances resulting from our recoverability assessments and additional tax benefits arising from the favorable resolution of tax audits.

On a consolidated basis, we paid a total of \$442, \$57 and \$354 in income taxes to federal, foreign and state jurisdictions in 2002, 2001 and 2000, respectively.

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Total income tax expense (benefit) for the three years ended December 31, 2002 was allocated as follows:

|   | 2002    | 2001  | 2000    |
|---|---------|-------|---------|
|   | ----    | ----  | ----    |
| Income taxes (benefits) on income (loss) .....            | \$ 60   | \$497 | \$ (10) |
| Tax benefit included in minorities' interests/(1)/ .....  | (55)    | (23)  | (1)     |
| Cumulative effect of change in accounting principle ..... | --      | 1     | --      |
| Common shareholders' equity/(2)/ .....                    | (173)   | 1     | --      |
|   | -----   | ----- | -----   |
| Total .....   | \$(168) | \$476 | \$ (11) |
|   | =====   | ===== | =====   |

/(1)/ Benefit relates to preferred securities' dividends as more fully described in Note 16.

/(2)/ For dividends paid on shares held by the ESOP, tax effects of items in accumulated other comprehensive loss and tax benefit on nonqualified stock options.

In substantially all instances, deferred income taxes have not been provided on the undistributed earnings of foreign subsidiaries and other foreign investments carried at equity. The amount of such earnings included in consolidated retained earnings at December 31, 2002 was approximately \$5 billion. These earnings have been permanently reinvested and we do not plan to initiate any action that would precipitate the payment of income taxes thereon. It is not practicable to estimate the amount of additional tax that might be payable on the foreign earnings. As a result of the March 31, 2001 disposition of one-half of our ownership interest in Fuji Xerox, the investment no longer qualifies as a foreign corporate joint venture. Accordingly, deferred taxes are required to be provided on the undistributed earnings of Fuji Xerox, arising subsequent to such date, as we no longer have the ability to ensure permanent reinvestment.

The tax effects of temporary differences that give rise to significant portions

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of the deferred taxes at December 31, 2002 and 2001 were as follows:

|  | 2002     | 2001     |
|--|----------|----------|
|  | ----     | ----     |
| Tax effect of future tax deductions    |          |          |
| Research and development .....         | \$1,142  | \$1,007  |
| Post-retirement medical benefits ..... | 487      | 464      |
| Depreciation .....                     | 475      | 438      |
| Net operating losses .....             | 416      | 295      |
| Other operating reserves .....         | 230      | 202      |
| Tax credit carryforwards .....         | 204      | 185      |
| Restructuring reserves .....           | 174      | 122      |
| Allowance for doubtful accounts .....  | 162      | 182      |
| Deferred compensation .....            | 159      | 180      |
| Other .....                            | 356      | 207      |
|  | -----    | -----    |
|  | 3,805    | 3,282    |
| Valuation allowance .....              | (524)    | (474)    |
|  | -----    | -----    |
| Total deferred tax assets .....        | \$3,281  | \$2,808  |
|  | =====    | =====    |
| Tax effect of future taxable income    |          |          |
| Installment sales and leases .....     | \$ (376) | \$ (358) |
| Unearned income .....                  | (987)    | (820)    |
| Other .....                            | (76)     | (150)    |
|  | -----    | -----    |
| Total deferred tax liabilities .....   | (1,439)  | (1,328)  |
|  | =====    | =====    |
| Total deferred taxes, net .....        | \$1,842  | \$1,480  |
|  | =====    | =====    |

The above amounts are classified as current or long-term in the Consolidated Balance Sheets in accordance with the asset or liability to which they relate. Current deferred tax assets at December 31, 2002 and 2001 amounted to \$449 and \$548, respectively.

The deferred tax assets for the respective periods were assessed for recoverability and, where applicable, a valuation allowance was recorded to reduce the total deferred tax asset to an amount that will, more likely than not, be realized in the future. The valuation allowance for deferred tax assets as of January 1, 2001 was \$187. The net change in the total valuation allowance for the years ended December 31, 2002 and 2001 was an increase of \$50 and \$287, respectively. The valuation allowance relates to certain foreign net operating loss carryforwards, foreign tax credit carryforwards and deductible temporary differences for which we have concluded it is more likely than not that these items will not be realized in the ordinary course of operations.

Although realization is not assured, we have concluded that it is more likely than not that the deferred tax assets for which a valuation allowance was determined to be unnecessary will be realized in the ordinary course of operations based on scheduling of deferred tax liabilities and projected income from operating activities. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if actual future income

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or income tax rates are lower than estimated, or if there are differences in the timing or amount of future reversals of existing taxable or deductible temporary differences.

At December 31, 2002, we had tax credit carryforwards of \$204 available to offset future income taxes, of which \$159 is available to carryforward indefinitely while the remaining \$45 will begin to expire, if not utilized, in 2004. We also had net operating loss carryforwards for income tax purposes of \$262 that will expire in 2003 through 2012, if not utilized, and \$1.9 billion available to offset future taxable income indefinitely.

At December 31, 2002, our Brazilian operations had assessments for indirect and other taxes which, inclusive of interest, were approximately \$260. These assessments related principally to the internal transfer of inventory. We do not agree with these assessments and intend to vigorously defend our position. We, as supported by the opinion of legal counsel, do not believe that the ultimate resolution of these assessments will materially impact our results of operations, financial position or cash flows.

We are subject to ongoing tax examinations and assessments in various jurisdictions. Accordingly, we provide for additional tax expense based upon the probable outcomes of such matters. In addition, when applicable, we adjust the previously recorded tax expense to reflect examination results.

From 1995 through 1998, we incurred capital losses from the disposition of our insurance group operations. Such losses were disallowed under the tax law existing at the time of the respective dispositions. As a result of IRS regulations issued in 2002, some portion of the losses may now be claimed subject to certain limitations. We have filed amended tax returns for 1995 through 1998 reporting \$1.2 billion of additional capital losses. As of December 31, 2002, we have \$425 of capital gains available to be offset by the capital losses during the relevant periods and anticipate a potential tax benefit of approximately \$150 to be recognized in a future period. The additional losses claimed and related tax benefits are subject to formal review by the U.S. government which is currently in process. We have not recognized any tax benefit of these losses pending the completion of this review. Any resulting capital loss carryforwards will expire, if not utilized, by 2003.

Note 15--Litigation, Regulatory Matters and Other Contingencies

Guarantees, Indemnifications and Warranty Liabilities:

As more fully discussed in Note 1, we apply the disclosure provisions of FIN 45 to our agreements that contain guarantee or indemnification clauses. These disclosure provisions expand those required by SFAS No. 5 "Accounting for Contingencies", by requiring that guarantors disclose certain types of guarantees, even if the likelihood of requiring the guarantor's performance is remote. As of December 31, 2002, we have accrued our estimate of liability incurred under these indemnification arrangements and guarantees. The following is a description of arrangements in which we are a guarantor.

Indemnifications provided as part of sales and purchases of businesses and real estate assets - We are a party to a variety of agreements pursuant to which we may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in the context of contracts that we entered into for the sale or purchase of businesses or real estate assets, under which we customarily agree to hold the other party harmless against losses arising from a breach of representations and covenants. These relate to such matters as adequate title to assets sold, intellectual property rights, specified environmental matters, and certain income taxes. In each of these circumstances, our payment is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically

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allow us to challenge the other party's claims. Further, our obligations under these agreements may be limited in terms of time and/or amount, and in some instances, we may have recourse against third parties for certain payments we made.

Patent indemnifications - In most sales transactions to resellers of our products, we indemnify against possible claims of patent infringement caused by our products or solutions. These indemnifications usually do not include limits on the claims, provided the claim is made pursuant to the procedures required in the sales contract.

For the indemnification agreements discussed above, it is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of our obligations and the unique facts and circumstances involved in each agreement. Historically, payments we have made under these agreements did not have a material effect on our business, financial condition or results of operations.

Residual value guarantees - For certain vendor-financing relationships, we have guaranteed the leasing company for the residual value position they have taken subject to the lease. The amount of these guarantees are insignificant at December 31, 2002, but may be material in future periods to the extent we offer additional guarantees.

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Indemnification of Officers and Directors - Our corporate by-laws require that, except to the extent expressly prohibited by law, we must indemnify our officers and directors against judgments, fines, penalties and amounts paid in settlement, including legal fees and all appeals, incurred in connection with civil or criminal action or proceedings, as it relates to their services to Xerox Corporation and our subsidiaries. The by-laws provide no limit on the amount of indemnification. As permitted under the State of New York, we have purchased directors and officers insurance coverage to cover claims made against the directors and officers during the applicable policy periods. The amounts and types of coverage have varied from period to period as dictated by market conditions. The current policy provides \$105 of coverage and has no deductible. The litigation matters and regulatory actions described below involve certain of the Company's current and former directors and officers, all of whom are covered by the aforementioned indemnity and if applicable, the current and prior period insurance policies. However, certain indemnification payments may not be covered under our director's and officer's insurance coverage.

### Product Warranty Liabilities:

In connection with our normal sales of equipment, including those under sales-type lease, we generally do not issue product warranties. Our arrangements typically involve a separate full service maintenance agreement with the customer. The agreements generally extend over a period equivalent to the lease term or the expected useful life under a cash sale. The service agreements involve the payment of fees in return for our performance of repairs and maintenance. As a consequence, we do not have any significant product warranty obligations including any obligations under customer satisfaction programs.

In few circumstances, particularly in certain cash sales, we may issue a limited product warranty if negotiated by the customer. We also issue warranties for certain of our lower-end products in the Office segment, where full service maintenance agreements are not available. In these instances, we record warranty obligations at the time of the sale.

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The following table summarizes product warranty activity recorded for the year ended December 31, 2002.

|                              | Balance<br>December 31, 2001 | Provisions,<br>Changes & Other | Payments | Balance<br>December 31, 2002 |
|------------------------------|------------------------------|--------------------------------|----------|------------------------------|
| Product warranty liabilities | \$46                         | \$51                           | \$(72)   | \$25                         |

The decrease in product warranty liabilities at December 31, 2002, as compared with December 31, 2001, is primarily due to our exit from the SOHO business in 2001.

### Legal Matters:

As more fully discussed below, we are a defendant in numerous litigation and regulatory matters involving securities law, patent law, environmental law, employment law and the Employee Retirement Income Security Act ("ERISA"). Should these matters result in a change in our determination as to an unfavorable outcome, result in a final adverse judgment or be settled for significant amounts, they could have a material adverse effect on our results of operations, cash flows and financial position in the period or periods in which such determination, judgment or settlement occurs.

### Litigation Against the Company:

In re Xerox Corporation Securities Litigation: A consolidated securities law action (consisting of 17 cases) is pending in the United States District Court for the District of Connecticut. Defendants are the Company, Barry Romeril, Paul Allaire and G. Richard Thoman. The consolidated action purports to be a class action on behalf of the named plaintiffs and all other purchasers of common stock of the Company during the period between October 22, 1998 through October 7, 1999 ("Class Period"). The amended consolidated complaint in the action alleges that in violation of Section 10(b) and/or 20(a) of the Securities Exchange Act of 1934, as amended ("1934 Act"), and SEC Rule 10b-5 thereunder, each of the defendants is liable as a participant in a fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of the Company's common stock during the Class Period by disseminating materially false and misleading statements and/or concealing material facts. The amended complaint further alleges that the alleged scheme: (i) deceived the investing public regarding the economic capabilities, sales proficiencies, growth, operations and the intrinsic value of the Company's common stock; (ii) allowed several corporate insiders, such as the named individual defendants, to sell shares of privately held common stock of the Company while in possession of materially adverse, non-public information; and (iii) caused the individual plaintiffs and the other members of the purported class to purchase common stock of the Company at inflated prices. The amended consolidated complaint seeks unspecified compensatory damages in favor of the plaintiffs and the other members of the purported class against all defendants, jointly and severally, for all damages sustained as a result of defendants' alleged wrongdoing, including interest thereon, together with reasonable costs and expenses incurred in the action, including counsel fees and expert fees. On September 28, 2001, the court denied the defendants' motion for dismissal of the complaint. On November 5, 2001, the defendants answered the complaint. On or about January 7, 2003, the plaintiffs filed a motion for class certification. That motion is currently pending. The individual defendants and we deny any

