

## Financial overview

(in millions, except EPS)

	2008	2007
Total revenue	\$ 17,608	\$ 17,228
Equipment sales	4,679	4,753
Post sale revenue	12,929	12,475
Net income	230	1,135
Adjusted net income*	985	1,135
Diluted earnings per share	0.26	1.19
Adjusted earnings per share*	1.10	1.19
Net cash provided by operating activities	939	1,871
Adjusted cash from core operations*	1,721	2,083

\* See Page 7 for the reconciliation of the difference between this financial measure that is not in compliance with Generally Accepted Accounting Principles (GAAP) and the most directly comparable financial measure calculated in accordance with GAAP.

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# Xerox Corporation

## Consolidated Statements of Income

(in millions, except per-share data)	Year Ended December 31,		
	2008	2007	2006
<b>Revenues</b>			
Sales	\$ 8,325	\$ 8,192	\$ 7,464
Service, outsourcing and rentals	8,485	8,214	7,591
Finance income	798	822	840
<b>Total Revenues</b>	<b>17,608</b>	<b>17,228</b>	<b>15,895</b>
<b>Costs and Expenses</b>			
Cost of sales	5,519	5,254	4,803
Cost of service, outsourcing and rentals	4,929	4,707	4,328
Equipment financing interest	305	316	305
Research, development and engineering expenses	884	912	922
Selling, administrative and general expenses	4,534	4,312	4,008
Restructuring and asset impairment charges	429	(6)	385
Other expenses, net	1,122	295	336
<b>Total Costs and Expenses</b>	<b>17,722</b>	<b>15,790</b>	<b>15,087</b>
<b>(Loss) Income before Income Taxes and Equity Income</b>	<b>(114)</b>	<b>1,438</b>	<b>808</b>
Income tax (benefits) expenses	(231)	400	(288)
Equity in net income of unconsolidated affiliates	113	97	114
<b>Net Income</b>	<b>\$ 230</b>	<b>\$ 1,135</b>	<b>\$ 1,210</b>
<b>Basic Earnings per Share</b>	<b>\$ 0.26</b>	<b>\$ 1.21</b>	<b>\$ 1.25</b>
<b>Diluted Earnings per Share</b>	<b>\$ 0.26</b>	<b>\$ 1.19</b>	<b>\$ 1.22</b>

The accompanying notes are an integral part of these Consolidated Financial Statements.

# Xerox Corporation

## Consolidated Balance Sheets

	December 31,	
(in millions, except share data in thousands)	2008	2007
<b>Assets</b>		
Cash and cash equivalents	\$ 1,229	\$ 1,099
Accounts receivable, net	2,184	2,457
Billed portion of finance receivables, net	254	304
Finance receivables, net	2,461	2,693
Inventories	1,232	1,305
Other current assets	790	682
Total current assets	8,150	8,540
Finance receivables due after one year, net	4,563	5,051
Equipment on operating leases, net	594	587
Land, buildings and equipment, net	1,419	1,587
Investments in affiliates, at equity	1,080	932
Intangible assets, net	610	621
Goodwill	3,182	3,448
Deferred tax assets, long-term	1,692	1,349
Other long-term assets	1,157	1,428
<b>Total Assets</b>	<b>\$ 22,447</b>	<b>\$ 23,543</b>
<b>Liabilities and Shareholders' Equity</b>		
Short-term debt and current portion of long-term debt	\$ 1,610	\$ 525
Accounts payable	1,446	1,367
Accrued compensation and benefits costs	625	673
Other current liabilities	1,769	1,512
Total current liabilities	5,450	4,077
Long-term debt	6,774	6,939
Liability to subsidiary trust issuing preferred securities	648	632
Pension and other benefit liabilities	1,747	1,115
Post-retirement medical benefits	896	1,396
Other long-term liabilities	694	796
Total Liabilities	16,209	14,955
Common stock, including additional paid-in-capital	3,313	4,096
Treasury stock, at cost	—	(31)
Retained earnings	5,341	5,288
Accumulated other comprehensive loss	(2,416)	(765)
Total Shareholders' Equity	6,238	8,588
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 22,447</b>	<b>\$ 23,543</b>
Shares of common stock issued	864,777	919,013
Treasury stock	—	(1,836)
Shares of common stock outstanding	864,777	917,177

The accompanying notes are an integral part of these Consolidated Financial Statements.

# Xerox Corporation

## Consolidated Statements of Cash Flows

(in millions)	Year Ended December 31,		
	2008	2007	2006
<b>Cash Flows from Operating Activities:</b>			
Net income	\$ 230	\$ 1,135	\$ 1,210
Adjustments required to reconcile net income to cash flows from operating activities:			
Depreciation and amortization	669	656	636
Provisions for receivables and inventory	314	197	145
Deferred tax (benefit) expense	(324)	224	99
Net gain on sales of businesses and assets	(21)	(7)	(44)
Undistributed equity in net income of unconsolidated affiliates	(53)	(60)	(70)
Stock-based compensation	85	89	64
Provision for litigation, net	781	—	—
Payments for securities litigation, net	(615)	—	—
Restructuring and asset impairment charges	429	(6)	385
Payments for restructurings	(131)	(235)	(265)
Contributions to pension benefit plans	(299)	(298)	(355)
Decrease (increase) in accounts receivable and billed portion of finance receivables	57	(79)	(30)
(Increase) decrease in inventories	(114)	(43)	11
Increase in equipment on operating leases	(331)	(331)	(271)
Decrease in finance receivables	164	119	192
(Increase) decrease in other current and long-term assets	(8)	130	64
Increase in accounts payable and accrued compensation	211	285	330
(Decrease) increase in other current and long-term liabilities	(174)	38	(70)
Net change in income tax assets and liabilities	(92)	73	(459)
Net change in derivative assets and liabilities	230	(10)	9
Other, net	(69)	(6)	36
Net cash provided by operating activities	939	1,871	1,617
<b>Cash Flows from Investing Activities:</b>			
Cost of additions to land, buildings and equipment	(206)	(236)	(215)
Proceeds from sales of land, buildings and equipment	38	25	82
Cost of additions to internal use software	(129)	(123)	(79)
Acquisitions, net of cash acquired	(155)	(1,615)	(229)
Net change in escrow and other restricted investments	8	200	38
Other, net	3	137	260
Net cash used in investing activities	(441)	(1,612)	(143)
<b>Cash Flows from Financing Activities:</b>			
Net debt payments on secured financings	(227)	(1,869)	(1,591)
Net proceeds on other debt	926	1,814	1,276
Payment of liability to subsidiary trust issuing preferred securities	—	—	(100)
Common stock dividends	(154)	—	—
Preferred stock dividends	—	—	(43)
Proceeds from issuances of common stock	6	65	82
Excess tax benefits from stock-based compensation	2	22	25
Payments to acquire treasury stock, including fees	(812)	(632)	(1,069)
Repurchases related to stock-based compensation	(33)	—	—
Other	(19)	(19)	(8)
Net cash used in financing activities	(311)	(619)	(1,428)
Effect of exchange rate changes on cash and cash equivalents	(57)	60	31
Increase (decrease) in cash and cash equivalents	130	(300)	77
Cash and cash equivalents at beginning of year	1,099	1,399	1,322
<b>Cash and cash equivalents at end of year</b>	<b>\$ 1,229</b>	<b>\$ 1,099</b>	<b>\$ 1,399</b>

The accompanying notes are an integral part of these Consolidated Financial Statements.

# Xerox Corporation

## Consolidated Statements of Shareholders' Equity

(in millions, except share data in thousands)	Common Stock Shares	Common Stock Amount	Additional Paid-In- Capital	Treasury Stock Shares	Treasury Stock Amount	Retained Earnings	AOCL <sup>(1)</sup>	Total
<b>Balance at December 31, 2005</b>	<b>945,106</b>	<b>\$945</b>	<b>\$ 3,796</b>	<b>(13,917)</b>	<b>\$ (203)</b>	<b>\$3,021</b>	<b>\$(1,240)</b>	<b>\$ 6,319</b>
Net income	—	—	—	—	—	1,210	—	1,210
Translation adjustments	—	—	—	—	—	—	485	485
Minimum pension liability	—	—	—	—	—	—	131	131
Other unrealized gains	—	—	—	—	—	—	1	1
<b>Comprehensive income</b>								<b>\$ 1,827</b>
Adjustment to initially apply FAS 158, net	—	—	—	—	—	—	(1,024)	(1,024)
Stock option and incentive plans, net	10,256	11	156	—	—	—	—	167
Series C mandatory convertible preferred stock dividends (\$6.25 per share)	—	—	—	—	—	(29)	—	(29)
Series C mandatory convertible preferred stock conversion	74,797	75	814	—	—	—	—	889
Payments to acquire treasury stock	—	—	—	(70,111)	(1,069)	—	—	(1,069)
Cancellation of treasury stock	(75,665)	(75)	(1,056)	75,665	1,131	—	—	—
Other	74	—	—	—	—	—	—	—
<b>Balance at December 31, 2006</b>	<b>954,568</b>	<b>\$956</b>	<b>\$ 3,710</b>	<b>(8,363)</b>	<b>\$ (141)</b>	<b>\$4,202</b>	<b>\$(1,647)</b>	<b>\$ 7,080</b>
Net income	—	—	—	—	—	1,135	—	1,135
Translation adjustments	—	—	—	—	—	—	501	501
Cumulative Effect of Change in Accounting Principles	—	—	—	—	—	(9)	—	(9)
Changes in defined benefit plans <sup>(2)</sup>	—	—	—	—	—	—	382	382
Other unrealized losses	—	—	—	—	—	—	(1)	(1)
<b>Comprehensive income</b>								<b>\$ 2,008</b>
Cash dividends declared on common stock (\$0.0425 per share)	—	—	—	—	—	(40)	—	(40)
Stock option and incentive plans, net	7,588	7	165	—	—	—	—	172
Payments to acquire treasury stock	—	—	—	(36,638)	(632)	—	—	(632)
Cancellation of treasury stock	(43,165)	(43)	(699)	43,165	742	—	—	—
Other	22	—	—	—	—	—	—	—
<b>Balance at December 31, 2007</b>	<b>919,013</b>	<b>\$920</b>	<b>\$ 3,176</b>	<b>(1,836)</b>	<b>\$ (31)</b>	<b>\$5,288</b>	<b>\$ (765)</b>	<b>\$ 8,588</b>
<b>Net income</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>230</b>	<b>—</b>	<b>230</b>
<b>Translation adjustments</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>(1,364)</b>	<b>(1,364)</b>
<b>Cumulative Effect of Change in Accounting Principles</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>(25)</b>	<b>—</b>	<b>(25)</b>
<b>Changes in defined benefit plans<sup>(2)</sup></b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>(286)</b>	<b>(286)</b>
<b>Other unrealized losses</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>(1)</b>	<b>(1)</b>
<b>Comprehensive loss</b>								<b>\$(1,446)</b>
<b>Cash dividends declared on common stock (\$0.17 per share)</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>(152)</b>	<b>—</b>	<b>(152)</b>
<b>Stock option and incentive plans, net</b>	<b>4,442</b>	<b>5</b>	<b>55</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>60</b>
<b>Payments to acquire treasury stock</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>(56,842)</b>	<b>(812)</b>	<b>—</b>	<b>—</b>	<b>(812)</b>
<b>Cancellation of treasury stock</b>	<b>(58,678)</b>	<b>(59)</b>	<b>(784)</b>	<b>58,678</b>	<b>843</b>	<b>—</b>	<b>—</b>	<b>—</b>
<b>Balance at December 31, 2008</b>	<b>864,777</b>	<b>\$866</b>	<b>\$ 2,447</b>	<b>—</b>	<b>—</b>	<b>5,341</b>	<b>\$(2,416)</b>	<b>\$ 6,238</b>

<sup>(1)</sup> Refer to Note 1 "Accumulated Other Comprehensive Loss (AOCL)" section for additional information.

<sup>(2)</sup> Refer to Note 1 "Benefit Plans Accounting" section for additional information.

The accompanying notes are an integral part of these Consolidated Financial Statements.

# Notes to the Consolidated Financial Statements

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

## Note 1 – Summary of Significant Accounting Policies

References herein to “we,” “us,” “our,” the “Company,” and Xerox refer to Xerox Corporation and its consolidated subsidiaries unless the context specifically requires otherwise.

### Description of Business and Basis of Presentation

We are a technology and services enterprise and a leader in the global document market. We develop, manufacture, market, service and finance a complete range of document equipment, software, solutions and services.

### 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% 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.

We consolidate variable interest entities if we are deemed to be the primary beneficiary of the entity. Operating results for variable interest entities in which we are determined to be the primary beneficiary are included in the Consolidated Statements of Income from the date such determination is made.

For convenience and ease of reference, we refer to the financial statement caption “(Loss) Income before Income Taxes and Equity Income” as “pre-tax loss” or “pre-tax income,” throughout the notes to the Consolidated Financial Statements.

### 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 leases and other multiple element arrangements; (ii) accounting for residual values;

(iii) economic lives of leased assets; (iv) allowance for doubtful accounts; (v) inventory valuation; (vi) restructuring and related charges; (vii) asset impairments; (viii) depreciable lives of assets; (ix) useful lives of intangible assets; (x) pension and post-retirement benefit plans; (xi) income tax reserves and valuation allowances and (xii) 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 certain significant charges that require management estimates:

	Year Ended December 31,		
	2008	2007	2006
Restructuring provisions and asset impairments	\$429	\$ (6)	\$385
Amortization of intangible assets (\$4 for patents included in cost of sales)	58	46	45
Provisions for receivables	199	131	76
Provisions for obsolete and excess inventory	115	66	69
Provisions for litigation and regulatory matters	781	(6)	89
Depreciation and obsolescence of equipment on operating leases	298	269	230
Depreciation of buildings and equipment	257	262	277
Amortization of internal use and product software	56	79	84
Pension benefits – net periodic benefit cost	174	235	355
Other post-retirement benefits – net periodic benefit cost	77	102	117
Deferred tax asset valuation allowance provisions	17	14	12

### 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.

# Notes to the Consolidated Financial Statements

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

## New Accounting Standards and Accounting Changes

### Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS No. 161 “Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133”. The new standard requires additional disclosures regarding a company’s derivative instruments and hedging activities by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also requires disclosure of derivative features that are credit risk – related as well as cross-referencing within the notes to the financial statements to enable financial statement users to locate important information about derivative instruments, financial performance and cash flows. We adopted this standard effective as of December 31, 2008. The only impact from this standard was to require us to expand our disclosures regarding our derivative instruments. Refer to Note 13 – Financial Instruments for additional information.

### Fair Value Accounting

In 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“FAS 157”). We adopted the provisions of FAS 157 on January 1, 2008. FAS 157 defines fair value, establishes a market-based framework or hierarchy for measuring fair value and expands disclosures about fair value measurements. FAS 157 is applicable whenever another accounting pronouncement requires or permits assets and liabilities to be measured at fair value. FAS 157 does not expand or require any new fair value measures; however, the application of this statement may change current practice. FAS 157 does not apply to fair value measurements for purposes of lease classification or measurement under SFAS No. 13, “Accounting for Leases”. In February 2008, the FASB decided that an entity need not apply this standard to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis until 2009. Accordingly, our adoption of this standard in 2008 was limited to financial assets and liabilities, which primarily affects the valuation of our derivative contracts. The adoption of FAS 157 did not have a material effect on our financial condition or results of operations. We do not believe the full adoption of FAS 157 with respect to our nonfinancial assets and liabilities will have a material effect on our financial condition or results of operations. Nonfinancial assets and liabilities for which we have not applied the provisions of FAS 157 primarily include those measured at fair value in impairment testing and those initially measured at fair value in a business combination.

In 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115” (“FAS 159”). FAS 159 became effective for us on January 1, 2008. FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis, with few exceptions. FAS 159 also establishes presentation and disclosure requirements to facilitate comparisons between companies that choose different measurement attributes for similar assets and liabilities. FAS 159 did not have an effect on our financial condition or results of operations as we did not elect this fair value option, nor is it expected to have a material impact on future periods as the election of this option for our financial instruments is expected to be at most, limited.