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wrongdoing and intend to vigorously defend the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Christine Abarca, et al. v. City of Pomona, et al. (Pomona Water Cases): On June 24, 1999, the Company was served with a summons and complaint filed in the Superior Court of the State of California for the County of Los Angeles. The complaint was filed on behalf of 681 individual plaintiffs claiming damages as a result of our alleged disposal and/or release of hazardous substances into the soil, air and groundwater. Subsequently, six additional complaints were filed in the same court on behalf of another 459 plaintiffs, with the same claims for damages as the June 1999 action. All seven cases have been served on the Company, the Company denies liability and it is actively defending against them. Plaintiffs in all seven cases further allege that they have been exposed to such hazardous substances by inhalation, ingestion and dermal contact, including but not limited to hazardous substances contained within the municipal drinking water supplied by the City of Pomona and the Southern California Water Company. Plaintiffs' claims against the Company include personal injury, wrongful death, property damage, negligence, trespass, nuisance, fraudulent concealment, absolute liability for ultra-hazardous activities, civil conspiracy, battery and violation of the California Unfair Trade Practices Act. Damages are unspecified. The seven cases against the Company ("Abarca Group") have been coordinated with approximately 13 unrelated cases against other defendants which involve alleged contaminated groundwater and drinking water in the San Gabriel Valley area of Los Angeles County. In all of those cases, plaintiffs have sued both the providers of drinking water and the industrial defendants who they contend contaminated the water. The body of groundwater involved in the Abarca cases, and allegedly contaminated by the Company, is separate and distinct from the body of groundwater that is involved in the San Gabriel Valley cases, and there is no allegation that the Company is involved in the San Gabriel Valley cases. Nonetheless, the court ordered both groups of cases to be coordinated because both groups concern allegations of groundwater and drinking water contamination, have similar theories of liability alleged against the defendants, and involve a number of similar legal issues, thus apparently making it more efficient, in the view of the court, for all of them to be handled by one judge. Discovery has begun and no trial date has been set. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Carlson v. Xerox Corporation, et al.: A consolidated securities law action (consisting of 21 cases) is pending in the United States District Court for the District of Connecticut against the Company, KPMG and Paul A. Allaire, G. Richard Thoman, Anne M. Mulcahy, Barry D. Romeril, Gregory Tayler and Philip Fishbach. On September 11, 2002, the court entered an endorsement order granting plaintiffs' motion to file a third consolidated amended complaint. The defendants' motion to dismiss the second consolidated amended complaint was denied, as moot. According to the third consolidated amended complaint, plaintiffs purport to bring this case as a class action on behalf of an expanded class consisting of all persons and/or entities who purchased Xerox common stock and/or bonds during the period between February 17, 1998 through June 28, 2002 and who were purportedly damaged thereby ("Class"). The third consolidated amended complaint sets forth two claims: one alleging that each of the Company, KPMG, and the individual defendants violated Section 10(b) of the 1934 Act and SEC Rule 10b-5 thereunder; the other alleging that the individual defendants are also allegedly liable as "controlling persons" of the Company pursuant to Section 20(a) of the 1934 Act. Plaintiffs claim that the defendants participated in a fraudulent scheme that operated as a fraud and deceit on purchasers of the Company's common stock and bonds by disseminating materially false and

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misleading statements and/or concealing material adverse facts relating to various of the Company's accounting and reporting practices and financial condition. The plaintiffs further allege that this scheme deceived the investing public regarding the true state of the Company's financial condition and caused the plaintiffs and other members of the alleged Class to purchase the Company's common stock and bonds at artificially inflated prices, and prompted a SEC investigation that led to the April 11, 2002 settlement which, among other things, required the Company to pay a \$10 penalty and restate its financials for the years 1997 - 2000 (including restatement of financials previously corrected in an earlier restatement which plaintiffs contend was improper). The third consolidated amended complaint seeks unspecified compensatory damages in favor of the plaintiffs and the other Class members against all defendants, jointly and severally, including interest thereon, together with reasonable costs and expenses, including counsel fees and expert fees. On December 2, 2002, the Company and the individual defendants filed a motion to dismiss the complaint. That motion is currently pending. The individual defendants and we deny any wrongdoing and intend to vigorously defend the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Bingham v. Xerox Corporation, et al: A lawsuit filed by James F. Bingham, a former employee of the Company, is pending in the Superior Court of Connecticut, Judicial District of Waterbury (Complex Litigation Docket) against the Company, Barry D. Romeril, Eunice M. Filter and Paul Allaire. The complaint alleges that the plaintiff was wrongfully terminated in violation of public policy because he attempted to disclose to senior management and to remedy alleged accounting fraud and reporting irregularities. The plaintiff further claims that the Company and the individual defendants violated the Company's policies/commitments to refrain from retaliating against employees who report ethics issues. The plaintiff also asserts claims of defamation and tortious interference with a contract. He seeks: (i) unspecified compensatory

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damages in excess of \$15 thousand, (ii) punitive damages, and (iii) the cost of bringing the action and other relief as deemed appropriate by the court. The parties are engaged in discovery. The individuals and we deny any wrongdoing and intend to vigorously defend the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Berger, et al. v. RIGP: A class was certified in an action originally filed in the United States District Court for the Southern District of Illinois on July 25, 2000 against the Company's Retirement Income Guarantee Plan ("RIGP"). The RIGP represents the primary U.S. pension plan for salaried employees. Plaintiffs bring this action on behalf of themselves and an alleged class of over 25,000 persons who received lump sum distributions from RIGP after January 1, 1990. Plaintiffs assert violations of the ERISA, claiming that the lump sum distributions were improperly calculated. On July 3, 2001, the court granted the Plaintiffs' motion for summary judgment, finding the lump sum calculations violated ERISA. Although the damages sought were not specified in the complaint, the Plaintiffs submitted papers in December 2001 claiming \$284 in damages. On September 30, 2002, the court entered a final judgment on damages, stating it would adopt plaintiffs' methodology for calculating such damages. RIGP denies any wrongdoing and has appealed the District Court's rulings with respect to both liability and damages. We believe, based on advice of legal counsel, that it is probable that on appeal that the judgment will be overturned. We cannot estimate the amount of loss that might result from this matter. If the appeal should ultimately not prevail, we would have to accrue the full amount of the

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expense associated with the judgment as if the judgment were directly against the Company. Any final judgment after appeal would be paid from RIGP assets. However, such payment may require the Company to make additional contributions to RIGP in the future based on a potential shortfall in plan assets available to pay other plan liabilities.

Florida State Board of Administration, et al. v. Xerox Corporation, et al.: A securities law action brought by four institutional investors, namely the Florida State Board of Administration, the Teachers' Retirement System of Louisiana, Franklin Mutual Advisers and PPM America, Inc., is pending in the United States District Court for the District of Connecticut against the Company, Paul Allaire, G. Richard Thoman, Barry Romeril, Anne Mulcahy, Philip Fishbach, Gregory Tayler and KPMG. The plaintiffs bring this action individually on their own behalves. In an amended complaint filed on October 3, 2002, one or more of the plaintiffs allege that each of the Company, the individual defendants and KPMG violated Sections 10(b) and 18 of the 1934 Act, SEC Rule 10b-5 thereunder, the Florida Securities Investors Protection Act, Fl. Stat. ss. 517.301, and the Louisiana Securities Act, R.S. 51:712(A). The plaintiffs further claim that the individual defendants are each liable as "controlling persons" of the Company pursuant to Section 20 of the 1934 Act and that each of the defendants is liable for common law fraud and negligent misrepresentation. The complaint generally alleges that the defendants participated in a scheme and course of conduct that deceived the investing public by disseminating materially false and misleading statements and/or concealing material adverse facts relating to the Company's financial condition and accounting and reporting practices. The plaintiffs contend that in relying on false and misleading statements allegedly made by the defendants, at various times from 1997 through 2000 they bought shares of the Company's common stock at artificially inflated prices. As a result, they allegedly suffered aggregated cash losses in excess of \$200. The plaintiffs further contend that the alleged fraudulent scheme prompted a SEC investigation that led to the April 11, 2002 settlement which, among other things, required the Company to pay a \$10 penalty and restate its financials for the years 1997 - 2000 including restatement of financials previously corrected in an earlier restatement which plaintiffs contend was false and misleading. The plaintiffs seek, among other things, unspecified compensatory damages against the Company, the individual defendants and KPMG, jointly and severally, including prejudgment interest thereon, together with the costs and disbursements of the action, including their actual attorneys' and experts' fees. On December 2, 2002, the Company and the individual defendants filed a motion to dismiss all claims in the complaint that are in common with the claims in the Carlson action. That motion is currently pending. The individual defendants and we deny any wrongdoing alleged in the complaint and intend to vigorously defend the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

In Re Xerox Corp. ERISA Litigation: On July 1, 2002, a class action complaint captioned Patti v. Xerox Corp. et al. was filed in the United States District Court for the District of Connecticut (Hartford) alleging violations of the ERISA. Three additional class actions (Hopkins, Uebele and Saba) were subsequently filed in the same court making substantially similar claims. On October 16, 2002, the four actions were consolidated as In Re Xerox Corporation ERISA Litigation. On November 15, 2002, a consolidated amended complaint was filed. A fifth class action (Wright) was filed in the District of Columbia. It has been transferred to Connecticut where it will be consolidated with the other actions. The purported class includes all persons who invested or maintained investments in the Xerox Stock Fund in the Xerox 401(k) Plans (either salaried or union) during the proposed class period, May 12, 1997 through November 15, 2002, and allegedly exceeds 50,000 persons. The defendants include Xerox Corporation and the following individuals or groups of individuals during the proposed class period: the Plan Administrator, the Board of Directors, the Fiduciary Investment Review Committee, the Joint Administrative Board, the



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Finance Committee of the Board of Directors, and the Treasurer. The complaint claims that all the foregoing defendants were "named" or "de facto" fiduciaries of the Plan under ERISA and, as such, were obligated to protect the Plan's assets and act in the best interest of Plan participants. The complaint alleges that the defendants failed to do so and thereby breached their fiduciary duties. Specifically, plaintiffs claim that the defendants failed to provide accurate and complete material information to participants concerning Xerox stock, including accounting practices which allegedly

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artificially inflated the value of the stock, and misled participants regarding the soundness of the stock and the prudence of investing retirement benefits in Xerox stock. Plaintiff also claims that defendants failed to ensure that Plan assets were invested prudently, to monitor the other fiduciaries and to disregard Plan directives they knew or should have known were imprudent. The complaint does not specify the amount of damages sought. However, it asks that the losses to the Plan be restored, which it describes as "millions of dollars." It also seeks other legal and equitable relief, as appropriate, to remedy the alleged breaches of fiduciary duty, as well as interest, costs and attorneys' fees. We and the other defendants deny any wrongdoing and intend to vigorously defend the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Digwamaje et al. v. IBM et al: A purported class action was filed in the United States District Court for the Southern District of New York on September 27, 2002. Service of the complaint on the Company was deemed effective as of December 6, 2002. The defendants include Xerox and 80 other corporate defendants who are accused of providing material assistance to the apartheid government in South Africa from 1948 to 1994, by engaging in commerce in South Africa and with the South African government and by employing forced labor, thereby violating both international and common law. Specifically, plaintiffs claim violations of the Alien Tort Claims Act, the Torture Victims Protection Act and RICO. They also assert human rights violations and crimes against humanity. Plaintiffs seek compensatory damages in excess of \$200 billion and punitive damages in excess of \$200 billion. The foregoing damages are being sought from all defendants, jointly and severally. Xerox intends to vigorously defend the action and plans to file a motion to dismiss the complaint. Based upon the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Arbitration between MPI Technologies, Inc. and Xerox Canada Ltd. and Xerox Corporation: On November 15, 2001, MPI Technologies, Inc. ("MPI") sent to the American Arbitration Association a Demand for Arbitration of a dispute arising under an Agreement made as of March 15, 1994 between MPI and Xerox Canada Ltd. ("XCL") to which the Company later became a party ("Agreement"). The Demand for Arbitration claimed that XCL and the Company owed royalties to MPI for software licensed under the Agreement and initially alleged damages "estimated to be in excess of \$30 million." In a subsequent claim submitted in the arbitration proceedings, MPI has alleged damages of \$68.9 for royalties owed, \$35.0 for breach of fiduciary duty, \$35.0 in punitive damages and unspecified damages and injunctive relief with respect to a claim of copyright infringement. The parties have selected three arbitrators and have agreed to conduct the arbitration in Canada. On January 13 and 14, 2003, the arbitrators heard argument on the motion of the Company and XCL to dismiss for lack of jurisdiction MPI's claims for copyright infringement, breach of fiduciary duty and for punitive damages. The arbitration panel ruled on February 14, 2003 that it had jurisdiction to hear all three issues. On March 14, 2003 the Company and XCL petitioned the Ontario

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courts to re-decide the issue of the panel's jurisdiction to hear copyright infringement claims. The Company and XCL deny any liability or wrongdoing, including any royalties owed, intend to assert a counterclaim against MPI for overpayment of royalties and intend to vigorously defend the claim. Based on the stage of the arbitration, it is not possible to estimate the amount of loss or the range of possible loss that might result from an adverse ruling or a settlement of this matter.

*Accuscan, Inc. v. Xerox Corporation*: On April 11, 1996, an action was commenced by Accuscan, Inc. ("Accuscan"), in the United States District Court for the Southern District of New York, against the Company seeking unspecified damages for infringement of a patent of Accuscan which expired in 1993. The suit, as amended, was directed to facsimile and certain other products containing scanning functions and sought damages for sales between 1990 and 1993. On April 1, 1998, the jury entered a verdict in favor of Accuscan for \$40. However, on September 14, 1998, the court granted our motion for a new trial on damages. The trial ended on October 25, 1999 with a jury verdict of \$10. Our motion to set aside the verdict or, in the alternative, to grant a new trial was denied by the court. We appealed to the Court of Appeals for the Federal Circuit ("CAFC") which found the patent not infringed, thereby terminating the lawsuit subject to an appeal which has been filed by Accuscan to the U.S. Supreme Court. The decision of the U.S. Supreme Court was to remand the case (along with eight others) back to the CAFC to consider its previous decision based on the Supreme Court's May 28, 2002 ruling in the *Festo* case. We deny any liability or wrongdoing and intend to vigorously defend the action.

### Derivative Litigation Brought on Behalf of the Company:

*In re Xerox Derivative Actions*: A consolidated putative shareholder derivative action is pending in the Supreme Court of the State of New York, County of New York against several current and former members of the Board of Directors including William F. Buehler, B.R. Inman, Antonia Ax:son Johnson, Vernon E. Jordan, Jr., Yotaro Kobayashi, Hilmar Kopper, Ralph Larsen, George J. Mitchell, N.J. Nicholas, Jr., John E. Pepper, Patricia Russo, Martha Seger, Thomas C. Theobald, Paul Allaire, G. Richard Thoman, Anne Mulcahy and Barry Romeril, and KPMG. The plaintiffs purportedly brought this action in the name of and for the benefit of the Company, which is named as a nominal defendant, and its public shareholders.

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The second consolidated amended complaint alleges that each of the director defendants breached their fiduciary duties to the Company and its shareholders by, among other things, ignoring indications of a lack of oversight at the Company and the existence of flawed business and accounting practices within the Company's Mexican and other operations; failing to have in place sufficient controls and procedures to monitor the Company's accounting practices; knowingly and recklessly disseminating and permitting to be disseminated, misleading information to shareholders and the investing public; and permitting the Company to engage in improper accounting practices. The plaintiffs further allege that each of the director defendants breached his/her duties of due care and diligence in the management and administration of the Company's affairs and grossly mismanaged or aided and abetted the gross mismanagement of the Company and its assets. The second amended complaint also asserts claims of negligence, negligent misrepresentation, breach of contract and breach of fiduciary duty against KPMG. Additionally, plaintiffs claim that KPMG is liable to Xerox for contribution, based on KPMG's share of the responsibility for any injuries or damages for which Xerox is held liable to plaintiffs in related pending securities class action litigation. On behalf of the Company, the plaintiffs seek a judgment declaring that the director defendants violated and/or aided and

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abetted the breach of their fiduciary duties to the Company and its shareholders; awarding the Company unspecified compensatory damages against the director defendants, individually and severally, together with pre-judgment and post-judgment interest at the maximum rate allowable by law; awarding the Company punitive damages against the director defendants; awarding the Company compensatory damages against KPMG; and awarding plaintiffs the costs and disbursements of this action, including reasonable attorneys' and experts' fees. On December 16, 2002, the Company and the individual defendants answered the complaint. The individual defendants deny the wrongdoing alleged and intend to vigorously defend the litigation.

*Pall v. Buehler, et al.*: On May 16, 2002, a shareholder commenced a derivative action in the United States District Court for the District of Connecticut against KPMG. The Company was named as a nominal defendant. Plaintiff purported to bring this action derivatively in the right, and for the benefit, of the Company. He contended that he is excused from complying with the prerequisite to make a demand on the Xerox Board of Directors, and that such demand would be futile, because the directors are disabled from making a disinterested, independent decision about whether to prosecute this action. In the original complaint, plaintiff alleged that KPMG, the Company's former outside auditor, breached its duties of loyalty and due care owed to Xerox by repeatedly acquiescing in, permitting and aiding and abetting the manipulation of Xerox's accounting and financial records in order to improve the Company's publicly reported financial results. He further claimed that KPMG committed malpractice and breached its duty to use such skill, prudence and diligence as other members of the accounting profession commonly possess and exercise. Plaintiff claimed that as a result of KPMG's breaches of duties, the Company has suffered loss and damage. On May 29, 2002, plaintiff amended the complaint to add as defendants the present and certain former directors of the Company. He added claims against each of them for breach of fiduciary duty, and separate additional claims against the directors who are or were members of the Audit Committee of the Board of Directors, based upon the alleged failure, *inter alia*, to implement, supervise and maintain proper accounting systems, controls and practices. The amended derivative complaint demands a judgment declaring that the defendants have violated and/or aided and abetted the breach of fiduciary and professional duties to the Company and its shareholders; awarding the Company unspecified compensatory damages, together with pre-judgment and post-judgment interest at the maximum rate allowable by law; awarding the Company punitive damages; and awarding the plaintiff the costs and disbursements of the action, including reasonable attorneys' and experts' fees. On August 16, 2002, the individual defendants and Xerox filed a motion to dismiss the action. That motion is currently pending. The individual defendants deny the wrongdoing alleged and intend to vigorously defend the litigation.

*Lerner v. Allaire, et al.*: On June 6, 2002, a shareholder, Stanley Lerner, commenced a derivative action in the United States District Court for the District of Connecticut against Paul A. Allaire, William F. Buehler, Barry D. Romeril, Anne M. Mulcahy and G. Richard Thoman. The plaintiff purports to bring the action derivatively, on behalf of the Company, which is named as a nominal defendant. Previously, on June 19, 2001, Lerner made a demand on the Board of Directors to commence suit against certain officers and directors to recover unspecified damages and compensation paid to these officers and directors. In his demand, Lerner contended, *inter alia*, that management was aware since 1998 of material accounting irregularities and failed to take action and that the Company has been mismanaged. At its September 26, 2001 meeting, the Board of Directors appointed a special committee to consider, investigate and respond to the demand. In this action, plaintiff alleges that the individual defendants breached their fiduciary duties of care and loyalty by disguising the true operating performance of the Company through improper undisclosed accounting mechanisms between 1997 and 2000. The complaint alleges that the defendants benefited personally, through compensation and the sale of company stock, and

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either participated in or approved the accounting procedures or failed to supervise adequately the accounting activities of the Company. The plaintiff demands a judgment declaring that defendants intentionally breached their fiduciary duties to the Company and its shareholders; awarding unspecified compensatory damages to the Company against the defendants, individually and severally, together with pre-judgment and post-judgment interest; awarding the Company punitive damages; and awarding the plaintiff the costs and disbursements of the action, including reasonable attorneys' and experts' fees. On September 18, 2002, the individual defendants and Xerox filed a motion to dismiss the action, or alternatively to stay the action pending the disposition of In re Xerox Derivative Actions. That motion is currently pending. The individual defendants deny the wrongdoing alleged and intend to vigorously defend the litigation.

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### Other Matters:

Xerox Corporation v. 3Com Corporation, et al.: On April 28, 1997, we commenced an action against Palm for infringement of the Xerox "Unistrokes" handwriting recognition patent by the Palm Pilot using "Graffiti." On January 14, 1999, the U.S. Patent and Trademark Office ("PTO") granted the first of two 3Com/Palm requests for reexamination of the Unistrokes patent challenging its validity. The PTO concluded its reexaminations and confirmed the validity of all 16 claims of the original Unistrokes patent. On June 6, 2000, the judge narrowly interpreted the scope of the Unistrokes patent claims and, based on that narrow determination, found the Palm Pilot with Graffiti did not infringe the Unistrokes patent claims. On October 5, 2000, the Court of Appeals for the Federal Circuit reversed the finding of no infringement and sent the case back to the lower court to continue toward trial on the infringement claims. On December 20, 2001, the District Court granted our motions on infringement and for a finding of validity thus establishing liability. On December 21, 2001, Palm appealed to the CAFC. We moved for a trial on damages and an injunction or bond in lieu of injunction. The District Court denied our motion for a temporary injunction, but ordered a \$50 bond to be posted to protect us against future damages until the trial. Palm issued a \$50 irrevocable letter of credit in favor of Xerox. In January 2003, after the oral argument, Palm announced that it would stop including Graffiti in its future operating systems. On February 20, 2003, the Court of Appeals affirmed the infringement of the Unistrokes patent by Palm's handheld devices and that Xerox will be entitled to an injunction if the validity of the patent is favorably determined. It remanded the validity issues back to the District Court for further validity analysis.

Xerox Corporation v. Business Equipment Research & Test Laboratories, Inc. On July 9, 2002, the Company filed an action in U.S. District Court for the Western District of New York against Business Equipment Research & Test Laboratories, Inc. and one of its owners (collectively "BERTL") alleging libel per se, trade libel, tortious interference with prospective business relationship, unfair competition, breach of contract, violation of the federal Computer Fraud and Abuse Act, deceptive acts and practices and conversion. On December 11, 2002, Xerox filed an amended complaint, alleging the same claims with greater specificity. Xerox seeks unspecified damages, injunctive relief and a declaratory judgment that Xerox has not infringed BERTL's trademarks or copyrights, breached any agreement with BERTL or engaged in unfair competition. On January 24, 2003, BERTL filed its answer and sixteen counterclaims against Xerox Corporation and XCL, totaling \$53; comprising \$33 in compensatory damages and \$20 in punitive damages in the aggregate. BERTL also moved to dismiss seven of Xerox's nine claims. BERTL's counterclaims against Xerox principally allege infringement of copyrights, appropriation of trade secrets, defamation and breach of contract. The Company and XCL deny any wrongdoing and intend to

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vigorously pursue the Company's claims and defend the counterclaims. Based on the stage of the litigation, it is not possible to assess the probable outcome of the litigation, including the amount of any loss or range of possible loss that might result from an adverse ruling on the counterclaim in this matter.

**U.S. Attorney's Office Investigation:** As we announced on September 23, 2002, we learned that the U.S. attorney's office in Bridgeport, Conn., is conducting an investigation into matters relating to Xerox. We have not been advised by the U.S. attorney's office regarding the nature, scope or timing of the investigation. We are cooperating and providing documents, as requested.

**Securities and Exchange Commission Investigation and Review:** On April 1, 2002, we announced that we had reached a settlement with the SEC on the previously disclosed proposed allegations related to matters that had been under investigation since June 2000. As a result, on April 11, 2002, the SEC filed a complaint, which we simultaneously settled by consenting to the entry of an Order enjoining us from future violations of Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a) and 13(b) of the 1934 Act and Rules 10b-5, 12b-20, 13a-1, 13a-13 and 13b2-1 thereunder, requiring payment of a civil penalty of \$10, and imposing other ancillary relief. We neither admitted nor denied the allegations of the complaint. The \$10 civil penalty is included in Other Expenses, net in 2002 in the Consolidated Statement of Income. Under the terms of the settlement, in 2001 we restated our financial statements for the years 1997 through 2000.

As part of the settlement, a special committee of our Board of Directors has retained Michael H. Sutton, former Chief Accountant of the SEC, as an independent consultant to review our material accounting controls and policies. Mr. Sutton commenced his review in July 2002. On February 21, 2003, Mr. Sutton delivered his final report, together with observations and recommendations, to members of the special committee. According to the terms of the settlement, the special committee has 60 days to review the report and submit it to our full Board of Directors and the SEC. Within 60 days of that submission, the Board of Directors must report to the SEC the decisions taken as a result of the recommendations.

**Other Matters:** It is our policy to carefully investigate, often with the assistance of outside advisers, allegations of impropriety that may come to our attention. If the allegations are substantiated, appropriate prompt remedial action is taken, and where appropriate, public disclosure is made. In India, we have learned of certain improper payments made over a period

of years in connection with sales to government customers by employees of our now majority-owned subsidiary in that country. This activity was terminated when we became aware of it. We have investigated the activity and reported it to the staff of the SEC and the Department of Justice, and are cooperating with their follow-up inquiries. In addition, various agencies of the Indian government are also investigating the issue. We do not believe that this matter will have any material impact on our consolidated financial statements. Separately, we learned that less than \$200 thousand was misappropriated from our Indian subsidiary during early 2002 which was not properly reflected in our subsidiary's books. The matter is currently being investigated. Certain transactions of our unconsolidated South African affiliate that appear to have been improperly recorded as part of an effort to sell supplies outside of its authorized territory have been investigated and a report of the results has been received by the Board of Directors of the South African affiliate. Disciplinary actions have been taken, and the adjustments to our financial statements were not material. Following an investigation we have determined that certain

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inter-company and other balances in the local books and records of our majority-owned affiliate in Nigeria could not be substantiated. The Company's records did not reflect these amounts and the local books have been adjusted to be consistent with them. This adjustment has had no effect on our financial statements. This matter has been reported to the SEC and the Department of Justice. We are in the process of liquidating ("winding-up") this company in connection with the December 2002 sale of our interest in the Nigerian business to our local partner.