### Business Combinations and Noncontrolling Interests

In 2007, the FASB issued SFAS No. 141 (revised 2007), “Business Combinations” (“FAS 141(R)”). FAS 141(R) requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose the information needed to evaluate and understand the nature and financial effect of the business combination. FAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The impact of FAS No. 141(R) on our consolidated financial statements will depend upon the nature, terms and size of the acquisitions we consummate after the effective date.

In 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51” (“FAS 160”). FAS 160 requires reporting entities to present noncontrolling (minority) interests as equity (as opposed to as a liability) and provides guidance on the accounting for transactions between an entity and noncontrolling interests. As of December 31, 2008, we had approximately \$120 in noncontrolling interests classified in other long-term liabilities. FAS 160 applies prospectively as of January 1, 2009, except for the presentation and disclosure requirements which will be applied retrospectively for all periods presented.

# Notes to the Consolidated Financial Statements

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

## Benefit Plans Accounting

In 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)" ("FAS 158") which requires the recognition of an asset or liability for the funded status of defined pension and other postretirement benefit plans in the statement of financial position of the sponsoring entity. The funded status of a benefit plan is measured as the difference between plan assets at fair value and the benefit obligation. The initial incremental recognition of the funded status under FAS 158 of our defined pension and other post retirement benefit plans, as well as subsequent changes in our funded status that are not included in net periodic benefit cost will be reflected in shareholders' equity and other comprehensive loss, respectively. As of December 31, 2006, the net unfunded status of our benefit plans was \$2,842 and recognition of this net unfunded status upon the adoption of FAS 158 resulted in an after-tax charge to equity of \$1,024. Prior to the adoption of FAS 158, we recorded an after-tax credit to our minimum pension liability of \$131, for a total equity charge in 2006 related to the funded status of our benefit plans of \$893. Amounts recognized in accumulated other comprehensive loss are adjusted as they are subsequently recognized as a component of net periodic benefit cost. The method of calculating net periodic benefit cost did not change from existing guidance. Refer to Note 14 – Employee Benefit Plans for additional information.

The funded status recognition and certain disclosure provisions of FAS 158 were effective as of our fiscal year ending December 31, 2006. FAS 158 also requires the consistent measurement of plan assets and benefit obligations as of the date of our fiscal year-end statement of financial position effective for the year ending December 31, 2008. Since several of our international plans had a September 30th measurement date, this standard required us to change that measurement date to December 31<sup>st</sup> in 2008. The adoption of this requirement by our international plans did not have a material effect on our financial condition or results of operations. The effect of adoption by our international plans resulted in a January 1, 2008 opening retained earnings charge of \$16, deferred tax asset increase of \$4, pension asset reduction of \$9, a pension liability increase of \$6 and a credit to accumulated other comprehensive loss of \$5.

FAS 158 was not effective for our equity investment in Fuji Xerox ("FX") until their annual year-end of March 31, 2007. Upon FX's adoption of FAS 158, we recorded a \$5 charge to equity representing our share of their after-tax charge to equity for the unfunded status of their benefit plans. We also recorded a \$44 after-tax charge to equity for our portion of a minimum pension liability adjustment recorded by FX prior to their adoption of FAS

158 for a total equity charge in 2007 related to the funded status of FX's benefit plans of \$49.

## Other Accounting Changes

In December 2008, the FASB issued Staff Position No. FAS 140-4 and FIN 46(R)-8, "Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities" ("FSP FAS 140-4 and FIN 46(R)-8"). This FSP required additional disclosures about transfers of financial assets and about an entity's involvement with variable interest entities. The FSP is effective for our fiscal year ended December 31, 2008. Adoption of this FSP affects disclosures only and therefore has no impact on the Company's financial condition, results of operations or cash flows. Since our transfers of financial assets and involvement with variable interest entities are not material, we do not expect a material disclosure requirement from this standard.

In April 2008, the FASB issued Staff Position No. FAS 142-3, "Determination of Useful Life of Intangible Assets" ("FSP FAS 142-3"). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FAS 142, "Goodwill and Other Intangible Assets." FSP FAS 142-3 also requires expanded disclosures related to the determination of intangible asset useful lives. This standard applies prospectively to intangible assets acquired and/or recognized on or after January 1, 2009. We do not believe that the adoption of this standard will have a material effect on our financial condition or results of operations.

In 2007, the FASB's Emerging Issues Task Force issued EITF Issue No. 06-10, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements" ("EITF 06-10"). EITF 06-10 provides that an employer should recognize a liability for the postretirement benefit related to collateral assignment split-dollar life insurance arrangements in accordance with either SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," or Accounting Principles Board Opinion No. 12, "Omnibus Opinion." We recorded a \$11 after-tax charge to retained earnings in 2008 reflecting the cumulative effect upon adoption of EITF 06-10. The standard is not expected to have a material impact on results of operations in the future.

In 2006, the FASB ratified the consensus reached on EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43" ("EITF 06-2"). EITF 06-2 clarifies recognition guidance on the accrual of employees' rights to compensated absences under a sabbatical or other similar benefit arrangement. We recorded a \$7 after-tax charge to Retained earnings in 2007 reflecting our share of the cumulative effect recorded by Fuji Xerox upon adoption of EITF 06-2. This was

# Notes to the Consolidated Financial Statements

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

adjusted by a \$2 credit in 2008. With the exception of this charge, the adoption of EITF 06-2 did not impact the Company as we do not have a similar benefit arrangement.

## Summary of Accounting Policies

### Revenue Recognition

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 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, other than the product warranty obligations associated with certain of our low end products in the Office segment, we do not have any significant product warranty obligations, including any obligations under customer satisfaction programs.

Revenues associated with outsourcing services as well as professional and value-added services are generally recognized as such services are performed. In those service arrangements where final acceptance of a system or solution by the customer is required, revenue is deferred until all acceptance criteria have been met. Costs associated with service arrangements are generally recognized as incurred. Initial direct costs of an arrangement are capitalized and amortized over the contractual service period. Long-lived assets used in the fulfillment of the arrangements are capitalized and depreciated over the shorter of their useful life or the term of the contract. Losses on service arrangements are recognized in the period that the contractual loss becomes probable and estimable.

**Sales to distributors and resellers:** We utilize distributors and resellers to sell certain of our products to end-users. We refer to our distributor and reseller network as our two-tier distribution model. Sales to distributors and resellers are generally recognized as revenue when products are sold to such distributors and resellers. Distributors and resellers participate in various cooperative marketing and other programs, and we record provisions for these programs as a reduction to revenue when the sales occur. We also similarly account for our estimates of sales returns and other allowances when the sales occur based on our historical experience.

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

**Software:** Software included within our equipment and services is generally considered incidental and is therefore accounted for as part of the equipment sales or services revenues. Software accessories sold in connection with our equipment sales as well as free-standing software revenues are accounted for in accordance with AICPA Statement of Position No. 97-2, "Software Revenue Recognition" ("SOP 97-2"). In most cases, these software products are sold as part of multiple element arrangements and include software maintenance agreements for the delivery of technical service as well as unspecified upgrades or enhancements on a when-and-if-available basis. In those software accessory and free-standing software arrangements that include more than one element, we allocate the revenue among the elements based on vendor-specific objective evidence ("VSOE") of fair value. VSOE of fair value is based on the price charged when the deliverable is sold separately by us on a regular basis and not as part of the multiple-element arrangement. Revenue allocated to software is normally recognized upon delivery while revenue allocated to the software maintenance element is recognized ratably over the term of the arrangement.

**Revenue Recognition for Leases:** Our accounting for leases involves specific determinations under FAS 13, which often involve complex provisions and significant judgments. The two primary criteria of FAS 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% of the economic life of the equipment and 2) a review of the present value of the minimum lease payments to determine if they are equal to or greater than 90% of the fair market value of the equipment at the inception of the lease. Our leases in our Latin America operations have historically been recorded as operating leases given the cancellability of the contract or because the recoverability of the lease investment is deemed not to be predictable at lease inception.

# Notes to the Consolidated Financial Statements

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

The critical elements 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. For purposes of determining the economic life, we consider the most objective measure to be the original contract term, since most equipment is returned by lessees at or near the end of the contracted term. The 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 have original terms longer than five years. We continually evaluate the economic life of both existing and newly introduced products for purposes of this determination. Residual values, if any, are established at lease inception using estimates of fair value at the end of the lease term.

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 lease receivables. A portion of our business involves sales to governmental units. Governmental units are those entities that have statutorily defined funding or annual budgets that are determined by their legislative bodies. 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 best interest of the governmental unit's taxpayers or 3) those that must be renewed each fiscal year, given limitations that may exist on entering into multi-year contracts that are imposed by statute. In these circumstances, we carefully evaluate these contracts to assess whether cancellation is remote. The evaluation of a lease agreement with a renewal option includes an assessment as to whether the renewal is reasonably assured based on the apparent intent and our experience of such governmental unit. We further ensure that the contract provisions described above are offered only in instances where required by law. Where such contract terms are not legally required, we consider the arrangement to be cancelable and account for the lease as an operating lease.

After the initial lease of equipment to our customers, we may enter subsequent transactions with the same customer whereby we extend the term. Revenue from such lease extensions is typically recognized over the extension period.

**Revenue Recognition Under Bundled Arrangements:** We sell the majority of our products and services under bundled lease arrangements, which typically include equipment, service, supplies and financing components for which the customer pays a single negotiated fixed minimum monthly payment for all elements over the contractual lease term. These arrangements typically also include an incremental, variable component for page volumes in excess of contractual page volume minimums, which are often expressed in terms of price per page. 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 page volumes are typically negotiated to equal the customer's estimated page volume at lease inception. In applying our lease accounting methodology, we only consider the fixed payments for purposes of allocating to the relative fair value elements of the contract. Contingent payments, if any, are inherently uncertain and therefore are recognized as revenue in the period when the customer exceeds the minimum copy volumes specified in the contract. Revenues under bundled arrangements are allocated considering the relative fair values of the lease and non-lease deliverables included in the bundled arrangement based upon the estimated relative fair values of each element. Lease deliverables include maintenance and executory costs, equipment and financing, while non-lease deliverables generally consist of the supplies and non-maintenance services. Our revenue allocation for the lease deliverables begins by allocating revenues to the maintenance and executory costs plus profit thereon. The remaining amounts are allocated to the equipment and financing elements.

## Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand, including money-market funds, and investments with original maturities of three months or less.

## Restricted Cash and Investments

Several of our secured financing arrangements and other contracts, require us to post cash collateral or maintain minimum cash balances in escrow. In addition, as more fully discussed in Note 16 – Contingencies, various litigation matters in Brazil require us to make cash deposits as a condition of continuing the litigation. These cash amounts are reported in our Consolidated Balance Sheets, depending on when the cash will be contractually released. At December 31, 2008 and 2007, such restricted cash amounts were as follows:

	December 31,	
	2008	2007
Escrow and cash collections related to secured borrowing arrangements	\$ 16	\$ 41
Tax and other litigation deposits in Brazil	167	200
Other restricted cash	20	23
<b>Total</b>	<b>\$203</b>	<b>\$264</b>

# Notes to the Consolidated Financial Statements

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

Of these amounts, \$20 and \$45 were included in Other current assets and \$183 and \$219 were included in Other long-term assets, as of December 31, 2008 and 2007, respectively.

## 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 default risks of repayment. Allowances for doubtful accounts receivable were \$131 and \$128, as of December 31, 2008 and 2007, respectively. Allowances for doubtful accounts on finance receivables were \$198 and \$203 at December 31, 2008 and 2007, respectively.

## Inventories

Inventories are carried at the lower of average cost or market. Inventories also include equipment that is returned at the end of the lease term. Returned equipment is recorded at the lower of remaining net book value or salvage value. Salvage value consists of the estimated market value (generally determined based on replacement cost) of the salvageable component parts, which are expected to be used in the remanufacturing process. We regularly review inventory quantities and record a provision for excess and/or obsolete inventory based primarily on our estimated forecast of product demand, production requirements and servicing commitments. Several factors may influence the realizability of our inventories, including our decision to exit a product line, technological changes and new product development. The provision for excess and/or obsolete raw materials and equipment inventories is based primarily on near term forecasts of product demand and include consideration of new product introductions as well as changes in remanufacturing strategies. The provision for excess and/or obsolete service parts inventory is based primarily on projected servicing requirements over the life of the related equipment populations.

Cost of sales in 2008 included a charge of \$39 associated with an Office segment product line equipment and residual value write-off. The write-off was the result of a late 2008 change in strategy reflecting our decision to discontinue the remanufacture of end-of-lease returned inventory from a certain Office segment product line following an assessment of the current and expected market for these products.

## 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 estimated salvage value over the lease term. Depreciation is computed using the straight-line method. Significant improvements are capitalized and maintenance and repairs are expensed. Refer to Note 5 – Inventories and Equipment on Operating Leases, Net and Note 6 – Land, Buildings and Equipment, Net for further discussion.

## Internal Use Software

We capitalize direct costs associated with developing, purchasing or otherwise acquiring software for internal use and amortize these costs on a straight-line basis over the expected useful life of the software, beginning when the software is implemented. Useful lives of the software generally vary from 3 to 5 years. Amortization expense was \$50, \$76, and \$73 for the years ended December 31, 2008, 2007 and 2006, respectively. Capitalized costs were \$288 and \$270 as of December 31, 2008 and 2007, respectively.

## Goodwill and Other Intangible Assets

Goodwill is tested for impairment annually or more frequently if an event or circumstance indicates that an impairment loss may have been incurred. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. We estimate the fair value of each reporting unit using a discounted cash flow methodology. This requires us to use significant judgment including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, the useful life over which cash flows will occur, determination of our weighted average cost of capital, and relevant market data.

Other intangible assets primarily consist of assets obtained in connection with business acquisitions, including installed customer base and distribution network relationships, patents on existing technology and trademarks. We apply an impairment evaluation whenever events or changes in business circumstances indicate that the carrying value of our intangible assets may not be recoverable. Other intangible assets are amortized on a straight-line basis over their estimated economic lives. We believe that the straight-line method of amortization reflects an appropriate allocation of the cost of the intangible assets to earnings in proportion to the amount of economic benefits obtained annually by the Company. Refer to Note 8 – Goodwill and Intangible Assets, Net for further information.

## Impairment of Long-Lived Assets

We review the recoverability of our long-lived assets, including buildings, equipment, internal-use software and other intangible

# Notes to the Consolidated Financial Statements

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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. Our primary measure of fair value is based on discounted cash flows.

## Treasury Stock

We account for repurchased common stock under the cost method and include such treasury stock as a component of our Common shareholders' equity. Retirement of Treasury stock is recorded as a reduction of Common stock and Additional paid-in-capital at the time such retirement is approved by our Board of Directors.

## Research, Development and Engineering ("R,D&E")

Research, development and engineering costs are expensed as incurred. R,D&E was \$884, \$912 and \$922, for the three years ended December 31, 2008, respectively. Research and development ("R&D") costs were \$750 in 2008, \$764 in 2007 and \$761 in 2006. Sustaining engineering costs are incurred with respect to on-going product improvements or environmental compliance after initial product launch. Our sustaining engineering costs were \$134, \$148, and \$161, for the three years ended December 31, 2008, respectively.

## Restructuring Charges

Costs associated with exit or disposal activities, including lease termination costs and certain employee severance costs associated with restructuring, plant closing or other activity, are recognized when they are incurred. In those geographies where we have either a formal severance plan or a history of consistently providing severance benefits representing a substantive plan, we recognize severance costs when they are both probable and reasonably estimable.

## Pension and Post-Retirement Benefit Obligations

We sponsor pension plans in various forms in several countries covering substantially all employees who meet eligibility requirements. Post-retirement benefit plans cover U.S. and Canadian employees for retirement medical costs. We employ a delayed recognition feature in measuring the costs of pension and post-retirement benefit plans. This requires 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 as components of net periodic benefit cost, except to the extent they may be offset by subsequent changes. At any point, changes that have been identified and quantified but not recognized as components of net periodic benefit cost, are recognized in Accumulated other comprehensive loss, net of tax.

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 delayed recognition requirement. 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).

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 discount rate is used to present value our future anticipated benefit obligations. In estimating our discount rate, we consider rates of return on high quality fixed-income investments included in various published bond indexes, adjusted to eliminate the effects of call provisions and differences in the timing and amounts of cash outflows related to the bonds, as well as, the expected timing of pension and other benefit payments. In the U.S. and the U.K., which comprise approximately 80% of our projected benefit obligation, we consider the Moody's Aa Corporate Bond Index and the International Index Company's iBoxx Sterling Corporate AA Cash Bond Index, respectively, in the determination of the appropriate discount rate assumptions. Refer to Note 14 – Employee Benefit Plans for further information.

# Notes to the Consolidated Financial Statements

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

Each year, the difference between the actual return on plan assets and the expected return on plan assets as well as increases or decreases in the benefit obligation as a result of changes in the discount rate are added to, or subtracted from, any cumulative actuarial gain or loss that arose in prior years. This resultant amount is the net actuarial gain or loss recognized in Accumulated other comprehensive loss and is subject to subsequent amortization to net periodic pension cost in future periods over the remaining service lives of the employees participating in the pension plan.

## 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 average exchange rates for the applicable period. The translation adjustments are recorded in Accumulated other comprehensive loss. 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 \$34, \$8 and \$39 in 2008, 2007 and 2006, respectively, and are included in Other expenses, net in the accompanying Consolidated Statements of Income.

## Accumulated Other Comprehensive Loss ("AOCL")

AOCL is composed of the following for the three years ending December 31, 2008:

	December 31,		
	2008	2007	2006
<b>Income (loss):</b>			
Cumulative translation adjustments	\$(1,395)	\$ (31)	\$ (532)
Benefit plans net actuarial losses and prior service credits (includes our share of Fuji Xerox)	(1,021)	(735)	(1,097)
Minimum pension liabilities	—	—	(20)
Other unrealized gains	—	1	2
<b>Total Accumulated Other Comprehensive Loss</b>	<b>\$(2,416)</b>	<b>\$(765)</b>	<b>\$(1,647)</b>

## Note 2 – Segment Reporting

Our reportable segments are consistent with how we manage the business and view the markets we serve. Our reportable segments are Production, Office and Other. The Production and Office segments are centered around strategic product groups which share common technology, manufacturing and product platforms, as well as classes of customers.

The Production segment includes black-and-white products which operate at speeds over 90 pages per minute ("ppm") excluding 95 ppm with an embedded controller and color products which operate at speeds over 40 ppm excluding 50, 60 and 70 ppm products with an embedded controller. Products include the Xerox iGen3 and iGen4 digital color production press, Xerox Nuvera®, DocuTech®, DocuPrint® and DocuColor families, as well as older technology light-lens products. These products are sold predominantly through direct sales channels to Fortune 1000, graphic arts, government, education and other public sector customers.

The Office segment includes black-and-white products which operate at speeds up to 90 ppm as well as 95 ppm with an embedded controller and color products up to 40 ppm as well as 50, 60 and 70 ppm products with an embedded controller. Products include the suite of CopyCentre®, WorkCentre®, WorkCentre Pro and Phaser® digital multifunction systems, DocuColor color multifunction products, color laser, solid ink color printers and multifunction devices, monochrome laser desktop printers, digital and light-lens copiers and facsimile products and non-Xerox branded products with similar specifications. These products are sold through direct and indirect sales channels to global, national and mid-size commercial customers as well as government, education and other public sector customers. Approximately 75% of Global Imaging Systems' ("GIS") revenue is included in our Office segment representing those sales and services that align to our Office segment.

The segment classified as Other includes several units, none of which met the thresholds for separate segment reporting. This group primarily includes Xerox Supplies Business Group (predominantly paper sales), value-added services, Wide Format Systems, Xerox Technology Enterprises, royalty and licensing revenues, GIS network integration solutions and electronic presentation systems, equity net income and non-allocated Corporate items. Other segment profit (loss) includes the operating results from these entities, other less significant businesses, our equity income from Fuji Xerox, and certain costs which have not been allocated to the Production and Office segments, including non-financing interest as well as other items included in Other expenses, net.

# Notes to the Consolidated Financial Statements

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

Selected financial information for our Operating segments for each of the years ended December 31, 2008, 2007 and 2006, respectively, was as follows:

	Production	Office	Other	Total
<b>2008<sup>(1)</sup></b>				
Revenues	\$4,937	\$9,347	\$2,526	\$16,810
Finance income	300	481	17	798
<b>Total Segment Revenues</b>	<b>\$5,237</b>	<b>\$9,828</b>	<b>\$2,543</b>	<b>\$17,608</b>
Interest expense	\$ 117	\$ 181	\$ 269	\$ 567
Segment profit (loss) <sup>(2)</sup>	394	1,062	(165)	1,291
Equity in net income of unconsolidated affiliates	\$ —	\$ —	\$ 113	\$ 113
<b>2007<sup>(1)</sup></b>				
Revenues	\$5,001	\$8,980	\$2,425	\$16,406
Finance income	314	493	15	822
<b>Total Segment Revenues</b>	<b>\$5,315</b>	<b>\$9,473</b>	<b>\$2,440</b>	<b>\$17,228</b>
Interest expense	\$ 123	\$ 186	\$ 270	\$ 579
Segment profit (loss) <sup>(2)</sup>	562	1,115	(89)	1,588
Equity in net income of unconsolidated affiliates	\$ —	\$ —	\$ 97	\$ 97
<b>2006<sup>(1)</sup></b>				
Revenues	\$4,735	\$8,207	\$2,113	\$15,055
Finance income	320	505	15	840
<b>Total Segment Revenues</b>	<b>\$5,055</b>	<b>\$8,712</b>	<b>\$2,128</b>	<b>\$15,895</b>
Interest expense	\$ 119	\$ 181	\$ 244	\$ 544
Segment profit (loss) <sup>(2)</sup>	504	1,010	(124)	1,390
Equity in net income of unconsolidated affiliates	\$ —	\$ —	\$ 114	\$ 114

<sup>(1)</sup> Asset information on a segment basis is not disclosed as this information is not separately identified and internally reported to our chief executive officer.

<sup>(2)</sup> Depreciation and amortization expense is recorded in cost of sales, research, development and engineering expenses and selling, administrative and general expenses and is included in the segment profit above. This information is neither identified nor internally reported to our chief executive officer. 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.

# Notes to the Consolidated Financial Statements

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

The following is a reconciliation of segment profit to pre-tax income:

	Year Ended December 31,		
	2008	2007	2006
<b>Total Segment profit</b>	<b>\$1,291</b>	\$ 1,588	\$ 1,390
Reconciling items:			
Restructuring and asset impairment charges	(429)	6	(385)
Restructuring charges of Fuji Xerox	(16)	(30)	—
Litigation matters <sup>(1)</sup>	(774)	—	(68)
Equipment write-off	(39)	—	—
Equity in net income of unconsolidated affiliates	(113)	(97)	(114)
Other	(34)	(29)	(15)
<b>Pre-tax (loss) income</b>	<b>\$ (114)</b>	<b>\$ 1,438</b>	<b>\$ 808</b>

<sup>(1)</sup> The 2008 provision for litigation represents \$670 for the *Carlson v. Xerox Corporation* court approved settlement, as well as provisions for other litigation matters including \$36 for the probable loss related to the Brazil labor related contingencies. The 2006 provision for litigation represents \$68 related to probable losses on Brazilian labor-related contingencies. Refer to Note 16 – Contingencies for further discussion.

Geographic area data is based upon the location of the subsidiary reporting the revenue or long-lived assets and is as follows:

	Revenues			Long-Lived Assets <sup>(1)</sup>		
	2008	2007	2006	2008	2007	2006
United States	\$ 9,122	\$ 9,078	\$ 8,406	\$ 1,386	\$ 1,375	\$ 1,309
Europe	6,011	5,888	5,378	680	746	572
Other Areas	2,475	2,262	2,111	248	341	356
<b>Total</b>	<b>\$17,608</b>	<b>\$17,228</b>	<b>\$15,895</b>	<b>\$2,314</b>	<b>\$2,462</b>	<b>\$2,237</b>

<sup>(1)</sup> Long-lived assets are comprised of (i) land, buildings and equipment, net, (ii) equipment on operating leases, net, (iii) internal use software, net and (iv) capitalized software costs, net.

## Note 3 – Acquisitions

### Veenman B.V.

In June 2008, we acquired Veenman B.V. (“Veenman”), expanding our reach into the small and mid-sized business market in Europe, for approximately \$69 (€44 million) in cash, including transaction costs. Veenman is the Netherlands’ leading independent distributor of office printers, copiers and multifunction devices serving small and mid-size businesses. The operating results of Veenman are not material to our financial statements, and are included within our Office segment from the date of acquisition. The purchase price was primarily allocated to intangible assets and goodwill based on third-party valuations and management’s estimates.

### Global Imaging Systems, Inc.

In 2007, we acquired GIS, a provider of office technology for small and mid-size businesses in the United States. The acquisition of GIS expanded our access to the U.S. small and mid-size business market. The aggregate purchase price was approximately \$1.5 billion. In addition, in connection with the closing, we also repaid \$200 of GIS’s then outstanding bank debt. The results of operations for GIS are included in our Consolidated Statements of

Income as of May 9, 2007. Refer to Note 2 – Segment Reporting for a discussion of the segment classification of GIS.

The total cost of the acquisition has been allocated to the assets acquired and the liabilities assumed based on their respective estimated fair values. Goodwill of \$1,335 and intangible assets of \$363 were recorded in connection with the acquisition based on third-party valuations and management’s estimates for those acquired intangible assets. The majority of the goodwill is not deductible for tax purposes and the primary elements that generated goodwill are the value of the acquired assembled workforce, specialized processes and procedures and operating synergies, none of which qualify as a separate intangible asset. Intangible assets included customer relationships of \$189 with a 12 year weighted average useful life and tradenames of \$174 with a 20 year weighted average useful life.

The unaudited pro forma results presented below include the effects of the GIS acquisition as if it had been consummated as of January 1, 2006. The pro forma results include the amortization associated with the estimated value of acquired intangible assets and interest expense associated with debt used to fund the acquisition. However, pro forma results do not include any anticipated synergies or other expected benefits of the acquisition.

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Accordingly, the unaudited pro forma financial information below is not necessarily indicative of either future results of operations or results that might have been achieved had the acquisition been consummated as of January 1, 2006.

	Year Ended December 31,	
	2007	2006
Revenue	\$17,619	\$16,992
Net income	1,139	1,222
Basic earnings per share	1.22	1.26
Diluted earnings per share	1.20	1.23

## GIS Acquisitions

In May 2008, GIS acquired Saxon Business Systems, an office equipment supplier in Florida, for approximately \$69 in cash, including transaction costs. GIS acquired three other similar businesses in 2008 for a total of \$17 in cash. In 2007, GIS acquired four businesses that provide office-imaging solutions and related services for \$39 in cash. These acquisitions continue GIS's development of a national network of office technology suppliers to serve its expanding base of small and mid-size businesses. The operating results of these acquired entities are not material to our financial statements and are included within our Office segment from the date of acquisition. The purchase prices were primarily allocated to intangible assets and goodwill based on third-party valuations and management's estimates.

## Advectis, Inc.

In 2007, we acquired Advectis, Inc. ("Advectis"), a privately-owned provider of a web-based solution to electronically manage the process needed to underwrite, audit, collaborate, deliver and archive mortgage loan documents, for \$30 in cash. The operating results of Advectis are not material to our financial statements, and are included within our Other segment from the date of acquisition. The purchase price was primarily allocated to intangible assets and goodwill based on management's estimates.

## XMPie, Inc.

In 2006, we acquired the stock of XMPie, Inc. ("XMPie"), a provider of variable information software, for \$54 in cash, including transaction costs. XMPie's software enables printers and marketers to create and print personalized and customized marketing materials to help improve response rates. We had an existing relationship with XMPie, as its largest reseller, and its software is primarily sold together with our Production systems including the iGen3.

The operating results of XMPie are not material to our financial statements, and are included within our Production segment from

the date of acquisition. The purchase price was primarily allocated to intangible assets and goodwill based on third-party valuations and management's estimates.

## Amici LLC

In 2006, we acquired all of the net assets of Amici LLC ("Amici"), a provider of electronic-discovery (e-discovery) services, for \$175 in cash, including transaction costs. Amici provides comprehensive litigation discovery management services, including the conversion, hosting and production of electronic and hardcopy documents. Amici also provides consulting and professional services to assist attorneys in the discovery process. The operating results of Amici were not material to our financial statements and are included within our Other segment from the date of acquisition.

The purchase price was allocated to Net assets \$2, Intangible assets \$37 (consisting of customer relationships of \$29 and software of \$8), and Goodwill of \$136. The primary elements that generated the Goodwill are the value of synergies and the acquired assembled workforce, neither of which qualify as a separate intangible asset. The allocations were based on third-party valuations and management's estimates.

## Note 4 – 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. Finance receivables, net at December 31, 2008 and 2007 were as follows:

	2008	2007
Gross receivables	\$ 8,718	\$ 9,643
Unearned income	(1,273)	(1,461)
Residual values	31	69
Allowance for doubtful accounts	(198)	(203)
Finance receivables, net	7,278	8,048
Less: Billed portion of finance receivables, net	(254)	(304)
Current portion of finance receivables not billed, net	(2,461)	(2,693)
Amounts due after one year, net	\$ 4,563	\$ 5,051

Contractual maturities of our gross finance receivables as of December 31, 2008 were as follows (including those already billed of \$254:

2009	2010	2011	2012	2013	Thereafter	Total
\$3,288	\$2,414	\$1,690	\$953	\$335	\$38	\$8,718

# Notes to the Consolidated Financial Statements

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

## Secured Borrowings

We have an agreement in the U.S. (the "Loan Agreement") under which General Electric Capital Corporation, a subsidiary of GE, provides secured funding for our customer leasing activities in the U.S. The maximum potential level of borrowing under this agreement is a function of the size of the portfolio of finance receivables generated by us that meet GE's funding requirements and cannot exceed \$5 billion.

Under this agreement, lease originations to be funded by GE are transferred to a wholly-owned consolidated subsidiary. The funds received under this agreement are recorded as secured borrowings and together with the associated lease receivables are included in our Consolidated Balance Sheet. We and GE intended for the transfers of the lease contracts to be "true sales at law" and that the wholly-owned consolidated subsidiary be bankruptcy remote and have received opinions to that effect from outside legal counsel. As a result, the transferred receivables are not available to satisfy any of our other obligations. The final funding date for the U.S. facility is December 2010. There have been no new borrowings under the Loan Agreement since December 2005.

As of December 31, 2008 and 2007, net encumbered finance receivables were \$104 and \$377, respectively, and secured debt associated with those receivables was \$56 and \$275, respectively.

## Accounts Receivable Sales Arrangements

We have a facility in Europe that enables us to sell, on an on-going basis, certain accounts receivables without recourse to a third-party. During 2008 and 2007, we sold approximately \$717 and \$326, respectively, of accounts receivables under this facility. Fees associated with these sales were \$4 and \$2, respectively. Of the amounts sold, \$178 and \$170 remained uncollected by the third-party as of December 31, 2008 and 2007, respectively. In the fourth quarter of 2008, we also sold an additional \$43 of accounts receivable in Europe without recourse under a separate one-time factoring arrangement.