### Note 16--Preferred Securities

As of December 31, 2002, we have four series of outstanding preferred securities. In total we are authorized to issue 22 million shares of cumulative preferred stock, \$1 par value.

**Convertible Preferred Stock:** As more fully discussed in Note 13 to the Consolidated Financial Statements, in 1989 we sold 10 million shares of our Series B Convertible Preferred Stock ("ESOP Shares") for \$785 in connection with the establishment of our ESOP. This debt was repaid in 2002. As employees with vested ESOP shares leave the Company, we redeem those shares. We have the option to settle such redemptions with either shares of common stock or cash, but have historically settled in common stock.

Outstanding preferred stock related to our ESOP at December 31, 2002 and 2001 follows (shares in thousands):

|                                   |        | 2002   |
|-----------------------------------|--------|--------|
|                                   | Shares | Amount |
|                                   | -----  | -----  |
| Convertible Preferred Stock ..... | 7,023  | \$550  |

**Preferred Stock Purchase Rights:** We have a shareholder rights plan designed to deter coercive or unfair takeover tactics and to prevent a person or persons from gaining control of us without offering a fair price to all shareholders. Under the terms of the plan, one-half of one preferred stock purchase right ("Right") accompanies each share of outstanding common stock. Each full Right entitles the holder to purchase from us one three-hundredth of a new series of preferred stock at an exercise price of \$250. Within the time limits and under the circumstances specified in the plan, the Rights entitle the holder to acquire either our common stock, the stock of the surviving company in a business combination, or the stock of the purchaser of our assets, having a value of two times the exercise price. The Rights, which expire in April 2007, may be redeemed prior to becoming exercisable by action of the Board of Directors at a redemption price of \$.01 per Right. The Rights are non-voting and, until they become exercisable, have no dilutive effect on the earnings per share or book value per share of our common stock.

**Company-obligated, Mandatorily Redeemable Preferred Securities of Subsidiary Trusts Holding Solely Subordinated Debentures of the Company:** The components of Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts holding solely subordinated debentures of the Company at December 31, 2002 and 2001 follow:

|                | 2002    | 2001    |
|----------------|---------|---------|
|                | ----    | ----    |
| Trust II ..... | \$1,016 | \$1,005 |
| Trust I .....  | 640     | 639     |

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|                                |         |         |
|--------------------------------|---------|---------|
| Deferred Preferred Stock ..... | 45      | 43      |
|                                | -----   | -----   |
| Total .....                    | \$1,701 | \$1,687 |
|                                | =====   | =====   |

Trust II: In 2001, Xerox Capital Trust II ("Capital II"), a trust sponsored and wholly-owned by us, issued 20.7 million 7.5 percent convertible trust preferred securities (the "Trust Preferred Securities") to investors for an aggregate liquidation amount of \$1,035 and 0.6 million shares of common securities to us for an aggregate liquidation amount of \$32. With the proceeds from these securities, Capital II purchased \$1,067 aggregate principal amount of 7.5 percent convertible junior subordinated debentures due 2021 of Xerox Funding LLC II ("Funding"), a wholly-owned subsidiary of ours. With the proceeds from these securities, Funding purchased \$1,067 aggregate principal amount of 7.5 percent convertible junior subordinated debentures due 2021 of the Company. Capital II's assets consist principally of Funding's debentures, and Funding's assets consist principally of our debentures. On a consolidated basis, we received net proceeds of \$1,004, which was net of \$31 of fees and expenses. The initial carrying value is being accreted to liquidation value through Minorities' interests in earnings of subsidiaries over three years to the earliest redemption date. As of December 31, 2002, the carrying

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value had accreted to \$1,016. We used the net proceeds from the issuance of our debentures for general corporate purposes, including the payment of our indebtedness. Our debentures, along with those of Funding, and related income statement effects are eliminated in our consolidated financial statements. Distributions on the Trust Preferred Securities are charged, net of tax, to Minorities' interests in earnings of subsidiaries and, together with the accretion noted above, amounted to \$54 after-tax (\$89 pre-tax) and \$2 after-tax (\$4 pre-tax) in 2002 and 2001, respectively. We have effectively guaranteed, fully and unconditionally, on a subordinated basis, the payment and delivery by Funding, of all amounts due on the Funding debentures and the payment and delivery by Capital II of all amounts due on the Trust Preferred Securities, in each case to the extent required under the terms of the securities.

The Trust Preferred Securities accrue and pay cash distributions quarterly at a rate of 7.5 percent per annum of the stated liquidation amount of fifty dollars per trust preferred security. Concurrently, with the initial issuance of the Trust Preferred Securities, Funding issued 0.2 million common securities to us, for an aggregate liquidation amount of \$229. Funding used the proceeds to purchase, and deposit with a pledge, trustee U.S. treasuries in order to secure Funding's obligations under its debentures through the distribution payment date (November 27, 2004). As of December 31, 2002 and 2001, the balance of these securities was \$151 and \$229, respectively, and is included in both Other current assets and Other long-term assets in the Consolidated Balance Sheets. The Trust Preferred Securities are convertible at any time, at the option of the investors, into 5.4795 shares of our common stock per Trust Preferred Security, subject to adjustment. The Trust Preferred Securities are mandatorily redeemable upon the maturity of the debentures on November 27, 2021 at fifty dollars per Trust Preferred Security plus accrued and unpaid distributions. Investors may require us to cause Capital II to purchase all or a portion of the Trust Preferred Securities on December 4, 2004, and November 27, 2006, 2008, 2011 and 2016 at a price of fifty dollars per Trust Preferred Security, plus accrued and unpaid distributions. In addition, if we undergo a change in control on or before December 4, 2004, investors may require us to cause Capital II to purchase all or a portion of the Trust Preferred Securities. In either case, the purchase price for such Trust Preferred Securities may be paid in cash or our common stock, or a combination thereof. If the purchase price or any portion

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thereof consists of common stock, investors will receive such common stock at a value of 95 percent of its then prevailing market price. Capital II may redeem all, but not part, of the Trust Preferred Securities for cash, prior to December 4, 2004, only if specified changes in tax and investment law occur, at a redemption price of 100 percent of their liquidation amount plus accrued and unpaid distributions. On or at anytime after December 4, 2004, Capital II may redeem all or a portion of the Trust Preferred Securities for cash at declining redemption prices, with an initial redemption price of 103.75 percent of their liquidation amount.

Trust I: In 1997, a trust that we sponsored and wholly-own, issued \$650 aggregate liquidation amount of preferred securities (the "Original Preferred Securities") to investors and 20,103 shares of common securities to us. The proceeds were invested by the trust in \$670 aggregate principal amount of our then newly issued 8 percent Junior Subordinated Debentures due 2027 (the "Original Debentures"). Pursuant to a registration statement that we, along with the trust, filed with the Securities and Exchange Commission in 1997, the Original Preferred Securities, with an aggregate liquidation preference amount of \$644, and the Original Debentures with a principal amount of \$644, were exchanged for a like amount of preferred securities (together with the Original Preferred Securities, the "Preferred Securities") and 8 percent Junior Subordinated Debentures due 2027 (together with the Original Debentures, the "Debentures") which were registered under the Securities Act of 1933. The Debentures represent all the assets of the trust. The Debentures and related income statement effects are eliminated in our consolidated financial statements.

The Preferred Securities accrue and pay cash distributions semiannually at a rate of 8 percent per annum of the stated liquidation amount of one thousand dollars per Preferred Security. These distributions are recorded in Minorities' interests in earnings of subsidiaries in the Consolidated Statements of Income. We have guaranteed (the "Guarantee"), on a subordinated basis, distributions and other payments due on the Preferred Securities. The Guarantee and our obligations under the Debentures and in the indenture pursuant to which the Debentures were issued and our obligations under the Amended and Restated Declaration of Trust governing the trust, taken together, provide a full and unconditional guarantee of amounts due on the Preferred Securities.

The Preferred Securities are mandatorily redeemable upon the maturity of the Debentures on February 1, 2027, or earlier to the extent of any redemption by us of any Debentures. The redemption price in either such case will be one thousand dollars per share plus accrued and unpaid distributions to the date fixed for redemption. Total net proceeds were \$637, net of \$13 in fees and expenses. The initial carrying value is being accreted to liquidation value over the remaining term. As of December 31, 2002 and 2001 the initial carrying value had accreted to \$640 and \$639, respectively.

Deferred Preferred Stock: In 1996, a subsidiary of ours issued 2 million deferred preferred shares for Canadian (Cdn.) \$50 (\$37 U.S.). These shares are mandatorily redeemable on February 28, 2006 for Cdn. \$90 (equivalent to \$57 U.S. at December 31, 2002). The difference between the redemption amount and the proceeds from the issue is being amortized on a straight-line basis, through the redemption date, to Minorities' interests in earnings of subsidiaries in the Consolidated Statements of Income. As of December 31, 2002, \$12 remained to be amortized. We have guaranteed the redemption value.



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We have 1.75 billion authorized shares of common stock, \$1 par value after shareholders approved an increase of 0.7 billion shares on September 9, 2002. At December 31, 2002 and 2001, 127 million and 113 million shares, respectively, were reserved for issuance under our incentive compensation plans. In addition, at December 31, 2002, 57 million common shares were reserved for the conversion of convertible debt, 36 million common shares were reserved for conversion of ESOP-related Convertible Preferred Stock and 113 million common shares were reserved for the conversion of Convertible Trust Preferred Securities.

**Stock Option and Long-term Incentive Plans:** In October 2002, we adopted the additional disclosure provisions of SFAS No. 148. See Note 1 for further discussion. We have a long-term incentive plan whereby eligible employees may be granted non-qualified stock options, shares of common stock (restricted or unrestricted) and performance/incentive unit rights. Beginning in 1998 and subject to vesting and other requirements, performance/incentive unit rights are typically paid in our common stock. The value of each performance/ incentive unit is based on the growth in earnings per share during the year in which granted. Performance/ incentive units ratably vest in the three years after the year awarded. Compensation expense recorded for performance/incentive units at December 31, 2000 was \$5. No amounts were recorded in 2002 and 2001 as the required 2000 performance/incentive measures were not met. This plan was discontinued in 2001.

We granted 1.6 million, 1.9 million and 0.4 million shares of restricted stock to key employees for the years ended December 31, 2002, 2001 and 2000, respectively. No monetary consideration is paid by employees who receive restricted shares. Compensation expense for restricted grants is based upon the grant date market price and is recorded over the vesting period which on average ranges from one to three years. Compensation expense recorded for restricted grants was \$17, \$15 and \$18 in 2002, 2001 and 2000, respectively.

Stock options and rights are settled with newly issued or, if available, treasury shares of our common stock. Stock options generally vest in three years and expire between eight and ten years from the date of grant. The exercise price of the options is equal to the market value of our common stock on the effective date of grant.