## Note 5 – Inventories and Equipment on Operating Leases, Net

Inventories at December 31, 2008 and 2007 were as follows:

	2008	2007
Finished goods	\$1,044	\$1,099
Work-in-process	80	70
Raw materials	108	136
<b>Total Inventories</b>	<b>\$1,232</b>	<b>\$1,305</b>

The transfer of equipment from our inventories to equipment subject to an operating lease is presented in our Consolidated

Statements of Cash Flows in the operating activities section as a non-cash adjustment. 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. We recorded \$115, \$66 and \$69 in inventory write-down charges for the years ended December 31, 2008, 2007 and 2006, respectively.

Equipment on operating leases and the related accumulated depreciation at December 31, 2008 and 2007 were as follows:

	2008	2007
Equipment on operating leases	\$1,507	\$1,435
Less: Accumulated depreciation	(913)	(848)
<b>Equipment on operating leases, net</b>	<b>\$ 594</b>	<b>\$ 587</b>

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 for equipment on operating leases was \$298, \$269 and \$230 for the years ended December 31, 2008, 2007 and 2006, 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:

2009	2010	2011	2012	2013	Thereafter
\$380	\$282	\$183	\$86	\$38	\$21

Total contingent rentals on operating leases, consisting principally of usage charges in excess of minimum contracted amounts, for the years ended December 31, 2008, 2007 and 2006 amounted to \$117, \$117 and \$112, respectively.

## Note 6 – Land, Buildings and Equipment, Net

Land, buildings and equipment, net at December 31, 2008 and 2007 were as follows:

	Estimated Useful Lives (Years)	2008	2007
Land		\$ 45	\$ 48
Buildings and building equipment	25 to 50	1,156	1,208
Leasehold improvements	Varies	372	371
Plant machinery	5 to 12	1,597	1,710
Office furniture and equipment	3 to 15	973	998
Other	4 to 20	100	86
Construction in progress	—	95	88
Subtotal		4,338	4,509
Less: Accumulated depreciation		(2,919)	(2,922)
<b>Land, buildings and equipment, net</b>		<b>\$ 1,419</b>	<b>\$ 1,587</b>

# Notes to the Consolidated Financial Statements

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

Depreciation expense and operating lease rent expense for the three years ended December 31, 2008 were as follows:

	2008	2007	2006
Depreciation expense	\$257	\$262	\$277
Operating lease rent expense <sup>(1)</sup>	\$252	\$286	\$269

<sup>(1)</sup> We lease certain land, buildings and equipment, substantially all of which are accounted for as operating leases.

Future minimum operating lease commitments that have initial or remaining non-cancelable lease terms in excess of one year at December 31, 2008 were as follows:

2009	2010	2011	2012	2013	Thereafter
\$223	\$188	\$151	\$100	\$84	\$123

EDS Contract: We have an information management contract with Electronic Data Systems Corp. ("EDS") through June 30, 2009. Services to be provided under this contract include support for global mainframe system processing, application maintenance, workplace and service desk, voice and data network management and server management. In 2008, the contracts for global mainframe system processing and workplace and service desk were extended through December 2013 and March 2014, respectively. In January 2009, the contract for voice and data network management services was revised and extended through March 2014. There are no minimum payments required under this contract. The amounts disclosed in the table reflect our estimate of probable minimum payments for the periods shown. We can terminate the contract for convenience with six months notice, as defined in the contract, with no termination fee and with payment to EDS for costs incurred as of the termination date. Should we terminate the contract for convenience, we have an option to purchase the assets placed in service under the EDS contract. Payments to EDS, which are primarily recorded in selling, administrative and general expenses, were \$279, \$294 and \$288 for the years ended December 31, 2008, 2007 and 2006, respectively.

In January 2009, we entered into a three year contract with Verizon Business to provide data network transport services. There are annual volume commitments included in the contract of \$5, \$7 and \$8 for the three years ended December 31, 2009, 2010 and 2011. We expect to meet the minimum volume commitments throughout the course of the contract.

## Note 7 – Investments in Affiliates, at Equity

Investments in corporate joint ventures and other companies in which we generally have a 20% to 50% ownership interest at December 31, 2008 and 2007 were as follows:

	2008	2007
Fuji Xerox	\$1,028	\$887
All other equity investments	52	45
<b>Investments in affiliates, at equity</b>	<b>\$1,080</b>	<b>\$932</b>

Fuji Xerox is headquartered in Tokyo and operates in Japan, China, Australia, New Zealand and other areas of the Pacific Rim. Our investment in Fuji Xerox of \$1,028 at December 31, 2008, differs from our implied 25% interest in the underlying net assets, or \$1,139, due primarily to our deferral of gains resulting from sales of assets by us to Fuji Xerox, partially offset by goodwill related to the Fuji Xerox investment established at the time we acquired our remaining 20% of Xerox Limited from The Rank Group plc.

Our equity in net income of our unconsolidated affiliates for the three years ended December 31, 2008 was as follows:

	2008	2007	2006
Fuji Xerox	\$101	\$89	\$107
Other investments	12	8	7
<b>Total</b>	<b>\$113</b>	<b>\$97</b>	<b>\$114</b>

Equity in net income of Fuji Xerox is affected by certain adjustments to reflect the deferral of profit associated with intercompany sales. These adjustments may result in recorded equity income that is different than that implied by our 25% ownership interest. Equity income for 2008 and 2007 includes after-tax restructuring charges of \$16 and \$30, respectively, primarily reflecting employee related costs as part of Fuji Xerox's continued cost-reduction actions to improve its competitive position.

# Notes to the Consolidated Financial Statements

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

Condensed financial data of Fuji Xerox for the three calendar years ended December 31, 2008 was as follows:

	2008	2007	2006
<b>Summary of Operations</b>			
Revenues	\$11,190	\$10,218	\$9,859
Costs and expenses	10,451	9,565	9,119
Income before income taxes	739	653	740
Income taxes	287	252	281
Minorities' interests	7	6	5
<b>Net income</b>	<b>\$ 445</b>	<b>\$ 395</b>	<b>\$ 454</b>
<b>Balance Sheet</b>			
Assets:			
Current assets	\$ 4,734	\$ 4,242	\$3,731
Long-term assets	5,470	4,639	4,184
<b>Total Assets</b>	<b>\$10,204</b>	<b>\$ 8,881</b>	<b>\$7,915</b>
Liabilities and Shareholders' Equity:			
Current liabilities	\$ 3,534	\$ 3,322	\$2,954
Long-term debt	996	900	685
Other long-term liabilities	1,095	746	590
Minorities' interests in equity of subsidiaries	23	25	21
Shareholders' equity	4,556	3,888	3,665
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$10,204</b>	<b>\$ 8,881</b>	<b>\$7,915</b>

Yen/U.S. Dollar exchange rates used to translate above are as follows:

	Exchange Basis	2008	2007	2006
Summary of Operations	Weighted Average Rate	103.31	117.53	116.36
Balance Sheet	Year-End Rate	90.28	112.55	118.89

In 2008, 2007 and 2006, we received dividends of \$56, \$37 and \$41, respectively, which were reflected as a reduction in our investment. Additionally, we have a technology agreement with Fuji Xerox whereby we receive royalty payments for their use of our Xerox brand trademark, as well as rights to access their patent portfolio in exchange for access to our patent portfolio.

In 2008, 2007 and 2006, we earned royalty revenues under our Technology Agreement of \$112, \$108 and \$117, respectively, which are included in Service, outsourcing and rental revenues in the Consolidated Statements of Income. We also 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. 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, 2008 were as follows:

	2008	2007	2006
Sales	\$ 162	\$ 186	\$ 168
Purchases	\$2,150	\$1,946	\$1,677

In addition to the amounts described above, in 2008, 2007 and 2006, we paid Fuji Xerox \$34, \$30 and \$28, respectively, and Fuji Xerox paid us \$5, \$3 and \$3, in 2008, 2007 and 2006, respectively, for unique research and development. As of December 31, 2008 and 2007, amounts due to Fuji Xerox were \$194 and \$205, respectively.

# Notes to the Consolidated Financial Statements

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

## Note 8 – Goodwill and Intangible Assets, Net

### Goodwill

The following table presents the changes in the carrying amount of goodwill, by reportable segment, for the three years ended December 31, 2008:

	Production	Office	Other	Total
<b>Balance at December 31, 2005</b>	<b>\$ 745</b>	<b>\$ 807</b>	<b>\$ 119</b>	<b>\$1,671</b>
Foreign currency translation adjustment	99	69	1	169
Acquisition of Amici LLC	—	—	136	136
Acquisition of XMPie, Inc.	48	—	—	48
<b>Balance at December 31, 2006</b>	<b>\$ 892</b>	<b>\$ 876</b>	<b>\$ 256</b>	<b>\$2,024</b>
Foreign currency translation adjustment	21	17	—	38
Acquisition of GIS	—	1,218	105	1,323
Acquisition of Advector, Inc.	—	—	26	26
GIS Acquisitions	—	30	3	33
Other	—	—	4	4
<b>Balance at December 31, 2007</b>	<b>\$ 913</b>	<b>\$2,141</b>	<b>\$ 394</b>	<b>\$3,448</b>
Foreign currency translation adjustment	(233)	(161)	(1)	(395)
Acquisition of Veenman B.V.	—	44	—	44
GIS acquisitions	—	73	—	73
Purchase Price allocation adjustment – GIS	—	120	(108)	12
<b>Balance at December 31, 2008</b>	<b>\$ 680</b>	<b>\$2,217</b>	<b>\$ 285</b>	<b>\$3,182</b>

In 2008, we finalized the GIS purchase price allocation. As a result, the \$108 of Goodwill reflected in our Other segment in 2007 was reallocated to our Office segment. This adjustment aligned goodwill to the reporting unit benefiting from the synergies of the purchase.

### Intangible Assets, Net

Intangible assets primarily relate to the Office operating segment. Intangible assets were comprised of the following as of December 31, 2008 and 2007:

	Weighted Average Amortization Period	December 31, 2008			December 31, 2007		
		Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Customer base	14 years	\$492	\$155	\$337	\$462	\$118	\$344
Distribution network	25 years	123	44	79	123	39	84
Trademarks	20 years	191	15	176	175	6	169
Technology, patents and non-compete	6 years	40	22	18	39	15	24
<b>Total</b>		<b>\$846</b>	<b>\$236</b>	<b>\$610</b>	<b>\$799</b>	<b>\$178</b>	<b>\$621</b>

Amortization expense related to intangible assets was \$58, \$46, and \$45 for the years ended December 31, 2008, 2007 and 2006, respectively, and, excluding the impact of additional acquisitions, is expected to approximate \$58 annually from 2009 through 2013. Amortization expense is primarily recorded in Other expenses, net, with the exception of amortization expense associated with licensed technology, which is recorded in Cost of sales and Cost of service, outsourcing and rentals, as appropriate.

# Notes to the Consolidated Financial Statements

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

## Note 9 – Restructuring and Asset Impairment Charges

The net restructuring and asset impairment charges in the Consolidated Statements of Income totaled \$429, \$(6) and \$385 in 2008, 2007 and 2006, respectively. Detailed information related to restructuring program activity during the three years ended December 31, 2008 is outlined below:

Restructuring Activity	Severance and Related Costs	Lease Cancellation and Other Costs	Asset Impairments <sup>(1)</sup>	Total
<b>Balance December 31, 2005</b>	<b>\$ 217</b>	<b>\$ 19</b>	<b>\$ —</b>	<b>\$ 236</b>
Restructuring provision	351	39	30	420
Reversals of prior accruals	(33)	(2)	—	(35)
Net current year charges <sup>(2)</sup>	318	37	30	385
Charges against reserve and currency	(242)	(12)	(30)	(284)
<b>Balance December 31, 2006</b>	<b>\$ 293</b>	<b>\$ 44</b>	<b>\$ —</b>	<b>\$ 337</b>
Restructuring provision	27	7	1	35
Reversals of prior accruals	(38)	(3)	—	(41)
Net current year charges <sup>(2)</sup>	(11)	4	1	(6)
Charges against reserve and currency	(211)	(10)	(1)	(222)
<b>Balance December 31, 2007</b>	<b>\$ 71</b>	<b>\$ 38</b>	<b>\$ —</b>	<b>\$ 109</b>
<b>Restructuring provision</b>	<b>363</b>	<b>20</b>	<b>53</b>	<b>436</b>
<b>Reversals of prior accruals</b>	<b>(6)</b>	<b>(1)</b>	<b>—</b>	<b>(7)</b>
<b>Net current year charges<sup>(2)</sup></b>	<b>357</b>	<b>19</b>	<b>53</b>	<b>429</b>
<b>Charges against reserve and currency</b>	<b>(108)</b>	<b>(25)</b>	<b>(53)</b>	<b>(186)</b>
<b>Balance December 31, 2008<sup>(3)</sup></b>	<b>\$ 320</b>	<b>\$ 32</b>	<b>\$ —</b>	<b>\$ 352</b>

<sup>(1)</sup> Charges associated with asset impairments represent the write-down of the related assets to their new cost basis and are recorded concurrently with the recognition of the provision.

<sup>(2)</sup> Represents amount recognized within the Consolidated Statements of Income for the years shown.

<sup>(3)</sup> We expect to utilize the majority of the December 31, 2008 restructuring balance in 2009.

# Notes to the Consolidated Financial Statements

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

## Reconciliation to Consolidated Statements of Cash Flows

	Year Ended December 31,		
	2008	2007	2006
Charges to reserve	<b>\$(186)</b>	\$(222)	\$(284)
Asset impairments	<b>53</b>	1	30
Effects of foreign currency and other non-cash items	<b>2</b>	(14)	(11)
<b>Cash payments for restructurings</b>	<b>\$(131)</b>	<b>\$(235)</b>	<b>\$(265)</b>

The following table summarizes the total amount of costs incurred in connection with these restructuring programs by segment for the three years ended December 31, 2008:

	2008	2007	2006
Production	<b>\$190</b>	\$(6)	\$147
Office	<b>200</b>	3	138
Other	<b>39</b>	(3)	100
<b>Total net charges</b>	<b>\$429</b>	<b>\$(6)</b>	<b>\$385</b>

Over the past several years we have engaged in a series of restructuring programs related to downsizing our employee base, exiting certain activities, outsourcing certain internal functions and engaging in other actions designed to reduce our cost structure and improve productivity. These initiatives primarily include severance actions and impact all major geographies and segments. Management continues to evaluate our business and, therefore, there may be additional provisions 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 also incurred in connection with these restructuring actions for those assets made obsolete as a result of these programs.

### 2008 Activity

During 2008, we recorded \$357 of net restructuring charges predominantly consisting of severance and costs related to the elimination of approximately 4,900 positions primarily in both North America and Europe. Focus areas for the actions include the following:

- Improving efficiency and effectiveness of infrastructure including: marketing, finance, human resources & training.
- Capturing efficiencies in technical services, managed services and supply chain & manufacturing infrastructure.
- Optimizing product development and engineering resources.

In addition, related to these activities, we also recorded lease cancellation and other costs of \$19 and asset impairment charges of \$53. The lease termination and asset impairment charges

primarily related to: (i) the relocation of certain manufacturing operations including the closing of our toner plant in Oklahoma City and the consolidation of our manufacturing operations in Ireland; and (ii) the exit from certain leased and owned facilities as a result of the actions noted above.

### 2007 Activity

Restructuring activity was minimal in 2007 and the related charges primarily reflected changes in estimates in severance costs from previously recorded actions.

### 2006 Activity

The 2006 charges primarily relate to the elimination of approximately 3,400 positions primarily in North America and Europe. The actions associated with these charges primarily include the following: technical and professional services infrastructure and global back-office optimization; continued R&D efficiencies and productivity improvements; supply chain optimization to ensure, for example, alignment to our global two-tier model implementation; and selected off-shoring opportunities. The lease termination and asset impairment charges primarily related to the relocation of certain manufacturing operations as well as an exit from certain leased and owned facilities. These charges were offset by reversals of \$35 primarily related to changes in estimates in severance costs from previously recorded actions.

## Note 10 – Supplementary Financial Information

The components of other current assets and other current liabilities at December 31, 2008 and 2007 were as follows:

	2008	2007
<b>Other current assets</b>		
Deferred taxes	<b>\$ 305</b>	\$ 200
Restricted cash	<b>20</b>	45
Prepaid expenses	<b>119</b>	120
Financial derivative instruments	<b>39</b>	27
Other	<b>307</b>	290
<b>Total Other current assets</b>	<b>\$ 790</b>	<b>\$ 682</b>
<b>Other current liabilities</b>		
Income taxes payable	<b>\$ 47</b>	\$ 84
Other taxes payable	<b>173</b>	179
Interest payable	<b>141</b>	137
Restructuring reserves	<b>325</b>	81
Unearned income	<b>203</b>	242
Financial derivative instruments	<b>134</b>	30
Product warranties	<b>25</b>	25
Dividends payable	<b>38</b>	40
Other	<b>683</b>	694
<b>Total Other current liabilities</b>	<b>\$1,769</b>	<b>\$1,512</b>

# Notes to the Consolidated Financial Statements

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

The components of other long-term assets and other long-term liabilities at December 31, 2008 and 2007 were as follows:

	2008	2007
<b>Other long-term assets</b>		
Prepaid pension costs	\$ 61	\$ 322
Net investment in discontinued operations <sup>(1)</sup>	259	277
Internal use software, net	288	270
Restricted cash	183	219
Debt issuance costs, net	48	47
Other	318	293
<b>Total Other long-term assets</b>	<b>\$1,157</b>	<b>\$1,428</b>
<b>Other long-term liabilities</b>		
Deferred and other tax liabilities	\$ 182	\$ 250
Minorities' interests in equity of subsidiaries	120	103
Financial derivative instruments	—	14
Other	392	429
<b>Total Other long-term liabilities</b>	<b>\$ 694</b>	<b>\$ 796</b>

<sup>(1)</sup> At December 31, 2008, our net investment in discontinued operations primarily consists of a \$285 performance-based instrument relating to the 1997 sale of The Resolution Group ("TRG") net of remaining net liabilities associated with our discontinued operations of \$26. The recovery of the performance-based instrument is dependent on the sufficiency of TRG's available cash flows, as guaranteed by TRG's ultimate parent, which are expected to be recovered in annual cash distributions through 2017.

## Note 11 – Debt

Short-term borrowings at December 31, 2008 and 2007 were as follows:

	2008	2007
Current maturities of long-term debt	\$1,549	\$426
Notes payable	7	18
France Bridge Facility due 2008	—	81
Italy Credit Facility due 2009	54	—
<b>Total</b>	<b>\$1,610</b>	<b>\$525</b>

We classify our debt based on the contractual maturity dates of the underlying debt instruments or as of the earliest put date available to the debt holders. We defer costs associated with debt issuance over the applicable term or to the first put date, in the case of convertible debt or debt with a put feature. These costs are amortized as interest expense in our Consolidated Statements of Income.

# Notes to the Consolidated Financial Statements

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

Long-term debt at December 31, 2008 and 2007 was as follows:

	Weighted Average Interest Rates at December 31, 2008	2008	2007
<b>U.S. Operations</b>			
Xerox Corporation			
Notes due 2008	—	\$ —	\$ 2
Notes due 2011	2.83%	1	—
Senior Notes due 2009	10.75%	583	600
Euro Senior Notes due 2009	10.62%	317	330
Floating Senior Notes due 2009	2.60%	150	150
Senior Notes due 2010	7.13%	700	700
Notes due 2011	7.01%	50	50
Senior Notes due 2011	6.59%	750	750
Credit Facility due 2012	2.21%	246	600
Senior Notes due 2012	5.59%	1,100	1,100
Senior Notes due 2013	5.65%	400	—
Senior Notes due 2013	7.63%	550	550
Convertible Notes due 2014	9.00%	19	19
Notes due 2016	7.20%	250	250
Senior Notes due 2016	6.48%	700	700
Senior Notes due 2017	6.83%	500	500
Senior Notes due 2018	6.37%	1,000	—
Zero Coupon Notes due 2022	5.77%	433	409
Zero Coupon Notes due 2023	5.41%	253	—
Subtotal		\$ 8,002	\$ 6,710
<b>Xerox Credit Corporation</b>			
Notes due 2012	—	—	25
Notes due 2013	6.42%	10	60
Notes due 2014	6.06%	50	50
Notes due 2018	—	—	25
Subtotal		\$ 60	\$ 160
Other U.S. Operations			
Borrowings secured by finance receivables <sup>(1)</sup>	5.59%	56	275
Borrowings secured by other assets	10.34%	6	8
Subtotal		\$ 62	\$ 283
Total U.S. Operations		\$ 8,124	\$ 7,153
<b>International Operations</b>			
Euro Bank Facility due 2008	—	—	177
Other debt due 2009-2010	4.12%	16	36
Total International Operations		\$ 16	\$ 213
Principal debt balance		8,140	7,366
Less: Unamortized discount		(6)	(13)
Add: SFAS No. 133 fair value adjustments <sup>(2)</sup>		189	12
Total Debt		8,323	7,365
Less current maturities		(1,549)	(426)
<b>Total Long-term debt</b>		<b>\$ 6,774</b>	<b>\$ 6,939</b>

<sup>(1)</sup> Refer to Note 4 – Receivables, Net for further discussion of borrowings secured by finance receivables, net.

<sup>(2)</sup> SFAS No. 133 fair value adjustments represent changes in the fair value of hedged debt obligations attributable to movements in benchmark interest rates. SFAS No. 133 requires hedged debt instruments to be reported at an amount equal to the sum of their carrying value (principal value plus/minus premiums/discounts) and any fair value adjustment.

# Notes to the Consolidated Financial Statements

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

Scheduled payments due on long-term debt for the next five years and thereafter are as follows:

2009	2010	2011	2012	2013	Thereafter	Total
\$1,549 <sup>(1)</sup>	\$962	\$802	\$1,169	\$1,138	\$2,520	\$8,140

<sup>(1)</sup> Quarterly total debt maturities for 2009 are \$937, \$12, \$442 and \$158 for the first, second, third and fourth quarters, respectively.

The zero coupon notes of \$433 due 2022 and \$253 due 2023 are included in the above maturity schedule based on the year of their first potential put date of 2009 and 2010, respectively.

## Credit Facility

The borrowing capacity under our \$2 billion Credit Facility was \$1.7 billion at December 31, 2008, reflecting \$246 outstanding borrowings and no outstanding letters of credit.

In February 2008, we exercised our right to request a one-year extension of the maturity date of the Credit Facility. Lenders representing approximately \$1.4 billion (or approximately 70%) agreed to the extension and the portion represented by these Lenders now has a maturity date of April 30, 2013, with the remaining portion of the Credit Facility to mature on April 30, 2012.

The Credit Facility is available, without sublimit, to certain of our qualifying subsidiaries and includes provisions that would allow us to increase the overall size of the Credit Facility up to an aggregate amount of \$2.5 billion. Our obligations under the Credit Facility are unsecured and are not currently guaranteed by any of our subsidiaries. In the event that any of our subsidiaries borrows under the Credit Facility, its borrowings thereunder would be guaranteed by us.

In October 2008, we amended our Credit Facility to increase the permitted leverage ratio (debt/consolidated EBITDA) and modify the pricing on borrowings. The following description of the key terms and conditions of the Credit Facility reflect the changes from the amendment.

Borrowings under the Credit Facility bear interest at LIBOR plus an all-in spread that will vary between 1.25% and 4.00% subject to our credit rating and our percentage utilization of the facility, in each case, at the time of borrowing. Based upon our current credit rating and utilization, the all-in spread was 1.75% as of December 31, 2008.

The Credit Facility contains various conditions to borrowing, and affirmative, negative and financial maintenance covenants. Certain of the more significant covenants are summarized below:

(a) Maximum leverage ratio (debt divided by consolidated EBITDA) calculated quarterly and at the date of each borrowing of 3.75.

(b) Minimum interest coverage ratio (a quarterly test that is calculated as consolidated EBITDA divided by consolidated interest expense) may not be less than 3.00:1.

(c) Limitations on (i) liens securing debt of Xerox and certain of our subsidiaries, (ii) certain fundamental changes to corporate structure, (iii) changes in nature of business and (iv) limitations on debt incurred by certain subsidiaries.

The Credit Facility also contains various events of default, the occurrence of which could result in a termination by the lenders and the acceleration of all our obligations under the Credit Facility. These events of default include, without limitation: (i) payment defaults, (ii) breaches of covenants under the Credit Facility (certain of which breaches do not have any grace period), (iii) cross-defaults and acceleration to certain of our other obligations and (iv) a change of control of Xerox.

## Private Placement Transaction

In September 2008, we issued \$250 of zero coupon notes in a private placement transaction. The bonds mature in 2023 and the final amount due at maturity is \$709. The bonds are putable annually at the option of the bond holder beginning in September 2010.

## Senior Notes Offerings

In April 2008, we issued \$400 of 5.65% senior notes due 2013 (the "2013 Senior Notes") at 99.996 percent of par and \$1.0 billion of 6.35% senior notes due 2018 (the "2018 Senior Notes") at 99.856 percent of par, resulting in net proceeds of approximately \$1,390. The 2013 Senior Notes accrue interest at the rate of 5.65% per annum, payable semiannually, and as a result of the discount, have a weighted average effective interest rate of 5.65%. The 2018 Senior Notes accrue interest at the rate of 6.35% per annum, payable semiannually, and as a result of the discount, have a weighted average effective interest rate of 6.37%. Debt issuance costs of approximately \$10 were deferred. The 2013 Senior Notes and 2018 Senior Notes are subordinated to our secured

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indebtedness and rank equally with our other existing senior unsecured indebtedness. Proceeds from the offering were used to repay borrowings under the Credit Facility and for general corporate purposes.

## Guarantees

At December 31, 2008, we have issued guarantees of \$139 to our foreign subsidiaries. Of this amount, \$67 is related to indebtedness of our foreign subsidiaries and is included in our Consolidated Balance Sheet as of December 31, 2008 with the remainder primarily representing letters of credit. In addition, as of December 31, 2008, \$55 of letters of credit have been issued in connection with insurance guarantees.

## Interest

Interest paid on our short-term debt, long-term debt and liabilities to subsidiary trusts issuing preferred securities amounted to \$527, \$552 and \$512 for the years ended December 31, 2008, 2007 and 2006, respectively.

Interest expense and interest income for the three years ended December 31, 2008 was as follows:

	2008	2007	2006
Interest expense <sup>(1)</sup>	\$567	\$579	\$544
Interest income <sup>(2)</sup>	\$833	\$877	\$909

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

<sup>(2)</sup> 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 an estimated cost of funds, applied against the estimated level of debt required to support our net finance receivables. The estimated cost of funds is based on a blended rate for term and duration comparable to available borrowing rates for a BBB rated company, which are reviewed at the end of each period. The estimated level of debt is based on an assumed 7 to 1 leverage ratio of debt/equity as compared to our average finance receivable balance during the applicable period.

Net cash proceeds on debt other than secured borrowings as shown on the Consolidated Statements of Cash Flows for the three years ended December 31, 2008 was as follows:

	2008	2007	2006
Cash payments on notes payable, net	\$ (238)	\$ (143)	\$ (19)
Net cash proceeds from issuance of long-term debt	1,883	2,254	1,502
Cash payments on long-term debt	(719)	(297)	(207)
<b>Net cash proceeds on other debt</b>	<b>\$ 926</b>	<b>\$1,814</b>	<b>\$1,276</b>

## Note 12 – Liability to Subsidiary Trust Issuing Preferred Securities

The Liability to Subsidiary Trust Issuing Preferred Securities included in our Consolidated Balance Sheets of \$648 and \$632 as of December 31, 2008 and 2007, respectively, reflects our obligations to Xerox Capital Trust I (“Trust I”) as a result of their loans to us from proceeds related to their issuance of preferred securities. This subsidiary is not consolidated in our financial statements because we are not the primary beneficiary of the trust.

In 1997, Trust I issued 650 thousand of 8.0% preferred securities (the “Preferred Securities”) to investors for \$644 (\$650 liquidation value) and 20,103 shares of common securities to us for \$20. With the proceeds from these securities, Trust I purchased \$670 principal amount of 8.0% Junior Subordinated Debentures due 2027 of the Company (“the Debentures”). The Debentures represent all of the assets of Trust I. On a consolidated basis, we received net proceeds of \$637 which was net of fees and discounts of \$13. Interest expense, together with the amortization of debt issuance costs and discounts, was \$54 in 2008, 2007 and 2006. We have guaranteed, on a subordinated basis, distributions and other payments due on the Preferred Securities. The guarantee, our obligations under the Debentures, 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 accrue and pay cash distributions semiannually at a rate of 8% per year of the stated liquidation amount of one thousand dollars per Preferred Security. 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.

## Note 13 – Financial Instruments

We are exposed to market risk from changes in foreign currency exchange rates and interest rates, which could affect operating results, financial position and cash flows. We manage our exposure to these market risks through our regular operating and financing activities and, when appropriate, through the use of derivative financial instruments. These derivative financial instruments are utilized to hedge economic exposures as well as to reduce earnings and cash flow volatility resulting from shifts in market rates. We enter into limited types of derivative contracts, including interest rate swap agreements, foreign currency spot, forward and swap contracts and net purchased foreign currency options to manage interest rate and foreign currency exposures. Our primary foreign

# Notes to the Consolidated Financial Statements

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currency market exposures include the Yen, Euro, and Pound Sterling. 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 changes in their values are offset by changes in the values of the underlying exposures. Derivative financial instruments are held solely as risk management tools and not for trading or speculative purposes.

We are required to recognize all derivative instruments as either assets or liabilities at fair value in the balance sheet. As permitted, certain of these derivative contracts have been designated for hedge accounting treatment. Certain of our derivatives that do not qualify for hedge accounting are effective as economic hedges. These derivative contracts are likewise required to be recognized each period at fair value and therefore do result in some level of volatility. The level of volatility will vary with the type and amount of derivative hedges outstanding, as well as fluctuations in the currency and interest rate market during the period. The related cash flow impacts of all of our derivative activities are reflected as cash flows from operating activities.

By their nature, all derivative instruments involve, to varying degrees, elements of market and credit risk. The market risk associated with these instruments resulting from currency exchange and interest rate movements is expected to offset the market risk of the underlying transactions, assets and liabilities being hedged. We do not believe there is significant risk of loss in the event of non-performance by the counterparties associated with these instruments because these transactions are executed with a diversified group of major financial institutions. Further, our policy is to deal with counterparties having a minimum investment grade or better credit rating. Credit risk is managed through the continuous monitoring of exposures to such counterparties.

## Interest Rate Risk Management

We use interest rate swap agreements to manage our interest rate exposure and to achieve a desired proportion of variable and fixed rate debt. These derivatives may be designated as fair value hedges or cash flow hedges depending on the nature of the risk being hedged.

## Fair Value Hedges

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current earnings. As of December 31, 2008 and 2007, pay variable/receive fixed interest rate swaps with notional amounts of \$675 and \$1.1 billion with a net asset (liability) fair value of \$53 and \$(6), respectively, were designated and accounted for as fair value hedges. The swaps were structured to hedge the fair value of related debt by converting them from fixed rate instruments to variable rate instruments. No ineffective portion was recorded to earnings during 2008, 2007, or 2006. The following is a summary of our fair value hedges at December 31, 2008:

Debt Instrument	Year First Designated	Notional Amount	Net Fair Value	Weighted Average Interest Rate Paid	Interest Rate Received	Basis	Maturity
Notes due 2016	2004	\$250	\$39	5.43 %	7.20 %	Libor	2016
Senior Notes due 2011	2004	125	8	5.28 %	6.88 %	Libor	2011
Liability to Capital Trust I	2005	300	6	5.64 %	8.00 %	Libor	2027
<b>Total</b>		<b>\$675</b>	<b>\$53</b>				

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## Cash Flow Hedges

During 2008, pay fixed/receive variable interest rate swaps with notional amounts of \$150 and a net liability fair value of \$2 were designated and accounted for as cash flow hedges. The swaps were structured to hedge the LIBOR interest rate of the floating Senior Notes due 2009 by converting it from a variable rate instrument to a fixed rate instrument. No ineffective portion was recorded to earnings during 2008 and all components of the derivative gain or loss was included in the assessment of hedged effectiveness.