At December 31, 2002 and 2001, 43.2 million and 39.7 million shares, respectively, were available for grant of options or rights. The following table provides information relating to the status of, and changes in, options granted:

|                                  | 2002<br>----              |                                     | 2001<br>----              |                           |
|----------------------------------|---------------------------|-------------------------------------|---------------------------|---------------------------|
|                                  | Stock<br>Options<br>----- | Average<br>Option<br>Price<br>----- | Stock<br>Options<br>----- | Aver<br>Opt<br>Pri<br>--- |
| Employee Stock Options<br>-----  |                           |                                     |                           |                           |
| Outstanding at January 1 .....   | 68,829                    | \$29                                | 58,233                    | \$                        |
| Granted .....                    | 14,286                    | 10                                  | 15,085                    |                           |
| Cancelled .....                  | (5,668)                   | 34                                  | (4,479)                   |                           |
| Exercised .....                  | (598)                     | 5                                   | (10)                      |                           |
|                                  | -----                     |                                     | -----                     |                           |
| Outstanding at December 31 ..... | 76,849                    | 26                                  | 68,829                    |                           |
|                                  | -----                     |                                     | -----                     |                           |
| Exercisable at end of year ..... | 45,250                    |                                     | 36,388                    |                           |
|                                  | -----                     |                                     | -----                     |                           |

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Options outstanding and exercisable at December 31, 2002 were as follows:

| Range of Exercise Prices | Number<br>Outstanding | Weighted<br>Average Remaining<br>Contractual Life | Weighted Average<br>Exercise Price | Nu<br>Exer |
|--------------------------|-----------------------|---|------------------------------------|------------|
| \$4.75 to \$6.98 .....   | 12,730                | 8.16  | \$4.85                             | 3          |
| 7.13 to 10.69 .....      | 14,554                | 8.97  | 10.12                              |            |
| 10.72 to 15.27 .....     | 468                   | 7.59  | 12.87                              |            |
| 16.91 to 23.25 .....     | 18,982                | 5.37  | 21.51                              | 15         |
| 25.81 to 36.70 .....     | 11,668                | 4.13  | 31.29                              | 8          |
| 41.72 to 60.95 .....     | 18,447                | 4.34  | 52.99                              | 16         |
| \$4.75 to \$60.95 .....  | 76,849                | 6.09  | \$25.58                            | 45         |

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### Note 18--Earnings Per Share

Basic earnings per share is computed by dividing income available to common shareholders (the numerator) by the weighted-average number of common shares outstanding (the denominator) for the period. Diluted earnings per share assumes that any dilutive convertible preferred shares, convertible subordinated debentures, and convertible securities outstanding were converted, with related preferred stock dividend requirements and outstanding common shares adjusted accordingly. It also assumes that outstanding common shares were increased by shares issuable upon exercise of those stock options for which market price exceeds the exercise price, less shares which could have been purchased by us with the related proceeds. In periods of losses, diluted loss per share is computed on the same basis as basic loss per share as the inclusion of any other potential shares outstanding would be anti-dilutive.

When computing diluted EPS, we are required to assume conversion of the ESOP preferred shares into common stock if we are profitable. The conversion guarantees that each ESOP preferred share be converted into shares worth a minimum value of \$78.25. As long as our common stock price is above \$13.04 per share, the conversion ratio is 6 to 1. As our share price falls below this amount, the conversion ratio increases.

A reconciliation of the numerators and denominators of the basic and diluted EPS calculation follows:

| Income                | 2002<br>-----<br>Shares | Per-Share<br>Amount | (Loss)<br>Income | 2001<br>-----<br>Shares | Per-Share<br>Amount |
|-----------------------|-------------------------|---------------------|------------------|-------------------------|---------------------|
| (Shares in thousands) |                         |                     |                  |                         |                     |

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|  |        |         |         |          |         |          |
|--|--------|---------|---------|----------|---------|----------|
| Basic EPS  |        |         |         |          |         |          |
| Net income (loss) before cumulative effect of change in accounting principle ... | \$ 154 |         |         | \$ (92)  |         |          |
| Accrued dividends on preferred stock, net ...                                    | (73)   |         |         | (12)     |         |          |
|  | -----  |         |         | -----    |         |          |
| Basic EPS before cumulative effect of change in accounting principle .....       |        |         |         |          |         |          |
|  | \$ 81  | 731,280 | \$ 0.11 | \$ (104) | 704,181 | \$(0.15) |
| Cumulative effect of change in accounting principle .....                        |        |         |         |          |         |          |
|  | (63)   | 731,280 | (0.09)  | (2)      | 704,181 | --       |
|  | -----  |         | -----   | -----    |         | -----    |
| Basic EPS .....  | \$ 18  | 731,280 | 0.02    | \$ (106) | 704,181 | \$(0.15) |
|  | =====  |         | =====   | =====    |         | =====    |
| Diluted EPS before cumulative effect of change in accounting principle .....     |        |         |         |          |         |          |
|  | \$ 81  | 807,144 | \$ 0.10 | \$ (104) | 704,181 | \$(0.15) |
| Cumulative effect of change in accounting principle .....                        |        |         |         |          |         |          |
|  | (63)   | 807,144 | (0.08)  | (2)      | 704,181 | --       |
|  | -----  |         | -----   | -----    |         | -----    |
| Diluted EPS .....  | \$ 18  | 807,144 | \$ 0.02 | \$ (106) | 704,181 | \$(0.15) |
|  | =====  |         | =====   | =====    |         | =====    |

A reconciliation of the individual weighted average shares outstanding was as follows:

|  |         |         |         |
|--|---------|---------|---------|
|  | 2002    | 2001    | 2000    |
|  | ----    | ----    | ----    |
| Weighted -average common shares outstanding: |         |         |         |
| Basic  | 731,280 | 704,181 | 667,000 |
| Stock options                                | 5,401   | -       | -       |
| ESOP Preferred stock                         | 70,463  | -       | -       |
|  | -----   | -----   | -----   |
| Diluted                                      | 807,144 | 704,181 | 667,000 |
|  | =====   | =====   | =====   |

The 2002, 2001 and 2000 computation of diluted loss per share did not include the effects of 63, 69 and 58 million issued and outstanding stock options, respectively, because either: i) their respective exercise prices were greater than the corresponding market value per share of our common stock or ii) where the respective exercise prices were less than the corresponding market value per share of our common stock, the inclusion of such options would have been anti-dilutive.

In addition, the following securities that could potentially dilute basic EPS in the future were not included in the computation of diluted EPS because to do so would have been anti-dilutive for 2002, 2001 and 2000 (in thousands of shares):

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|   |         |
|---|---------|
|   | 2002    |
|   | ----    |
| Convertible preferred stock .....                           | --      |
| Mandatorily redeemable preferred securities--Trust II ..... | 113,426 |
| 3.625% Convertible subordinated debentures .....            | 7,129   |
| Other convertible debt .....                                | 1,992   |
|   | -----   |
| Total .....   | 122,547 |
|   | =====   |

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Note 19-Financial Statements of Subsidiary Guarantors Subsequent to the 2003 Recapitalization

As more fully discussed in Note 21, on June 25, 2003, we completed a \$3.6 billion recapitalization of which a portion included the 2003 Credit Facility. After effectiveness of the 2003 Credit Facility, certain of our subsidiaries that were formerly required to guarantee our outstanding 9-3/4% Senior Notes due 2009 (see Notes 11 and 20) were no longer required to and no longer guarantee those notes. As a result, our Senior Notes due 2009 are now guaranteed only by Intelligent Electronics, Inc. and Xerox International Joint Marketing, Inc. (the "New Guarantor Subsidiaries"). The Senior Notes due 2010 and 2013 are also guaranteed only by the New Guarantor Subsidiaries.

The subsidiary guarantees provide that each New Guarantor Subsidiary will fully and unconditionally guarantee the obligations of Xerox Corporation ("the Parent Company") under the Senior Notes on a joint and several basis. Each New Guarantor Subsidiary is wholly-owned by the Parent Company. The following supplemental financial information sets forth, on a condensed consolidating basis, the balance sheets, statements of income and statements of cash flows for the Parent Company, the New Guarantor Subsidiaries, the New Non-Guarantor Subsidiaries and total consolidated Xerox Corporation and subsidiaries as of December 31, 2002 and 2001 and for the years ended December 31, 2002, 2001 and 2000.

Condensed Consolidating Statements of Income  
For the Year Ended December 31, 2002

|                                  | Parent<br>Company | New<br>Guarantor<br>Subsidiaries | Ne<br>Gua<br>Subsi |
|----------------------------------|-------------------|----------------------------------|--------------------|
| Revenues                         |                   |                                  |                    |
| Sales                            | \$ 3,396          | \$ 54                            | \$                 |
| Service, outsourcing and rentals | 4,589             | 48                               |                    |
| Finance income                   | 294               | -                                |                    |
| Intercompany revenues            | 327               | 3                                |                    |
| Total Revenues                   | 8,606             | 105                              |                    |

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|   |       |    |        |
|---|-------|----|--------|
| Costs and Expenses  |       |    |        |
| Cost of sales   | 2,019 |    | 48     |
| Cost of service, outsourcing and rentals                  | 2,507 |    | 50     |
| Equipment financing interest                              | 119   |    | -      |
| Intercompany cost of sales                                | 294   |    | 3      |
| Research and development expenses                         | 804   |    | -      |
| Selling, administrative and general expenses              | 2,607 |    | 33     |
| Restructuring and asset impairment charges                | 95    |    | 1      |
| Other expenses (income), net                              | 255   |    | (25)   |
| <hr/>   |       |    |        |
| Total Costs and Expenses                                  | 8,700 |    | 110    |
| <hr/>   |       |    |        |
| Income (Loss) before Income Taxes (Benefits), Equity      |       |    |        |
| Income, Minorities' Interests and Cumulative Effect of    |       |    |        |
| Change in Accounting Principle                            | (94)  |    | (5)    |
| Income taxes (benefits)                                   | (17)  |    | 10     |
| <hr/>   |       |    |        |
| Income (Loss) before Equity Income, Minorities' Interests | (77)  |    | (15)   |
| and Cumulative Effect of Change in Accounting Principle   |       |    |        |
| Equity in net income of unconsolidated affiliates         | (6)   |    | 12     |
| Equity in net income of consolidated affiliates           | 237   |    | -      |
| Minorities' interests in earnings of subsidiaries         | -     |    | -      |
| <hr/>   |       |    |        |
| Income (Loss) before Cumulative Effect of Change in       |       |    |        |
| Accounting Principle                                      | 154   |    | (3)    |
| Cumulative effect of change in accounting principle       | (63)  |    | -      |
| <hr/>   |       |    |        |
| Net Income (Loss)   | \$ 91 | \$ | (3) \$ |
| <hr/>   |       |    |        |
| <hr/>   |       |    |        |

Condensed Consolidating Balance Sheets  
As of December 31, 2002

|  | Parent<br>Company | New<br>Guarantor<br>Subsidiaries | New<br>Non-Guar<br>Subsidiaries |
|--|-------------------|----------------------------------|---------------------------------|
| <hr/>  |                   |                                  |                                 |
| Assets   |                   |                                  |                                 |
| Cash and cash equivalents                                | \$ 1,672          | \$ -                             | \$ 1                            |
| Accounts receivable, net                                 | 714               | 20                               | 1                               |
| Billed portion of finance receivables, net               | 341               | -                                |                                 |
| Finance receivables, net                                 | 392               | -                                | 2                               |
| Inventories  | 683               | 2                                |                                 |
| Other current assets                                     | 554               | 5                                |                                 |
| <hr/>  |                   |                                  |                                 |
| Total Current Assets                                     | 4,356             | 27                               | 6                               |
| <hr/>  |                   |                                  |                                 |
| Finance receivables, due after one year, net             | 712               | -                                | 4                               |
| Equipment on operating leases, net                       | 209               | -                                |                                 |
| Land, buildings and equipment, net                       | 1,058             | 2                                |                                 |
| Investments in affiliates, at equity                     | 32                | 41                               |                                 |
| Investments in and advances to consolidated subsidiaries | 7,842             | -                                |                                 |
| Other long-term assets                                   | 1,412             | 2                                | 2                               |

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|   |           |        |       |
|---|-----------|--------|-------|
| Intangible assets, net  | 360       | -      |       |
| Goodwill  | 491       | 296    |       |
| <hr/>   |           |        |       |
| Total Assets  | \$ 16,472 | \$ 368 | \$ 17 |
| <hr/>   |           |        |       |
| Liabilities and Equity  |           |        |       |
| Short-term debt and current portion of long-term debt   | \$ 1,880  | \$ -   | \$ 2  |
| Accounts payable  | 447       | 6      |       |
| Other current liabilities   | 793       | 30     | 1     |
| <hr/>   |           |        |       |
| Total Current Liabilities   | 3,120     | 36     | 4     |
| <hr/>   |           |        |       |
| Long-term debt  | 4,791     | -      | 5     |
| Intercompany payables, net  | 3,304     | (95)   | (3)   |
| Other long-term liabilities   | 2,856     | -      |       |
| <hr/>   |           |        |       |
| Total Liabilities   | 14,071    | (59)   | 7     |
| <hr/>   |           |        |       |
| Minorities' interest in equity of subsidiaries  | -         | -      |       |
| Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts holding solely subordinated debentures of the Company | -         | -      | 1     |
| Preferred stock   | 550       | -      |       |
| Deferred ESOP benefits  | (42)      | -      |       |
| Common stock, including additional paid-in capital  | 2,739     | 420    | 7     |
| Retained earnings   | 1,025     | 7      | 2     |
| Accumulated other comprehensive loss  | (1,871)   | -      | (1)   |
| <hr/>   |           |        |       |
| Total Liabilities and Equity  | \$ 16,472 | \$ 368 | \$ 17 |