## Terminated Swaps

During the period from 2004 to 2008, we terminated several interest rate swaps which had been designated as fair value hedges of certain debt instruments. These terminated interest rate swaps had an aggregate notional value of \$4.2 billion including \$1.6 billion terminated in 2008. The associated net fair value adjustments to the debt instruments are being amortized to interest expense over the remaining term of the related notes. In 2008, 2007 and 2006, the amortization of these fair value adjustments reduced interest expense by \$12, \$9 and \$9, respectively, and we expect to record a net decrease in interest expense of \$116 in future years through 2027.

## Foreign Exchange Risk Management

We may use certain derivative instruments to manage the exposures associated with the foreign currency exchange risks discussed below.

## Foreign Currency Denominated Assets and Liabilities

We generally utilize forward foreign exchange contracts and purchased option contracts to hedge these exposures. 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.

## Forecasted Purchases and Sales in Foreign Currency

We generally utilize forward foreign exchange contracts and purchased option contracts to hedge these anticipated transactions. These contracts generally mature in six months or less. A portion of these contracts are designated as cash-flow hedges.

At December 31, 2008, we had outstanding forward exchange and purchased option contracts with gross notional values of \$2.6 billion which is reflective of the amounts that are normally outstanding at any point during the year. The following is a summary of the primary hedging positions and corresponding fair values held as of December 31, 2008:

Currency Hedged (Buy/Sell)	Gross Notional Value	Fair Value Asset (Liability) <sup>(1)</sup>
U.K. Pound Sterling/Euro	\$ 628	\$(85)
Euro/U.S. Dollar	555	3
U.S. Dollar/Euro	308	(6)
Swedish Kronor/Euro	112	(9)
Swiss Franc/Euro	184	4
Japanese Yen/U.S. Dollar	110	6
Japanese Yen/Euro	243	(8)
Euro/U.K. Pound Sterling	42	1
U.S. Dollar/Canadian Dollar	16	—
Canadian Dollar/Euro	149	2
Canadian Dollar/U.S. Dollar	73	1
All Other	180	(2)
<b>Total</b>	<b>\$2,600</b>	<b>\$(93)</b>

<sup>(1)</sup> Represents the net receivable (payable) amount included in the Consolidated Balance Sheet at December 31, 2008.

## Cash Flow Hedges

We designate a portion of our foreign currency derivative contracts as cash flow hedges of our foreign currency denominated inventory purchases and sales. The changes in fair value for these contracts were reported in Accumulated other comprehensive loss and reclassified to Cost of sales and revenue in the period or periods during which the related inventory was sold to a third party. No amount of ineffectiveness was recorded in the Consolidated Statements of Income for these designated cash flow hedges and all components of each derivative's gain or loss was included in the assessment of hedge effectiveness. As of December 31, 2008, the net liability fair value of these contracts was \$1.

# Notes to the Consolidated Financial Statements

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The following tables provide a summary of the fair value amounts of derivative instruments and gains and losses on derivative instruments at and for the years ended December 31, 2008 and 2007, respectively.

## Fair Values of Derivative Instruments at December 31, 2008 and 2007

Designation of Derivatives	Balance Sheet Location	Fair Value	
		2008	2007
<b>Derivatives designated as hedging instruments</b>	<b>Other long-term assets:</b>		
	Interest Rate Swaps	\$ 53	\$ 8
	<b>Other current liabilities:</b>		
	Interest Rate Swaps	\$ 2	\$ —
	Foreign Exchange Contracts – Forwards	1	—
	Total	\$ 3	\$ —
<b>Derivatives NOT designated as hedging instruments</b>	<b>Other long-term liabilities:</b>		
	Interest Rate Swaps	\$ —	\$ 14
	<b>Other current assets:</b>		
	Foreign Exchange Contracts – Forwards	\$ 39	\$ 26
	Foreign Exchange Contracts – Options	—	1
	Total	\$ 39	\$ 27
	<b>Other current liabilities:</b>		
	Foreign Exchange Contracts – Forwards	\$131	\$ 31
	<b>Total Derivative Assets</b>	<b>\$ 92</b>	<b>\$ 35</b>
	<b>Total Derivative Liabilities</b>	<b>134</b>	<b>45</b>
	<b>Total Net Derivative Liabilities</b>	<b>\$ (42)</b>	<b>\$ (10)</b>

## Fair Value Hedges and Cash Flow Hedges for the Years Ended December 31, 2008 and 2007

Derivatives in Fair Value Hedging Relationships	Location of Gain (Loss) Recognized In Income	Derivative Gain (Loss) Recognized in Income		Hedged Item Gain (Loss) Recognized in Income	
		2008	2007	2008	2007
<b>Interest Rate Contracts</b>	Interest expense	\$206	\$36	\$(206)	\$(36)
Derivatives in Cash Flow Hedging Relationships	Derivative Gain (Loss) Recognized in OCI (Effective Portion)	Location of Derivative Gain (Loss) Reclassified from AOCI into Income (Effective Portion)	Gain (Loss) Reclassified from AOCI to Income (Effective Portion)	2008	2007
Interest rate contracts	\$ (2)	\$ 9	Interest expense	\$ —	\$ 10
Foreign exchange contracts – forwards	4	—	Cost of sales	2	(1)
<b>Total Cash Flow Hedges</b>	<b>\$ 2</b>	<b>\$ 9</b>		<b>\$ 2</b>	<b>\$ 9</b>

Note: No amount of ineffectiveness was recorded in the Consolidated Statements of Income for these designated cash flow hedges and all components of each derivative's gain or loss was included in the assessment of hedge effectiveness.

# Notes to the Consolidated Financial Statements

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## Non Designated Derivatives for the Years Ended December 31, 2008 and 2007

Derivatives Not designated as hedging instruments	Location of Derivative Gain (Loss)	2008	2007
Foreign exchange contracts – forwards	Other expense	\$(143)	\$(10)
Foreign exchange contracts – options	Other expense	(4)	3
<b>Total Non Designated Derivatives</b>		<b>\$(147)</b>	<b>\$ (7)</b>

## Accumulated Other Comprehensive Loss (“AOCL”)

The following table provides a summary of the activity associated with all of our designated cash flow hedges (interest rate and foreign currency) reflected in AOCL for the three years ended December 31, 2008:

	Year Ended December 31,		
	2008	2007	2006
Beginning balance, net of tax	\$ —	\$ 1	\$ 1
Changes in fair value gain (loss)	1	4	(1)
Reclass to earnings	(1)	(5)	1
<b>Ending balance, net of tax</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 1</b>

## Fair Value of Financial Assets and Liabilities

As discussed in Note 1 – Summary of Significant Accounting Policies, we adopted FAS 157 on January 1, 2008, which among other things, requires enhanced disclosures about assets and liabilities measured at fair value on a recurring basis. Our adoption of FAS 157 was limited to financial assets and liabilities, which primarily relate to our derivative contracts.

FAS 157 includes a fair value hierarchy that is intended to increase consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy is based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity’s pricing based upon their own market assumptions.

The fair value hierarchy consists of the following three levels:

- Level 1 – Inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 – Inputs are quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable and market-corroborated inputs which are derived principally from or corroborated by observable market data.

- Level 3 – Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.

The following table represents our assets and liabilities measured at fair value on a recurring basis as of December 31, 2008 and the basis for that measurement:

	Total Fair Value Measurement December 31, 2008	Quoted Prices in Active Markets for Identical Asset (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Derivative Assets	\$ 92	\$ —	\$ 92	\$ —
Derivative Liabilities	\$134	\$ —	\$134	\$ —

We utilize the income approach to measure fair value for our derivative assets and liabilities. The income approach uses pricing models that rely on market observable inputs such as yield curves, currency exchange rates and forward prices, and therefore are classified as Level 2.

The estimated fair values of our other financial assets and liabilities not measured at fair value on a recurring basis at December 31, 2008 and 2007 were as follows:

	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$1,229	\$1,229	\$1,099	\$1,099
Accounts receivable, net	2,184	2,184	2,457	2,457
Short-term debt	1,610	1,593	525	525
Long-term debt	6,774	5,918	6,939	7,176
Liability to subsidiary trust issuing preferred securities	648	555	632	632

The fair value amounts for Cash and cash equivalents and Accounts receivable, net approximate carrying amounts due to the short maturities of these instruments. The fair value of Short and Long-term debt, as well as our Liability to subsidiary trust issuing preferred securities, was estimated based on quoted market prices for publicly traded securities 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.

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## Note 14 – Employee Benefit Plans

We sponsor numerous pension and other post-retirement benefit plans, primarily retiree health, in our U.S. and international operations. December 31 is the measurement date for all of our other post-retirement benefit plans, including all of our domestic plans. Refer to Note 1 – “New Accounting Standards and Accounting Changes” for further information regarding recent accounting changes for our benefit plans. Information regarding our benefit plans is presented below:

	Pension Benefits		Retiree Health	
	2008	2007	2008	2007
<b>Change in Benefit Obligation</b>				
Benefit obligation, January 1	\$ 10,458	\$ 10,467	\$ 1,501	\$ 1,592
Service cost	209	237	14	17
Interest cost	(5)	578	84	87
Plan participants' contributions	13	12	31	20
Plan amendments	1	11	(219)	—
Actuarial gain	(550)	(508)	(251)	(114)
Acquisitions	20	—	—	—
Currency exchange rate changes	(1,090)	331	(23)	21
Curtailments	3	(1)	—	—
Benefits paid/settlements	(657)	(669)	(135)	(122)
Other*	93	—	—	—
<b>Benefit obligation, December 31</b>	<b>\$ 8,495</b>	<b>\$ 10,458</b>	<b>\$ 1,002</b>	<b>\$ 1,501</b>
<b>Change in Plan Assets</b>				
Fair value of plan assets, January 1	\$ 9,805	\$ 9,217	\$ —	\$ —
Actual return on plan assets	(1,527)	667	—	—
Employer contribution	299	298	105	102
Plan participants' contributions	13	12	30	20
Acquisitions	20	—	—	—
Currency exchange rate changes	(1,049)	280	—	—
Benefits paid/settlements	(657)	(669)	(135)	(122)
Other*	19	—	—	—
<b>Fair value of plan assets, December 31</b>	<b>\$ 6,923</b>	<b>\$ 9,805</b>	<b>\$ —</b>	<b>\$ —</b>
<b>Net funded status (including under-funded and non-funded plans) at December 31</b>	<b>\$ (1,572)</b>	<b>\$ (653)</b>	<b>\$ (1,002)</b>	<b>\$ (1,501)</b>
Amounts recognized in the Consolidated Balance Sheets:				
Other long-term assets	\$ 61	\$ 322	\$ —	\$ —
Accrued compensation and benefit costs	(48)	(48)	(106)	(105)
Pension and other benefit liabilities	(1,585)	(927)	—	—
Post-retirement medical benefits	—	—	(896)	(1,396)
<b>Net amounts recognized</b>	<b>\$ (1,572)</b>	<b>\$ (653)</b>	<b>\$ (1,002)</b>	<b>\$ (1,501)</b>

\* Other reflects adjustments associated with the change in measurement dates for several European countries as required by FAS 158. See Note 1 – Summary of Significant Accounting Policies for additional information.

The pre-tax amounts recognized in Accumulated other comprehensive (income) loss consist of:

	Pension Benefits		Retiree Health	
	2008	2007	2008	2007
Net actuarial loss (gain)	\$ 1,818	\$ 1,032	\$ (85)	\$ 169
Prior service (credit) cost	(192)	(212)	(186)	11
<b>Total</b>	<b>\$ 1,626</b>	<b>\$ 820</b>	<b>\$ (271)</b>	<b>\$ 180</b>

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The accumulated benefit obligation for all defined benefit pension plans was \$7,902 and \$9,748 at December 31, 2008 and 2007, respectively.

Information for pension plans with an accumulated benefit obligation in excess of plan assets is presented below:

	2008	2007
Aggregate projected benefit obligation	\$5,374	\$1,193
Aggregate accumulated benefit obligation	5,051	1,109
Aggregate fair value of plan assets	3,821	399

Our domestic retirement defined benefit plans provide employees a benefit, depending on eligibility, 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			Retiree Health		
	2008	2007	2006	2008	2007	2006
<b>Components of Net Periodic Benefit Cost</b>						
Service cost	\$ 209	\$ 237	\$ 244	\$ 14	\$ 17	\$ 19
Interest cost <sup>(1)</sup>	(5)	578	732	84	87	92
Expected return on plan assets <sup>(2)</sup>	(80)	(668)	(802)	—	—	—
Recognized net actuarial loss	36	75	104	—	10	19
Amortization of prior service credit	(20)	(20)	(16)	(21)	(12)	(13)
Recognized curtailment/settlement loss	34	33	93	—	—	—
Net periodic defined benefit cost	174	235	355	77	102	117
Defined contribution plans	80	80	70	—	—	—
Total Net Periodic Benefit Costs	\$ 254	\$ 315	\$ 425	\$ 77	\$ 102	\$ 117

## Other Changes in Plan Assets and Benefit Obligations

### Recognized in Other Comprehensive Income:

Net actuarial loss (gain)	1,062	(499)	(244)	(114)
Prior service cost (credit)	1	5	(219)	—
Amortization of net actuarial (loss) gain	(70)	(108)	—	(10)
Amortization of prior service (cost) credit	20	20	21	12
Total recognized in other comprehensive income <sup>(3)</sup>	1,013	(582)	(442)	(112)

### Total Recognized in Net Periodic Benefit Cost and Other Comprehensive Income

	\$1,267	\$(267)	\$(365)	\$ (10)
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<sup>(1)</sup> Interest cost includes interest expense on non-TRA obligations of \$408, \$374, and \$340 and interest expense (income) directly allocated to TRA participant accounts of \$(413), \$204, and \$392 for the years ended December 31, 2008, 2007 and 2006, respectively.

<sup>(2)</sup> Expected return on plan assets includes expected investment income on non-TRA assets of \$493, \$464, and \$410 and actual investment income (expense) on TRA assets of \$(413), \$204, and \$392 for the years ended December 31, 2008, 2007 and 2006, respectively.

<sup>(3)</sup> Amount represents the pre-tax effect included within other comprehensive income. The net of tax amount and effect of translation adjustments as well as our share of Fuji Xerox benefit plan changes are included within the Consolidated Statements of Common Shareholders' Equity. The net after-tax loss (gain) included in other comprehensive (loss) income for the two years ended December 31, 2008 was \$286 and \$(382), respectively.

The net actuarial loss and prior service credit for the defined benefit pension plans that will be amortized from Accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are \$20 and \$(20), respectively. The net actuarial loss and prior service credit for the retiree health benefit plans that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year are less than \$1 and \$(42) respectively.

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.

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## Plan Amendment

In October 2008, we amended our domestic retiree health benefit plan to eliminate the subsidy currently paid to current and future Medicare-eligible retirees effective January 1, 2010. The amendment resulted in a net decrease of approximately \$225 in the benefit obligation and a corresponding after-tax increase to shareholders equity. The amendment is also expected to decrease pre-tax net retiree health benefit expense by approximately \$50 in 2009. Retiree health expense may also be impacted by other factors, including but not limited to changes in the discount rate and health care costs in the future.