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Condensed Consolidating Statements of Cash Flows  
For the Year Ending December 31, 2002

|  | Parent<br>Company | New<br>Guarantor<br>Subsidiaries | Non-G<br>Subsi |
|--|-------------------|----------------------------------|----------------|
| Net cash provided by (used in) operating activities          | \$ 2,761          | \$ 4                             | \$             |
| Net cash (used in) provided by investing activities          | (1,667)           | (1)                              |                |
| Net cash (used in) provided by financing activities          | (1,836)           | (3)                              |                |
| Effect of exchange rate changes on cash and cash equivalents | -                 | -                                |                |
| <hr/>  |                   |                                  |                |
| Decrease (increase) in cash and cash equivalents             | (742)             | -                                |                |
| Cash and cash equivalents at beginning of year               | 2,414             | -                                |                |
| <hr/>  |                   |                                  |                |
| Cash and cash equivalents at end of year                     | \$ 1,672          | \$ -                             | \$             |

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Condensed Consolidating Statements of Income  
For the Year Ended December 31, 2001

|  | Parent<br>Company | New<br>Guarantor<br>Subsidiaries | New<br>Guar<br>Subsid |
|--|-------------------|----------------------------------|-----------------------|
| <hr/>  |                   |                                  |                       |
| Revenues   |                   |                                  |                       |
| Sales  | \$ 3,765          | \$ 73                            | \$                    |
| Service, outsourcing and rentals   | 4,783             | 59                               |                       |
| Finance income   | 248               | -                                |                       |
| Intercompany revenues  | 386               | 8                                |                       |
| <hr/>  |                   |                                  |                       |
| Total Revenues   | 9,182             | 140                              |                       |
| <hr/>  |                   |                                  |                       |
| Costs and Expenses   |                   |                                  |                       |
| Cost of sales  | 2,429             | 65                               |                       |
| Cost of service, outsourcing and rentals   | 2,716             | 65                               |                       |
| Equipment financing interest   | (60)              | -                                |                       |
| Intercompany cost of sales   | 344               | 8                                |                       |
| Research and development expenses  | 930               | -                                |                       |
| Selling, administrative and general expenses   | 2,664             | 41                               |                       |
| Restructuring and asset impairment charges   | 329               | -                                |                       |
| Gain on sale of half of interest in Fuji Xerox   | 26                | -                                |                       |
| Gain on affiliate's sale of stock  | (4)               | -                                |                       |
| Other (income) expenses, net   | (62)              | (12)                             |                       |
| <hr/>  |                   |                                  |                       |
| Total Costs and Expenses   | 9,312             | 167                              |                       |
| <hr/>  |                   |                                  |                       |
| (Loss) Income before Income Taxes (Benefits), Equity<br>Income, Minorities' Interests and Cumulative Effect of<br>Change in Accounting Principle | (130)             | (27)                             |                       |
| Income taxes (benefits)  | (129)             | 9                                |                       |
| <hr/>  |                   |                                  |                       |
| Income (Loss) before Equity Income, Minorities' Interests<br>and Cumulative Effect of Change in Accounting Principle                             | (1)               | (36)                             |                       |
| Equity in net income of unconsolidated affiliates  | (7)               | 10                               |                       |
| Equity in net income of consolidated affiliates  | (84)              | -                                |                       |
| Minorities' interests in earnings of subsidiaries  | -                 | -                                |                       |
| <hr/>  |                   |                                  |                       |
| Income (Loss) before Cumulative Effect of Change in<br>Accounting Principle  | (92)              | (26)                             |                       |
| Cumulative effect of change in accounting principle  | (2)               | -                                |                       |
| <hr/>  |                   |                                  |                       |
| Net Income (Loss)  | \$ (94)           | \$ (26)                          | \$                    |
| <hr/>  |                   |                                  |                       |

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Condensed Consolidating Balance Sheets  
As of December 31, 2001

New

New

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|   | Parent<br>Company | Guarantor<br>Subsidiaries | Guar<br>Subsid |
|---|-------------------|---------------------------|----------------|
| <b>Assets</b>   |                   |                           |                |
| Cash and cash equivalents   | \$ 2,414          | \$ -                      | \$             |
| Accounts receivable, net  | 598               | 19                        |                |
| Billed portion of finance receivables, net  | 357               | -                         |                |
| Finance receivables, net  | 288               | -                         |                |
| Inventories   | 703               | 1                         |                |
| Other current assets  | 746               | 9                         |                |
| <b>Total Current Assets</b>   | <b>5,106</b>      | <b>29</b>                 |                |
| Finance receivables, due after one year, net  | 415               | -                         |                |
| Equipment on operating leases, net  | 302               | -                         |                |
| Land, buildings and equipment, net  | 1,188             | 4                         |                |
| Investments in affiliates, at equity  | 74                | 26                        |                |
| Investments in and advances to consolidated subsidiaries  | 6,964             | -                         |                |
| Other long-term assets  | 1,102             | -                         |                |
| Intangible assets, net  | 443               | -                         |                |
| Goodwill  | 498               | 296                       |                |
| <b>Total Assets</b>   | <b>\$ 16,092</b>  | <b>\$ 355</b>             | <b>\$</b>      |
| <b>Liabilities and Equity</b>   |                   |                           |                |
| Short-term debt and current portion of long-term debt   | \$ 2,490          | \$ 3                      | \$             |
| Accounts payable  | 353               | 6                         |                |
| Other current liabilities   | 591               | 31                        |                |
| <b>Total Current Liabilities</b>  | <b>3,434</b>      | <b>40</b>                 |                |
| Long-term debt  | 4,973             | -                         |                |
| Intercompany payables, net  | 2,619             | (88)                      |                |
| Other long-term liabilities   | 2,799             | -                         |                |
| <b>Total Liabilities</b>  | <b>13,825</b>     | <b>(48)</b>               |                |
| Minorities' interest in equity of subsidiaries  | -                 | -                         |                |
| Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts holding solely subordinated debentures of the Company | -                 | -                         |                |
| Preferred stock   | 605               | -                         |                |
| Deferred ESOP benefits  | (135)             | -                         |                |
| Common stock, including additional paid-in capital  | 2,622             | 420                       |                |
| Retained earnings   | 1,008             | (17)                      |                |
| Accumulated other comprehensive loss  | (1,833)           | -                         |                |
| <b>Total Liabilities and Equity</b>   | <b>\$ 16,092</b>  | <b>\$ 355</b>             | <b>\$</b>      |



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|  | Parent<br>Company | New<br>Guarantor<br>Subsidiaries | New<br>Guar<br>Subsid |
|--|-------------------|----------------------------------|-----------------------|
| Net cash provided by (used in) operating activities          | \$ 3,603          | \$ 4                             | \$                    |
| Net cash (used in) provided by investing activities          | (1,545)           | (1)                              |                       |
| Net cash provided by (used in) financing activities          | (641)             | (3)                              |                       |
| Effect of exchange rate changes on cash and cash equivalents | -                 | -                                |                       |
| Increase (decrease) in cash and cash equivalents             | 1,417             | -                                |                       |
| Cash and cash equivalents at beginning of year               | 997               | -                                |                       |
| Cash and cash equivalents at end of year                     | \$ 2,414          | \$ -                             | \$                    |

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Condensed Consolidating Statements of Income  
For the Year Ended December 31, 2000

|  | Parent<br>Company | New<br>Guarantor<br>Subsidiaries | New<br>Guar<br>Subsid |
|--|-------------------|----------------------------------|-----------------------|
| <b>Revenues</b>  |                   |                                  |                       |
| Sales  | \$ 4,173          | \$ 104                           | \$                    |
| Service, outsourcing and rentals   | 4,834             | 72                               |                       |
| Finance income   | 205               | -                                |                       |
| Intercompany revenues  | 467               | 8                                |                       |
| <b>Total Revenues</b>  | <b>9,679</b>      | <b>184</b>                       |                       |
| <b>Costs and Expenses</b>  |                   |                                  |                       |
| Cost of sales  | 2,628             | 94                               |                       |
| Cost of service, outsourcing and rentals   | 2,863             | 78                               |                       |
| Equipment financing interest   | (22)              | -                                |                       |
| Intercompany cost of sales   | 455               | 7                                |                       |
| Research and development expenses  | 951               | -                                |                       |
| Selling, administrative and general expenses   | 2,930             | 47                               |                       |
| Restructuring and asset impairment charges   | 274               | 3                                |                       |
| Gain on sale of China operations   | (119)             | -                                |                       |
| Gain on sale of affiliates stock   | (21)              | -                                |                       |
| Other (income) expenses, net   | (52)              | (6)                              |                       |
| <b>Total Costs and Expenses</b>  | <b>9,887</b>      | <b>223</b>                       |                       |
| (Loss) Income before Income Taxes (Benefits), Equity Income<br>and Minorities' Interests | (208)             | (39)                             |                       |
| Income taxes (benefits)  | (236)             | 8                                |                       |
| (Loss) Income before Equity Income and Minorities'<br>Interests                          | 28                | (47)                             |                       |
| Equity in net income of unconsolidated affiliates  | (24)              | 8                                |                       |

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|   |          |         |
|---|----------|---------|
| Equity in net income of consolidated affiliates   | (277)    | -       |
| Minorities' interests in earnings of subsidiaries | -        | -       |
| -----   |          |         |
| Net (Loss) Income                                 | \$ (273) | \$ (39) |
| =====   |          |         |

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Condensed Consolidating Statements of Cash Flows  
For the Year Ending December 31, 2000

|  | Parent<br>Company | New<br>Guarantor<br>Subsidiaries | New<br>Guarantor<br>Subsidiaries |
|--|-------------------|----------------------------------|----------------------------------|
| Net cash provided by (used in) operating activities          | \$ (1,073)        | \$ 5                             | \$                               |
| Net cash (used in) provided by investing activities          | (99)              | (2)                              |                                  |
| Net cash provided by (used in) financing activities          | 2,151             | (3)                              |                                  |
| Effect of exchange rate changes on cash and cash equivalents | -                 | -                                |                                  |
|  | -----             | -----                            | -----                            |
| Increase (decrease) in cash and cash equivalents             | 979               | -                                |                                  |
| Cash and cash equivalents at beginning of year               | 18                | -                                |                                  |
|  | -----             | -----                            | -----                            |
| Cash and cash equivalents at end of year                     | \$ 997            | \$ -                             | \$                               |
|  | =====             | =====                            | =====                            |

Note 20-Financial Statements of Subsidiary Guarantors Prior to the Recapitalization

Prior to the Recapitalization discussed in Note 21, the guarantor subsidiaries included Palo Alto Research Center Incorporated, Talegen Holdings, Inc., Xerox Credit Corporation, Xerox Export, LLC, Xerox Finance, Inc., Xerox Financial Services, Inc., Xerox Imaging Systems, Inc., Xerox International Joint Marketing, Inc., Xerox Latin-American Holdings, Inc., Intelligent Electronics, Inc. and Xerox Global Services Inc. (formerly Xerox Connect, Inc.) (the "Former Guarantor Subsidiaries"). The Subsidiary Guarantees provided that each Former Guarantor Subsidiary would fully and unconditionally guarantee the obligations of the Parent Company under the Senior Notes on a joint and several basis. Each Former Subsidiary Guarantor was wholly-owned by the Parent Company. The following supplemental financial information sets forth, on a condensed consolidating basis, the balance sheets, statements of income and statements of cash flows for the Parent Company, the Former Guarantor Subsidiaries, the Former Non-Guarantor Subsidiaries and total consolidated Xerox Corporation and subsidiaries as of December 31, 2002 and 2001 and for the years ended December 31, 2002, 2001 and 2000.

Condensed Consolidating Statements of Income  
For the Year Ended December 31, 2002

|  | Parent<br>Company | Former<br>Guarantor<br>Subsidiaries | Former<br>Guarantor<br>Subsidiaries |
|--|-------------------|-------------------------------------|-------------------------------------|
|--|-------------------|-------------------------------------|-------------------------------------|

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|  |              |              |           |
|--|--------------|--------------|-----------|
| Revenues   |              |              |           |
| Sales  | \$ 3,396     | \$ 62        | \$        |
| Service, outsourcing and rentals                                 | 4,589        | 71           |           |
| Finance income   | 294          | 276          |           |
| Intercompany revenues  | 327          | 29           |           |
| <b>Total Revenues</b>  | <b>8,606</b> | <b>438</b>   |           |
| Costs and Expenses   |              |              |           |
| Cost of sales  | 2,019        | 50           |           |
| Cost of service, outsourcing and rentals                         | 2,507        | 51           |           |
| Equipment financing interest                                     | 119          | 128          |           |
| Intercompany cost of sales                                       | 294          | 3            |           |
| Research and development expenses                                | 804          | 47           |           |
| Selling, administrative and general expenses                     | 2,607        | 47           |           |
| Restructuring and asset impairment charges                       | 95           | 1            |           |
| Other expenses (income), net                                     | 255          | (44)         |           |
| <b>Total Costs and Expenses</b>                                  | <b>8,700</b> | <b>283</b>   |           |
| Income (Loss) before Income Taxes (Benefits), Equity             |              |              |           |
| Income, Minorities' Interests and Cumulative Effect of           |              |              |           |
| Change in Accounting Principle                                   | (94)         | 155          |           |
| Income taxes (benefits)  | (17)         | 70           |           |
| <b>Income (Loss) before Equity Income, Minorities' Interests</b> | <b>(77)</b>  | <b>85</b>    |           |
| <b>and Cumulative Effect of Change in Accounting Principle</b>   |              |              |           |
| Equity in net income of unconsolidated affiliates                | (6)          | 12           |           |
| Equity in net income of consolidated affiliates                  | 237          | -            |           |
| Minorities' interests in earnings of subsidiaries                | -            | -            |           |
| <b>Income (Loss) before Cumulative Effect of Change in</b>       | <b>154</b>   | <b>97</b>    |           |
| <b>Accounting Principle</b>                                      |              |              |           |
| Cumulative effect of change in accounting principle              | (63)         | -            |           |
| <b>Net Income (Loss)</b>   | <b>\$ 91</b> | <b>\$ 97</b> | <b>\$</b> |

Condensed Consolidating Balance Sheets  
As of December 31, 2002

|  | Parent<br>Company | Former<br>Guarantor<br>Subsidiaries | Former<br>Non-Guar<br>Subsidiaries |
|--|-------------------|-------------------------------------|------------------------------------|
| Assets                                     |                   |                                     |                                    |
| Cash and cash equivalents                  | \$ 1,672          | \$ 13                               | \$ 1                               |
| Accounts receivable, net                   | 714               | 20                                  | 1                                  |
| Billed portion of finance receivables, net | 341               | -                                   |                                    |
| Finance receivables, net                   | 392               | 374                                 | 2                                  |
| Inventories                                | 683               | 3                                   |                                    |
| Other current assets                       | 554               | 285                                 |                                    |

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|   |           |          |       |
|---|-----------|----------|-------|
| Total Current Assets  | 4,356     | 695      | 6     |
| Finance receivables, due after one year, net  | 712       | 651      | 3     |
| Equipment on operating leases, net  | 209       | -        |       |
| Land, buildings and equipment, net  | 1,058     | 13       |       |
| Investments in affiliates, at equity  | 32        | 41       |       |
| Investments in and advances to consolidated subsidiaries  | 7,842     | -        |       |
| Other long-term assets  | 1,412     | 737      | 2     |
| Intangible assets, net  | 360       | -        |       |
| Goodwill  | 491       | 296      |       |
| Total Assets  | \$ 16,472 | \$ 2,433 | \$ 15 |
| Liabilities and Equity  |           |          |       |
| Short-term debt and current portion of long-term debt   | \$ 1,880  | \$ 410   | \$ 2  |
| Accounts payable  | 447       | 7        |       |
| Other current liabilities   | 793       | 370      | 1     |
| Total Current Liabilities   | 3,120     | 787      | 3     |
| Long-term debt  | 4,791     | 1,442    | 3     |
| Intercompany payables, net  | 3,304     | (3,097)  |       |
| Other long-term liabilities   | 2,856     | 7        |       |
| Total Liabilities   | 14,071    | (861)    | 7     |
| Minorities' interest in equity of subsidiaries  | -         | -        |       |
| Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts holding solely subordinated debentures of the Company | -         | -        | 1     |
| Preferred stock   | 550       | -        |       |
| Deferred ESOP benefits  | (42)      | -        |       |
| Common stock, including additional paid-in capital  | 2,739     | 2,632    | 4     |
| Retained earnings   | 1,025     | 665      | 2     |
| Accumulated other comprehensive loss  | (1,871)   | (3)      | (1)   |
| Total Liabilities and Equity  | \$ 16,472 | \$ 2,433 | \$ 15 |

Condensed Consolidating Statements of Cash Flows  
For the Year Ending December 31, 2002

|  | Parent<br>Company | Former<br>Guarantor<br>Subsidiaries | Former<br>Non-Guarantor<br>Subsidiaries |
|--|-------------------|-------------------------------------|---|
| Net cash provided by (used in) operating activities          | \$ 2,761          | \$ 155                              | \$                                      |
| Net cash (used in) provided by investing activities          | (1,667)           | 1,664                               |   |
| Net cash (used in) provided by financing activities          | (1,836)           | (1,807)                             |   |
| Effect of exchange rate changes on cash and cash equivalents | -                 | -                                   |   |
| Decrease (increase) in cash and cash equivalents             | (742)             | 12                                  |   |
| Cash and cash equivalents at beginning of year               | 2,414             | 1                                   |   |
| Cash and cash equivalents at end of year                     | \$ 1,672          | \$ 13                               | \$                                      |

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Condensed Consolidating Statements of Income  
For the Year Ended December 31, 2001

|  | Parent<br>Company | Former<br>Guarantor<br>Subsidiaries | Form<br>Non-Gu<br>Subsid |
|--|-------------------|-------------------------------------|--------------------------|
| <hr/>  |                   |                                     |                          |
| Revenues   |                   |                                     |                          |
| Sales  | \$ 3,765          | \$ 213                              | \$                       |
| Service, outsourcing and rentals   | 4,783             | 70                                  |                          |
| Finance income   | 248               | 400                                 |                          |
| Intercompany revenues  | 386               | 9                                   |                          |
| <hr/>  |                   |                                     |                          |
| Total Revenues   | 9,182             | 692                                 |                          |
| <hr/>  |                   |                                     |                          |
| Costs and Expenses   |                   |                                     |                          |
| Cost of sales  | 2,429             | 198                                 |                          |
| Cost of service, outsourcing and rentals   | 2,716             | 73                                  |                          |
| Equipment financing interest   | (60)              | 314                                 |                          |
| Intercompany cost of sales   | 344               | 8                                   |                          |
| Research and development expenses  | 930               | -                                   |                          |
| Selling, administrative and general expenses   | 2,664             | 53                                  |                          |
| Restructuring and asset impairment charges   | 329               | -                                   |                          |
| Gain on sale of half of interest in Fuji Xerox   | 26                | -                                   |                          |
| Gain on affiliate's sale of stock  | (4)               | -                                   |                          |
| Other (income) expenses, net   | (62)              | (31)                                |                          |
| <hr/>  |                   |                                     |                          |
| Total Costs and Expenses   | 9,312             | 615                                 |                          |
| <hr/>  |                   |                                     |                          |
| (Loss) Income before Income Taxes (Benefits), Equity<br>Income, Minorities' Interests and Cumulative Effect of<br>Change in Accounting Principle | (130)             | 77                                  |                          |
| Income taxes (benefits)  | (129)             | 45                                  |                          |
| <hr/>  |                   |                                     |                          |
| Income (Loss) before Equity Income, Minorities' Interests<br>and Cumulative Effect of Change in Accounting Principle                             | (1)               | 32                                  |                          |
| Equity in net income of unconsolidated affiliates  | (7)               | 10                                  |                          |
| Equity in net income of consolidated affiliates  | (84)              | -                                   |                          |
| Minorities' interests in earnings of subsidiaries  | -                 | -                                   |                          |
| <hr/>  |                   |                                     |                          |
| Income (Loss) before Cumulative Effect of Change in<br>Accounting Principle  | (92)              | 42                                  |                          |
| Cumulative effect of change in accounting principle  | (2)               | (3)                                 |                          |
| <hr/>  |                   |                                     |                          |
| Net Income (Loss)  | \$ (94)           | \$ 39                               | \$                       |
| <hr/>  |                   |                                     |                          |

Condensed Consolidating Balance Sheets  
As of December 31, 2001

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|   | Parent<br>Company | Former<br>Guarantor<br>Subsidiaries | For<br>Non-Gu<br>Subsid |
|---|-------------------|-------------------------------------|-------------------------|
| <b>Assets</b>   |                   |                                     |                         |
| Cash and cash equivalents   | \$ 2,414          | \$ 1                                | \$                      |
| Accounts receivable, net  | 598               | 19                                  |                         |
| Billed portion of finance receivables, net  | 357               | -                                   |                         |
| Finance receivables, net  | 288               | 1,039                               |                         |
| Inventories   | 703               | 2                                   |                         |
| Other current assets  | 746               | 366                                 |                         |
| <b>Total Current Assets</b>   | <b>5,106</b>      | <b>1,427</b>                        |                         |
| Finance receivables, due after one year, net  | 415               | 1,798                               |                         |
| Equipment on operating leases, net  | 302               | -                                   |                         |
| Land, buildings and equipment, net  | 1,188             | 4                                   |                         |
| Investments in affiliates, at equity  | 74                | 26                                  |                         |
| Investments in and advances to consolidated subsidiaries  | 6,964             | -                                   |                         |
| Other long-term assets  | 1,102             | 712                                 |                         |
| Intangible assets, net  | 443               | -                                   |                         |
| Goodwill  | 498               | 296                                 |                         |
| <b>Total Assets</b>   | <b>\$ 16,092</b>  | <b>\$ 4,263</b>                     | <b>\$</b>               |
| <b>Liabilities and Equity</b>   |                   |                                     |                         |
| Short-term debt and current portion of long-term debt   | \$ 2,490          | \$ 1,764                            | \$                      |
| Accounts payable  | 353               | 6                                   |                         |
| Other current liabilities   | 591               | 369                                 |                         |
| <b>Total Current Liabilities</b>  | <b>3,434</b>      | <b>2,139</b>                        |                         |
| Long-term debt  | 4,973             | 1,766                               |                         |
| Intercompany payables, net  | 2,619             | (2,860)                             |                         |
| Other long-term liabilities   | 2,799             | 51                                  |                         |
| <b>Total Liabilities</b>  | <b>13,825</b>     | <b>1,096</b>                        |                         |
| Minorities' interest in equity of subsidiaries  | -                 | -                                   |                         |
| Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts holding solely subordinated debentures of the Company | -                 | -                                   |                         |
| Preferred stock   | 605               | -                                   |                         |
| Deferred ESOP benefits  | (135)             | -                                   |                         |
| Common stock, including additional paid-in capital  | 2,622             | 2,605                               |                         |
| Retained earnings   | 1,008             | 573                                 |                         |
| Accumulated other comprehensive loss  | (1,833)           | (11)                                |                         |
| <b>Total Liabilities and Equity</b>   | <b>\$ 16,092</b>  | <b>\$ 4,263</b>                     | <b>\$</b>               |

Condensed Consolidating Statements of Cash Flows  
For the Year Ending December 31, 2001

Former For

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|  | Parent<br>Company | Guarantor<br>Subsidiaries | Non-Gu<br>Subsid |
|--|-------------------|---------------------------|------------------|
| Net cash provided by (used in) operating activities          | \$ 3,603          | \$ 4                      | \$               |
| Net cash (used in) provided by investing activities          | (1,545)           | 1,235                     |                  |
| Net cash provided by (used in) financing activities          | (641)             | (1,233)                   |                  |
| Effect of exchange rate changes on cash and cash equivalents | -                 | -                         |                  |
| Increase (decrease) in cash and cash equivalents             | 1,417             | 6                         |                  |
| Cash and cash equivalents at beginning of year               | 997               | (5)                       |                  |
| Cash and cash equivalents at end of year                     | \$ 2,414          | \$ 1                      | \$               |

Condensed Consolidating Statements of Income  
For the Year Ended December 31, 2000

|  | Parent<br>Company | Former<br>Guarantor<br>Subsidiaries | For<br>Non-Gu<br>Subsid |
|--|-------------------|-------------------------------------|-------------------------|
| Revenues   |                   |                                     |                         |
| Sales  | \$ 4,173          | \$ 272                              | \$                      |
| Service, outsourcing and rentals   | 4,834             | 81                                  |                         |
| Finance income   | 205               | 441                                 |                         |
| Intercompany revenues  | 467               | 10                                  |                         |
| Total Revenues   | 9,679             | 804                                 |                         |
| Costs and Expenses   |                   |                                     |                         |
| Cost of sales  | 2,628             | 254                                 |                         |
| Cost of service, outsourcing and rentals   | 2,863             | 84                                  |                         |
| Equipment financing interest   | (22)              | 290                                 |                         |
| Intercompany cost of sales   | 455               | 10                                  |                         |
| Research and development expenses  | 951               | -                                   |                         |
| Selling, administrative and general expenses   | 2,930             | 69                                  |                         |
| Restructuring and asset impairment charges   | 274               | 3                                   |                         |
| Gain on sale of China operations   | (119)             | -                                   |                         |
| Gain on sale of affiliates stock   | (21)              | -                                   |                         |
| Other (income) expenses, net   | (52)              | 2                                   |                         |
| Total Costs and Expenses   | 9,887             | 712                                 |                         |
| (Loss) Income before Income Taxes (Benefits), Equity Income<br>and Minorities' Interests | (208)             | 92                                  |                         |
| Income taxes (benefits)  | (236)             | 61                                  |                         |
| (Loss) Income before Equity Income and Minorities'<br>Interests                          | 28                | 31                                  |                         |
| Equity in net income of unconsolidated affiliates  | (24)              | 8                                   |                         |
| Equity in net income of consolidated affiliates  | (277)             | -                                   |                         |
| Minorities' interests in earnings of subsidiaries  | -                 | -                                   |                         |
| Net (Loss) Income  | \$ (273)          | \$ 39                               | \$                      |