## Plan Assets

### Current Allocation and Investment Targets

As of the 2008 and 2007 measurement dates, the global pension plan assets were \$6.9 billion and \$9.8 billion, respectively. These assets were invested among several asset classes. None of the investments include debt or equity securities of Xerox Corporation. The amount and percentage of assets invested in each asset class as of December 31, 2008 and 2007 is shown below:

Asset Category	Asset Value		Percentage of Total Assets	
	2008	2007	2008	2007
Equity securities	\$3,042	\$5,060	44%	52%
Debt securities	3,296	3,973	47	40
Real estate	465	720	7	7
Other	120	52	2	1
<b>Total</b>	<b>\$6,923</b>	<b>\$9,805</b>	<b>100%</b>	<b>100%</b>

Our pension plan assets at December 31, 2008, were as follows: U.S. \$3.2 billion; U.K. \$2.2 billion; Canada \$0.4 billion and Other \$1.1 billion.

**Investment strategy:** The target asset allocations for our worldwide plans for 2008 were 50% invested in equities, 42% invested in fixed income, 7% invested in real estate and 1% invested in Other. The target asset allocations for our worldwide plans for 2007 were 50% invested in equities, 42% invested in fixed income, 7% invested in real estate and 1% invested in Other.

We employ a total return investment approach whereby a mix of equities and fixed income investments are used to maximize the long-term return of plan assets for a prudent level of risk. The intent of this strategy is to minimize plan expenses by exceeding the interest growth in long-term plan liabilities. Risk tolerance is established through careful consideration of plan liabilities, plan funded status, and corporate financial condition. This consideration involves the use of long-term measures that address both return and risk. The investment portfolio contains a diversified

blend of equity and fixed income investments. Furthermore, equity investments are diversified across U.S. and non-U.S. stocks as well as growth, value and small and large capitalizations. Other assets such as real estate, private equity, and hedge funds are used to improve portfolio diversification. Derivatives may be used to hedge market exposure in an efficient and timely manner; however, derivatives may not be used to leverage the portfolio beyond the market value of the underlying investments. Investment risks and returns are measured and monitored on an ongoing basis through annual liability measurements and quarterly investment portfolio reviews.

**Expected long-term rate of return:** We employ a "building block" approach in determining the long-term rate of return for plan assets. Historical markets are studied and long-term relationships between equities and fixed income are assessed. Current market factors such as inflation and interest rates are evaluated before long-term capital market assumptions are determined. The long-term portfolio return is established giving consideration to investment diversification and rebalancing. Peer data and historical returns are reviewed periodically to assess reasonableness and appropriateness.

**Contributions:** We expect to contribute approximately \$108 to our worldwide defined benefit pension plans and approximately \$105 to our retiree health benefit plans in 2009. The 2009 expected pension plan contributions do not include any planned contribution for our domestic tax-qualified defined benefit plans because none are required due to the availability of a credit balance which results from funding prior to 2008 in excess of minimum requirements. This credit balance can be utilized in lieu of any 2009 pension contributions. However, once the January 1, 2009 actuarial valuations and projected results as of the end of the 2009 measurement year are available, the desirability of additional contributions will be reassessed. Based on these results, we may voluntarily decide to contribute to these plans. In 2008 and 2007, after making this assessment, we contributed \$165 and \$158, respectively, to our domestic tax qualified plans to make them 100% funded on a current liability basis under the ERISA funding rules.

**Estimated future benefit payments:** The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid during the following years:

	Pension Benefits	Retiree Health
2009	\$ 557	\$105
2010	606	99
2011	603	99
2012	636	98
2013	633	97
Years 2014-2018	3,300	445

# Notes to the Consolidated Financial Statements

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

## Assumptions

Weighted-average assumptions used to determine benefit obligations at the plan measurement dates:

	Pension Benefits			Retiree Health		
	2008	2007	2006	2008	2007	2006
Discount rate	6.3%	5.9%	5.3%	6.3%	6.2%	5.8%
Rate of compensation increase	3.9	4.1	4.1	— <sup>(1)</sup>	— <sup>(1)</sup>	— <sup>(1)</sup>

<sup>(1)</sup> Rate of compensation increase is not applicable to the retiree health benefits as compensation levels do not impact earned benefits.

Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31:

	Pension Benefits				Retiree Health			
	2009	2008	2007	2006	2009	2008	2007	2006
Discount rate	6.3%	5.9%	5.3%	5.2%	6.3%	6.2%	5.8%	5.6%
Expected return on plan assets	7.4	7.6	7.6	7.8	— <sup>(1)</sup>	— <sup>(1)</sup>	— <sup>(1)</sup>	— <sup>(1)</sup>
Rate of compensation increase	3.9	4.1	4.1	3.9	— <sup>(2)</sup>	— <sup>(2)</sup>	— <sup>(2)</sup>	— <sup>(2)</sup>

<sup>(1)</sup> Expected return on plan assets is not applicable to retiree health benefits as these plans are not funded.

<sup>(2)</sup> Rate of compensation increase is not applicable to retiree health benefits as compensation levels do not impact earned benefits.

## Assumed health care cost trend rates at December 31,

	2008	2007
Health care cost trend rate assumed for next year	9.4%	10.4%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.0%	5.0%
Year that the rate reaches the ultimate trend rate	2013	2013

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	One-percentage-point increase	One-percentage-point decrease
Effect on total service and interest cost components	\$ 6	\$ (5)
Effect on post-retirement benefit obligation	68	(61)

## Note 15 – Income and Other Taxes

(Loss) income before income taxes for the three years ended December 31, 2008 were as follows:

	2008	2007	2006
Domestic (loss) income	\$(662)	\$ 667	\$429
Foreign income	548	771	379
<b>(Loss) income before income taxes</b>	<b>\$(114)</b>	<b>\$1,438</b>	<b>\$808</b>

(Benefits) provisions for income taxes for the three years ended December 31, 2008 were as follows:

	2008	2007	2006
Federal income taxes			
Current	\$ (26)	\$ 30	\$(448)
Deferred	(285)	92	94
Foreign income taxes			
Current	118	144	50
Deferred	4	120	(9)
State income taxes			
Current	1	2	11
Deferred	(43)	12	14
<b>Total</b>	<b>\$(231)</b>	<b>\$400</b>	<b>\$(288)</b>

A reconciliation of the U.S. federal statutory income tax rate to the consolidated effective income tax rate for the three years ended December 31, 2008 was as follows:

	2008	2007	2006
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
Nondeductible expenses	(13.5)	0.9	1.4
Effect of tax law changes	11.1	1.1	(1.8)
Change in valuation allowance for deferred tax assets	(14.6)	1.0	1.4
State taxes, net of federal benefit	25.4	1.3	1.8
Audit and other tax return adjustments	58.5	(4.2)	(62.5)
Tax-exempt income	5.9	(0.6)	(0.9)
Other foreign, including earnings taxed at different rates	103.2	(7.4)	(10.5)
Other	(8.4)	0.7	0.5
<b>Effective income tax rate</b>	<b>202.6%</b>	<b>27.8%</b>	<b>(35.6)%</b>

On a consolidated basis, we paid a total of \$194, \$104, and \$76 in income taxes to federal, foreign and state jurisdictions during the three years ended December 31, 2008, 2007 and 2006, respectively.

# Notes to the Consolidated Financial Statements

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

Total income tax (benefit) expense for the three years ended December 31, 2008 was allocated as follows:

	2008	2007	2006
Pre-tax income	<b>\$(231)</b>	\$ 400	\$(288)
Common shareholders' equity:			
Defined benefit plans/minimum pension liability	<b>(183)</b>	222	(432)
Stock option and incentive plans, net	<b>(2)</b>	(22)	(25)
Translation adjustments and other	<b>10</b>	24	(9)
<b>Total</b>	<b>\$(406)</b>	<b>\$624</b>	<b>\$(754)</b>

## Unrecognized Tax Benefits and Audit Resolutions

In 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109" ("FIN 48") which we adopted on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a minimum recognition threshold for a tax position taken or expected to be taken in a tax return that is required to be met before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The cumulative effect of adopting FIN 48 of \$2 was recorded as a reduction to Retained earnings. The total amount of unrecognized tax benefits as of the date of adoption was \$287.

Due to the extensive geographical scope of our operations, we are subject to ongoing tax examinations in numerous jurisdictions. Accordingly, we may record incremental tax expense based upon the more-likely-than-not outcomes of any uncertain tax positions. In addition, when applicable, we adjust the previously recorded tax expense to reflect examination results when the position is effectively settled. Our ongoing assessments of the more-likely-than-not outcomes of the examinations and related tax positions require judgment and can increase or decrease our effective tax rate, as well as impact our operating results. The specific timing of when the resolution of each tax position will be reached is uncertain. As of December 31, 2008, we do not believe that there are any positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next 12 months.

## Unrecognized Tax Benefits

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	2008	2007
Balance at January 1	<b>\$303</b>	\$287
Additions from acquisitions	—	4
Additions related to current year	<b>12</b>	33
Additions related to prior years positions	<b>13</b>	78
Reductions related to prior years positions	<b>(65)</b>	(33)
Settlements with taxing authorities <sup>(1)</sup>	<b>(28)</b>	(66)
Reductions related to lapse of statute of limitations	<b>(45)</b>	(14)
Currency	<b>(20)</b>	14
<b>Balance at December 31</b>	<b>\$170</b>	<b>\$303</b>

<sup>(1)</sup> Majority of settlements did not result in the utilization of cash.

Included in the balance at December 31, 2008 and 2007 are \$67 and \$137, respectively, of tax positions that are highly certain of realizability but for which there is uncertainty about the timing or may be reduced through an indirect benefit from other taxing jurisdictions. Because of the impact of deferred tax accounting, other than for the possible incurrence of interest and penalties, the disallowance of these positions would not affect the annual effective tax rate.

We have filed claims in certain jurisdictions to assert our position should the law be clarified by judicial means. At this point in time, we believe it is unlikely that we will receive any benefit from these types of claims but we will continue to analyze as the issues develop. Accordingly, we have not included any benefit for these types of claims in the amount of unrecognized tax benefits.

We recognized interest and penalties accrued on unrecognized tax benefits as well as interest received from favorable settlements within income tax expense. We had \$22 and \$23 accrued for the payment of interest and penalties associated with unrecognized tax benefits at December 31, 2008 and 2007, respectively.

We file income tax returns in the U.S. federal jurisdiction and various foreign jurisdictions. In the U.S. we are no longer subject to U.S. federal income tax examinations by tax authorities for years before 2007. With respect to our major foreign jurisdictions, we are no longer subject to tax examinations by tax authorities before 2000.

# Notes to the Consolidated Financial Statements

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## Audit Resolution

In 2006, we recognized an income tax benefits of \$472 from the favorable resolution of certain tax issues associated with the finalization of our 1999-2003 Internal Revenue Service ("IRS") audit as well as an income tax benefits of \$46 related to the favorable resolution of certain tax matters associated with the finalization of foreign tax audits. The recorded benefits did not result in a significant cash refund, but it did increase tax credit carryforwards and reduced taxes otherwise potentially due.

## Deferred Income Taxes

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, 2008 was approximately \$7.5 billion. These earnings have been indefinitely reinvested and we currently 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. Our 2001 sale of half of our ownership interest in Fuji Xerox resulted in our investment no longer qualifying 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 indefinite reinvestment.

The tax effects of temporary differences that give rise to significant portions of the deferred taxes at December 31, 2008 and 2007 were as follows:

	2008	2007
Tax effect of future tax deductions		
Research and development	\$ 930	\$ 895
Post-retirement medical benefits	392	577
Depreciation	249	292
Net operating losses	486	576
Other operating reserves	249	216
Tax credit carryforwards	552	434
Deferred compensation	248	249
Allowance for doubtful accounts	84	100
Restructuring reserves	88	15
Pension	373	58
Other	182	181
	<b>3,833</b>	3,593
Valuation allowance	<b>(628)</b>	(747)
<b>Total</b>	<b>\$ 3,205</b>	<b>\$ 2,846</b>
Tax effect of future taxable income		
Unearned income and installment sales	\$(1,119)	\$(1,283)
Intangibles and goodwill	(160)	(142)
Other	(53)	(40)
<b>Total</b>	<b>(1,332)</b>	(1,465)
<b>Total deferred taxes, net</b>	<b>\$ 1,873</b>	<b>\$ 1,381</b>

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 or, when applicable, based on the expected timing of the reversal. Current deferred tax assets at December 31, 2008 and 2007 amounted to \$305 and \$200, 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 net change in the total valuation allowance for the years ended December 31, 2008 and 2007 was a decrease of \$119 and an increase of \$100, respectively. The valuation allowance relates primarily to certain net operating loss carryforwards, 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.

# Notes to the Consolidated Financial Statements

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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 the available positive and negative evidence, including 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 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, 2008, we had tax credit carryforwards of \$552 available to offset future income taxes, of which \$213 are available to carryforward indefinitely while the remaining \$339 will begin to expire, if not utilized, in 2009. We also had net operating loss carryforwards for income tax purposes of \$345 that will expire in 2009 through 2024, if not utilized, and \$2.3 billion available to offset future taxable income indefinitely.

## Note 16 – Contingencies

### Brazil Tax and Labor Contingencies

Our Brazilian operations are involved in various litigation matters and have received or been the subject of numerous governmental assessments related to indirect and other taxes as well as disputes associated with former employees and contract labor. The tax matters, which comprise a significant portion of the total contingencies, principally relate to claims for taxes on the internal transfer of inventory, municipal service taxes on rentals and gross revenue taxes. We are disputing these tax matters and intend to vigorously defend our position. Based on the opinion of legal counsel and current reserves for those matters deemed probable of loss, we do not believe that the ultimate resolution of these matters will materially impact our results of operations, financial position or cash flows. The labor matters principally relate to claims made by former employees and contract labor for the equivalent payment of all social security and other related labor benefits, as well as consequential tax claims, as if they were regular employees. Following our assessment of the most recent trend in the outcomes of these matters, we reassessed the probable estimated loss and, as a result, recorded an additional reserve of \$36 in 2008. As of December 31, 2008, the total amounts related to the unreserved portion of the tax and labor contingencies, inclusive of any related interest, amounted to approximately \$839, with the decrease from December 31, 2007 balance of \$1.1 billion primarily related to currency partially offset by the additional reserve. In connection with the above proceedings, customary local regulations may require us to make escrow cash deposits or post other security of up to half of the total amount in dispute. As of December 31, 2008

we had \$167 of escrow cash deposits for matters we are disputing and there are liens on certain Brazilian assets with a net book value of \$30 and additional letters of credit of approximately \$88. Generally, any escrowed amounts would be refundable and any liens would be removed to the extent the matters are resolved in our favor. We routinely assess all these matters as to probability of ultimately incurring a liability against our Brazilian operations and record our best estimate of the ultimate loss in situations where we assess the likelihood of an ultimate loss as probable.

### Legal Matters

As more fully discussed below, we are involved in a variety of claims, lawsuits, investigations and proceedings concerning securities law, intellectual property law, environmental law, employment law and the Employee Retirement Income Security Act (“ERISA”). We determine whether an estimated loss from a contingency should be accrued by assessing whether a loss is deemed probable and can be reasonably estimated. We assess our potential liability by analyzing our litigation and regulatory matters using available information. We develop our views on estimated losses in consultation with outside counsel handling our defense in these matters, which involves an analysis of potential results, assuming a combination of litigation and settlement strategies. Should developments in any of these matters cause a change in our determination as to an unfavorable outcome and result in the need to recognize a material accrual, or should any of these matters 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 change in determination, judgment or settlement occurs.

The following is a summary of significant developments in litigation matters:

- [Carlson v. Xerox Corporation, et al.](#) – settlement reached, approved by the district court and paid.
- [In re Xerox Corp. ERISA Litigation](#) – settlement reached and preliminary court approval granted.
- [Florida State Board of Administration, et al v. Xerox Corporation, et al.](#) – settlement reached and paid.
- [National Union Fire Insurance Company v. Xerox Corporation, et al.](#) – settlement reached and payment made to Xerox.
- [Digwamaje et al. v. IBM et al.](#) – amended complaint drops Xerox as a defendant.
- [Warren, et al. v. Xerox Corporation](#) – settlement received final court approval and was paid.