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### Condensed Consolidating Statements of Cash Flows For the Year Ending December 31, 2000

|  | Parent<br>Company | Former<br>Guarantor<br>Subsidiaries | For<br>Non-Gu<br>Subsid |
|--|-------------------|-------------------------------------|-------------------------|
| Net cash provided by (used in) operating activities          | \$ (1,073)        | \$ 76                               | \$                      |
| Net cash (used in) provided by investing activities          | (99)              | (624)                               |                         |
| Net cash provided by (used in) financing activities          | 2,151             | 545                                 |                         |
| Effect of exchange rate changes on cash and cash equivalents | -                 | -                                   |                         |
|  | -----             | -----                               | -----                   |
| Increase (decrease) in cash and cash equivalents             | 979               | (3)                                 |                         |
| Cash and cash equivalents at beginning of year               | 18                | (2)                                 |                         |
|  | -----             | -----                               | -----                   |
| Cash and cash equivalents at end of year                     | \$ 997            | \$ (5)                              | \$                      |
|  | =====             | =====                               | =====                   |

#### Note 21-Subsequent Events (Unaudited)

The following, which was disclosed in Note 8 to the Company's previously filed Form 10-Q for the quarter ended March 31, 2003, represents an update to the Berger, et al. v. RIGP litigation matter that is discussed in Note 15. RIGP appealed the District Court's ruling with respect to both liability and damages. Subsequent to this appeal, there were briefings, followed by an oral argument of the appeal to the Seventh Circuit of Appeals on April 9, 2003. Following the oral argument, RIGP and its counsel reassessed the probability of a favorable outcome related to the litigation which has resulted in the Company recording a charge in the 2003 first quarter equal to the amount of the initial judgment of \$284 plus applicable interest, or \$300. Other than for the accrual of interest at the prime rate, the charge will only be subject to adjustment upon final legal determination, or upon settlement of the parties. As sponsor of the Plan, we were required to record the charge related to our obligation as, under relevant accounting standards, the results of the reassessment required recognition of the judgment. Although counsel and RIGP continue to believe the District Court's judgment should be overturned, it is possible that the appeal may ultimately not prevail. Any final judgment after the decision would be paid from RIGP assets. However, such payment may require the Company to make additional contributions to RIGP in the future but not before 2005.

In June 2003, we completed a \$3.6 billion recapitalization, that included public offerings of common stock (\$0.4 billion), 3-year mandatory convertible preferred stock (\$0.9 billion), and 7-year and 10-year senior unsecured notes due 2010 and 2013 (\$1.3 billion), respectively, as well as a \$1 billion credit facility (collectively referred to as the "Recapitalization"). The credit facility consists of a \$700 million revolving facility and a \$300 million term loan, both maturing in September 2008 (the "2003 Credit Facility").



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|  | First<br>Quarter<br>----- | Second<br>Quarter<br>----- |
|--|---------------------------|----------------------------|
| 2002/(1)/  |                           |                            |
| Revenues .....   | \$3,858                   | \$3,952                    |
| Costs and Expenses/(3)/.....   | 3,919                     | 3,791                      |
|  | -----                     | -----                      |
| (Loss) Income before Income Taxes (Benefits), Equity Income,<br>Minorities' Interests and Cumulative Effect of Change in<br>Accounting Principle ..... | (61)                      | 161                        |
| Income taxes (benefits) .....  | (23)                      | 64                         |
| Equity in net income of unconsolidated affiliates .....  | 11                        | 15                         |
| Minorities' interests in earnings of subsidiaries .....  | (24)                      | (25)                       |
| (Loss) Income before Cumulative Effect of Change in<br>Accounting Principle .....  | (51)                      | 87                         |
| Cumulative effect of change in accounting principle .....  | (63)                      | --                         |
|  | -----                     | -----                      |
| Net (Loss) Income .....  | \$ (114)                  | \$ 87                      |
|  | =====                     | =====                      |
| Basic (Loss) Earnings per share before Cumulative Effect of Change in<br>Accounting Principle .....  | \$(0.07)                  | \$ 0.12                    |
|  | =====                     | =====                      |
| Basic (Loss) Earnings per Share/(2)/.....  | \$(0.16)                  | \$ 0.12                    |
|  | =====                     | =====                      |
| Diluted (Loss) Earnings per Share before Cumulative Effect of Change in<br>Accounting Principle .....  | \$(0.07)                  | \$ 0.11                    |
|  | =====                     | =====                      |
| Diluted (Loss) Earnings per Share/(2)/.....  | \$(0.16)                  | \$ 0.11                    |
|  | =====                     | =====                      |
| 2001   |                           |                            |
| Revenues .....   | \$4,291                   | \$4,283                    |
| Costs and Expenses/(3)/(4)/ .....  | 3,626                     | 4,535                      |
|  | -----                     | -----                      |
| Income (Loss) before Income Taxes (Benefits), Equity Income,<br>Minorities' Interests and Cumulative Effect of Change in<br>Accounting Principle ..... | 665                       | (252)                      |
| Income taxes (benefits) .....  | 437                       | (124)                      |
| Equity in net income of unconsolidated affiliates .....  | 3                         | 31                         |
| Minorities' interests in earnings of subsidiaries .....  | (7)                       | (10)                       |
| Income (Loss) before Cumulative Effect of Change in<br>Accounting Principle .....  | 224                       | (107)                      |
| Cumulative effect of change in accounting principle .....  | (2)                       | --                         |
|  | -----                     | -----                      |
| Net Income (Loss) .....  | \$ 222                    | \$ (107)                   |
|  | =====                     | =====                      |
| Basic Earnings (Loss) per Share/(2)/.....  | \$ 0.31                   | \$(0.15)                   |
|  | =====                     | =====                      |
| Diluted Earnings (Loss) per Share/(2)/.....  | \$ 0.28                   | \$(0.15)                   |
|  | =====                     | =====                      |

/(1)/ The amounts reported above have been revised from the amounts originally included in the Form 10-Qs to reflect the correction of interest expense as reported in a Form 8-K filed on December 20, 2002. The pre-tax amounts were adjusted to increase expenses by \$8 for the first quarter, \$9 for the second quarter and \$10 for the third quarter and increase net loss by \$5 for the first quarter and reduce net income by \$6 for the second and third quarters.

/(2)/ The sum of quarterly (loss) earnings per share may differ from the full-year amounts due to rounding, or in the case of diluted earnings per

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share, because securities that are anti-dilutive in certain quarters may not be anti-dilutive on a full-year basis.

/(3)/ Costs and expenses included restructuring and asset impairment charges of \$146, \$53, \$63 and \$408 for the first, second, third and fourth quarters of 2002, respectively. Restructuring and asset impairment charges of \$129, \$295, \$63 and \$228 were incurred in the corresponding four quarters of 2001, respectively.

/(4)/ Costs and expenses for the first quarter of 2001 included gains on the sale of half our interest in Fuji Xerox of \$769.

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### FIVE YEARS IN REVIEW

|   | 2002<br>---- | 2001/(2)/<br>----- | 20<br>--- |
|---|--------------|--------------------|-----------|
| (Dollars in millions, e   |              |                    |           |
| <b>Per-Share Data/(1)/</b>  |              |                    |           |
| <b>Earnings (Loss) from continuing operations/(1)/</b>  |              |                    |           |
| Basic/(1)/ .....  | \$ 0.02      | \$ (0.15)          | \$ (      |
| Diluted/(1)/ .....  | 0.02         | (0.15)             | (         |
| Common dividends declared .....   | --           | 0.05               |           |
| <b>Operations</b>   |              |                    |           |
| Revenues .....  | \$ 15,849    | \$ 17,008          | \$ 18     |
| Sales .....   | 6,752        | 7,443              | 8         |
| Service, outsourcing, and rentals .....   | 8,097        | 8,436              | 8         |
| Finance Income .....  | 1,000        | 1,129              | 1         |
| Research and development expenses .....   | 917          | 997                | 1         |
| Selling, administrative and general expenses .....  | 4,437        | 4,728              | 5         |
| Income (Loss) from continuing operations/(1)/ .....   | 91           | (94)               |           |
| Net income (loss)/(1)/ .....  | 91           | (94)               |           |
| <b>Financial Position</b>   |              |                    |           |
| Cash and cash equivalents .....   | \$ 2,887     | \$ 3,990           | \$ 1      |
| Accounts and finance receivables, net .....   | 11,077       | 11,574             | 13        |
| Inventories .....   | 1,222        | 1,364              | 1         |
| Equipment on operating leases, net .....  | 459          | 804                | 1         |
| Land, buildings and equipment, net .....  | 1,757        | 1,999              | 2         |
| Investment in discontinued operations .....   | 728          | 749                |           |
| Total assets .....  | 25,458       | 27,645             | 28        |
| <b>Consolidated capitalization</b>  |              |                    |           |
| Short-term debt and current portion of long-term debt ....  | 4,377        | 6,637              | 3         |
| Long-term debt .....  | 9,794        | 10,107             | 15        |
| Total debt .....  | 14,171       | 16,744             | 18        |
| Minorities' interests in equity of subsidiaries .....   | 73           | 73                 |           |
| Obligation for equity put options   | --           | --                 |           |
| Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts holding solely subordinated debentures of the Company ..... | 1,701        | 1,687              |           |
| Preferred stock .....   | 550          | 605                |           |
| Deferred ESOP benefits .....  | (42)         | (135)              |           |
| Common shareholders' equity .....   | 1,893        | 1,797              | 1         |
| Total capitalization .....  | 18,346       | 20,771             | 21        |
| <b>Selected Data and Ratios</b>   |              |                    |           |
| Common shareholders of record at year-end .....   | 57,300       | 59,830             | 59        |

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|  |          |          |      |
|--|----------|----------|------|
| Book value per common share .....                        | \$ 2.56  | \$ 2.49  | \$   |
| Year-end common stock market price .....                 | \$ 8.05  | \$ 10.42 | \$   |
| Employees at year-end .....                              | 67,800   | 78,900   | 91   |
| Gross margin .....                                       | 42.4%    | 38.2%    |      |
| Sales gross margin .....                                 | 37.8%    | 30.5%    |      |
| Service, outsourcing, and rentals gross margin .....     | 44.0%    | 42.2%    |      |
| Finance gross margin .....                               | 59.9%    | 59.5%    |      |
| Working capital .....                                    | \$ 3,232 | \$ 2,340 | \$ 4 |
| Current ratio .....                                      | 1.4      | 1.2      |      |
| Cost of additions to land, buildings and equipment ..... | \$ 146   | \$ 219   | \$   |
| Depreciation on buildings and equipment .....            | \$ 341   | \$ 402   | \$   |

- (1) Income (Loss) from continuing operations and Net income (loss), as well as Basic and Diluted Earnings per Share for the year ended December 31, 2002, exclude the effect of amortization of goodwill in accordance with the adoption of Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets." For additional information regarding the adoption of this standard and its effects on Income from continuing operations, Net income (loss) and Earnings (Loss) per share, refer to Note 1 to the Consolidated Financial Statements under the heading "Adoption of New Accounting Standards - Goodwill and Other Intangible Assets."
- (2) In March 2001, we sold half of our ownership interest in Fuji Xerox to Fuji Photo Film Co. Ltd. For \$1.3 billion in cash. In connection with the sale, we recorded a pre-tax gain of \$773. As a result, our ownership percentage decreased from 50 percent to 25 percent. Refer to Note 4 to the Consolidated Financial Statements under the caption "Fuji Xerox Interest" for further information.

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, Registrant has duly authorized this report to be signed on its behalf by the undersigned duly authorized.

XEROX CORPORATION

/s/ GARY R. KABURECK

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By: GARY R. KABURECK  
Vice President and  
Chief Accounting Officer

Date: July 23, 2003