# Notes to the Consolidated Financial Statements

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## 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 is a class action on behalf of all persons and entities who purchased Xerox Corporation common stock during the period October 22, 1998 through October 7, 1999 inclusive ("Class Period") and who suffered a loss as a result of misrepresentations or omissions by Defendants as alleged by Plaintiffs (the "Class"). The Class 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 relating to the defendants' alleged failure to disclose the material negative impact that the April 1998 restructuring had on the Company's operations and revenues. The 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 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. In 2001, the Court denied the defendants' motion for dismissal of the complaint. The plaintiffs' motion for class certification was denied by the Court in 2006, without prejudice to re-filing. In February 2007, the Court granted the motion of the International Brotherhood of Electrical Workers Welfare Fund of Local Union No. 164, Robert W. Roten, Robert Agius ("Agius") and Georgia Stanley to appoint them as additional lead plaintiffs. In July 2007, the Court denied plaintiffs' renewed motion for class certification, without prejudice to renewal after the Court holds a pre-filing conference to identify factual disputes the Court will be required to resolve in ruling on the motion. After that conference and Agius's withdrawal as lead plaintiff and proposed class representative, in February 2008 plaintiffs filed a second renewed motion for class certification. In April 2008, Defendants filed their response and motion to disqualify Milberg

LLP as a lead counsel. On September 30, 2008, the Court entered an order certifying the class and denying the appointment of Milberg LLP as a lead counsel. The parties have filed motions to exclude certain expert testimony. Briefing with respect to those motions is complete. The Court has not yet rendered a decision. On November 6, 2008, the defendants filed a motion for summary judgment, which has not yet been fully briefed. The individual defendants and we deny any wrongdoing and are vigorously defending the action. In the course of litigation, we periodically engage in discussions with plaintiffs' counsel for possible resolution of this matter. Should developments cause a change in our determination as to an unfavorable outcome, or result in a final adverse judgment or a settlement for a significant amount, there could be a material adverse effect on our results of operations, cash flows and financial position in the period in which such change in determination, judgment or settlement occurs.

***Carlson v. Xerox Corporation, et al.:*** A consolidated securities law action (consisting of 21 cases) was 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. Plaintiffs purported to bring this case as a class action on behalf of a 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"). Two claims were asserted: 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; and the other alleging that the individual defendants are also liable as "controlling persons" of the Company pursuant to Section 20(a) of the 1934 Act. Plaintiffs claimed 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 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 alleged 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 purported Class to purchase the Company's common stock and bonds at artificially inflated prices. On March 27, 2008, the Court granted preliminary approval of an agreement to settle this case, pursuant to which the Company agreed to make cash payments totaling \$670 and KPMG agreed to make cash payments totaling \$80. The individual defendants and the Company did not admit any wrongdoing as a part of the settlement. On January 15, 2009, the Court entered an order and final judgment approving the settlement, awarding attorneys' fees and expenses, and dismissing the action with prejudice. The Company's portion of the settlement amount has been paid. On

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February 9, 2009, three class members filed a notice of appeal of the Court's January 15, 2009 order and final judgement and ruling on motion for award of attorneys fees.

***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. Four additional class actions were subsequently filed, and the five actions were consolidated as *In Re Xerox Corporation ERISA Litigation*. 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 Finance Committee of the Board of Directors, and the Treasurer. The complaint alleges that the defendants breached their fiduciary duties under ERISA to protect the Plan's assets and act in the interest of Plan participants. Specifically, plaintiffs allege that the defendants failed to provide accurate and complete material information to participants concerning Xerox stock, including accounting practices which allegedly artificially inflated the value of the stock, and misled participants regarding the soundness of the stock and the prudence of investing their retirement assets in Xerox stock. The plaintiffs filed a Second Consolidated Amended Complaint, alleging that some or all defendants breached their ERISA fiduciary duties during 1997-2002 by (1) maintaining the Xerox Stock Fund as an investment option under the Plan; (2) failing to monitor the conduct of Plan fiduciaries; and (3) misleading Plan participants about Xerox stock as an investment option under the Plans. The complaint does not specify the amount of damages sought, but demands that the losses to the Plans 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. On January 28, 2009, the Court granted preliminary approval of an agreement to settle this case, the terms of which are within the amount previously reserved by the Company for this matter. The Company and the other defendants do not admit any wrongdoing as a part of the settlement, which is subject to final Court approval and other conditions. A fairness hearing has been scheduled for April 13, 2009.

***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

purported class includes all persons who lived in South Africa at any time from 1948 until the present and purportedly suffered damages as a result of human rights violations and crimes against humanity through the system of apartheid. The defendants included the Company and a number of other corporate defendants who were 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 claimed violations of the Alien Tort Claims Act, the Torture Victims Protection Act and RICO. They also asserted human rights violations and crimes against humanity. Plaintiffs sought compensatory damages in excess of \$200 billion and punitive damages in excess of \$200 billion. On October 27, 2008, plaintiffs filed an amended complaint that did not name the Company as a defendant, so the Company is no longer a party to the action.

***Arbitration between MPI Technologies, Inc. and MPI Tech S.A. and Xerox Canada Ltd. and Xerox Corporation:*** In an arbitration proceeding the hearing of which commenced in January 2005, MPI Technologies, Inc. and MPI Tech S.A. (collectively "MPI") sought damages from the Company and Xerox Canada Ltd. ("XCL") for royalties owed under a license agreement between MPI and XCL (the "Agreement") and breach of fiduciary duty, breach of confidence, equitable royalties and punitive damages and disgorgement of profits and injunctive relief with respect to a claim of copyright infringement. In September 2005, the arbitration panel rendered its decision, holding in part that the Agreement had been assigned to Xerox and that no punitive damages should be granted, and awarded MPI approximately \$89, plus interest thereon. In December 2005, the arbitration panel rendered its decision on the applicable rate of pre-judgment interest resulting in an award of \$13 for pre- and post-judgment interest. In 2006, Xerox's application for judicial review of the award, seeking to have the award set aside in its entirety, was denied by the Ontario Superior Court in Toronto and Xerox released all monies and software it had placed in escrow. In January 2007, Xerox and XCL served an arbitration claim against MPI seeking a declaratory award concerning the preclusive effect of the remedy awarded by the prior arbitration panel. In March 2007, MPI delivered to Xerox a statement of defense and counterclaim in response to Xerox's arbitration claim. MPI claims entitlement to an unspecified amount of damages for royalties. In addition, MPI claims damages of \$50 for alleged "misuse" of its licensed software by Xerox after December 2006. MPI also claims entitlement to unspecified amounts of pre and post-judgment interest and its costs of the arbitration. A panel of three arbitrators has been appointed to hear the dispute. The panel heard oral arguments relating to preliminary dispositive motions on

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May 20-21, 2008. The panel's decision was released on August 28, 2008, in which the panel determined that MPI is precluded from advancing certain claims to royalties in respect of Xerox's Version 8 software and its derivatives, but that certain other claims being advanced by MPI are not precluded. A hearing relating to most of the issues raised in the current arbitration, other than damages issues relating to one of MPI's claims that has been bifurcated, is expected to take place in October 2009. Should developments cause a change in our determination as to an unfavorable outcome, or result in a final adverse judgment or a settlement for a significant amount, there could be a material adverse effect on our results of operations, cash flows and financial position in the period in which such change in determination, judgment or settlement occurs. Based on the present stage of the proceeding, it is not possible to estimate the amount of any material loss or range of material loss that might result from any of the claims advanced in such counterclaim.

**Warren, et al. v. Xerox Corporation:** On March 11, 2004, the United States District Court for the Eastern District of New York entered an order certifying a nationwide class of all black salespersons employed by Xerox from February 1, 1997 to the present under Title VII of the Civil Rights Act of 1964, as amended, and the Civil Rights Act of 1871. The suit was commenced on May 9, 2001 by six black sales representatives. The plaintiffs alleged that Xerox had engaged in a pattern or practice of race discrimination against them and other black sales representatives by assigning them to less desirable sales territories, denying them promotional opportunities, and paying them less than their white counterparts. Although the complaint did not specify the amount of damages sought, plaintiffs sought, on behalf of themselves and the classes they sought to represent, front and back pay, compensatory and punitive damages, and attorneys' fees. A settlement agreement was reached, the terms of which are not material to Xerox. On September 22, 2008, an Order and Judgment of Final Approval of the Settlement was entered. The Company denies any wrongdoing as part of the settlement. The period for appeal has expired and the settlement is now final.

## Other Matters

It is our policy to promptly and 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. When and where appropriate, we report such matters to the U.S. Department of Justice and to the SEC, and/or make public disclosure.

## India

In recent years we became aware of a number of matters at our Indian subsidiary, Xerox India Ltd. (formerly Xerox Modicorp Ltd.),

that occurred over a period of several years, much of which occurred before we obtained majority ownership of these operations in mid-1999. These matters include misappropriations of funds and payments to other companies that may have been inaccurately recorded on the subsidiary's books and certain alleged improper payments in connection with sales to government customers. These transactions were not material to the Company's financial statements. We reported these transactions to the Indian authorities, the U.S. Department of Justice ("DOJ") and to the SEC. In 2005, the private Indian investigator engaged by the Indian Ministry of Company Affairs completed an investigation of these matters and issued a report ("Report"). A copy of the Report was provided to our Indian subsidiary, which was asked by the Indian Ministry of Company Affairs to comment on the Report. The Report addresses the previously disclosed misappropriation of funds and alleged improper payments and includes allegations that Xerox India Ltd.'s senior officials and the Company were aware of such activities. The Report also asserts the need for further investigation into potential criminal acts related to the improper activities addressed by the Report. The matter is now pending in the Indian Ministry of Company Affairs. The Company reported these developments and made a copy of the Report received by Xerox India Ltd. available to the DOJ and the SEC. On November 17, 2005, Xerox India Ltd. filed its reply with the Ministry of Company Affairs (or "MCA"). Xerox sent copies of the reply to the SEC and DOJ in the United States. In its reply, Xerox India Ltd. argued that the alleged violations of Indian Company Law by means of alleged improper payments and alleged defaults/failures of the Xerox India Ltd. board of directors were generally unsubstantiated and without any basis in law. Further, Xerox India Ltd. stated that the Report's findings of other alleged violations were unsubstantiated and unproven. The MCA will consider our reply and will let us know their conclusions. There is the possibility of fines or criminal penalties if conclusive proof of wrongdoing is found. We have told the MCA that Xerox's conduct in voluntarily disclosing the initial information and readily and willingly submitting to investigation, coupled with the non-availability of earlier records, warrants complete closure and early settlement. In January 2006, we learned that the MCA had issued a "Show Cause Notice" to certain former executives of Xerox India Ltd. seeking a response to allegations of potential violations of the Indian Companies Act. We also learned that Xerox India Ltd. had received a formal Notice of Enquiry from the Indian Monopolies & Restrictive Trade Practices Commission ("MRTP Commission") alleging that Xerox India Ltd. committed unfair trading practices arising from the events described in the Report. Xerox India Ltd. filed its reply to the Notice of Enquiry and the investigating officer subsequently filed his response to our reply. At a hearing in August 2007, Xerox India Ltd. argued that the Enquiry is not maintainable under the Commission's jurisdiction. The issue of maintainability of the Notice

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of Enquiry has been framed as the preliminary issue, which was argued in hearings held on November 17, 2008 and February 3, 2009; the matter is now fixed for further arguments on April 17, 2009. Our Indian subsidiary is contesting the Notice of Enquiry and has been fully cooperating with the authorities.

## Other Contingencies

### Guarantees, Indemnifications and Warranty Liabilities

Guarantees and claims arise during the ordinary course of business from relationships with suppliers, customers and nonconsolidated affiliates when the Company undertakes an obligation to guarantee the performance of others if specified triggering events occur. Nonperformance under a contract could trigger an obligation of the Company. These potential claims include actions based upon alleged exposures to products, real estate, intellectual property such as patents, environmental matters, and other indemnifications. The ultimate effect on future financial results is not subject to reasonable estimation because considerable uncertainty exists as to the final outcome of these claims. However, while the ultimate liabilities resulting from such claims may be significant to results of operations in the period recognized, management does not anticipate they will have a material adverse effect on the Company's consolidated financial position or liquidity. As of December 31, 2008, we have accrued our estimate of liability incurred under our indemnification arrangements and guarantees.

### Indemnifications Provided as Part of Contracts and Agreements

We are a party to the following types of agreements pursuant to which we may be obligated to indemnify the other party with respect to certain matters:

- 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, including obligations to pay rent. Typically, these relate to such matters as adequate title to assets sold, intellectual property rights, specified environmental matters and certain income taxes arising prior to the date of acquisition.
- Guarantees on behalf of our subsidiaries with respect to real estate leases. These lease guarantees may remain in effect subsequent to the sale of the subsidiary.
- Agreements to indemnify various service providers, trustees and bank agents from any third party claims related to their performance on our behalf, with the exception of claims that result from third-party's own willful misconduct or gross negligence.

- Guarantees of our performance in certain sales and services contracts to our customers and indirectly the performance of third parties with whom we have subcontracted for their services. This includes indemnifications to customers for losses that may be sustained as a result of the use of our equipment at a customer's location.

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 allow us to challenge the other party's claims. In the case of lease guarantees, we may contest the liabilities asserted under the lease. Further, our obligations under these agreements and guarantees 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.

### Indemnification of Officers and Directors

Our corporate by-laws require that, except to the extent expressly prohibited by law, we must indemnify Xerox Corporation's 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. Although the by-laws provide no limit on the amount of indemnification, we may have recourse against our insurance carriers for certain payments made by us. However, certain indemnification payments may not be covered under our directors' and officers' insurance coverage. In addition, we indemnify certain fiduciaries of our employee benefit plans for liabilities incurred in their service as fiduciary whether or not they are officers of the Company.

### Product Warranty Liabilities

In connection with our normal sales of equipment, including those under sales-type leases, 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 a few

# Notes to the Consolidated Financial Statements

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

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. Aggregate product warranty liability expenses for the three years ended December 31, 2008 were \$39, \$40 and \$43, respectively. Total product warranty liabilities as of December 31, 2008 and 2007 were \$27 and \$26, respectively.

## Note 17 – Shareholders' Equity

### Preferred Stock

As of December 31, 2008, we had no preferred stock shares or preferred stock purchase rights outstanding. We are authorized to issue approximately 22 million shares of cumulative preferred stock, \$1.00 par value.

### Common Stock

We have 1.75 billion authorized shares of common stock, \$1 par value. At December 31, 2008, 90 million shares were reserved for

issuance under our incentive compensation plans, 48 million shares were reserved for debt to equity exchanges and 2 million shares were reserved for the conversion of convertible debt.

### Stock-Based Compensation

We have a long-term incentive plan whereby eligible employees may be granted restricted stock units ("RSUs"), performance shares ("PSs") and non-qualified stock options.

We grant PSs and RSUs in order to continue to attract and retain employees and to better align employee interest with those of our shareholders. Each of these awards is subject to settlement with newly issued shares of our common stock. At December 31, 2008 and 2007, 15 million and 19 million shares, respectively, were available for grant of awards.

Stock-based compensation expense for the three years ended December 31, 2008 was as follows:

	2008	2007	2006
Stock-based compensation expense, pre-tax	\$85	\$89	\$64
Stock-based compensation expense, net of tax	52	55	39

**Restricted stock units:** Compensation expense is based upon the grant date market price and is recorded over the vesting period. RSU awards vest three years from the date of the grant. A summary of the activity for RSUs as of December 31, 2008, 2007 and 2006, and changes during the years then ended, is presented below (shares in thousands):

	2008		2007		2006	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested Restricted Stock Units						
Outstanding at January 1	11,696	\$16.78	8,635	\$15.71	5,491	\$15.69
Granted	5,923	13.63	4,444	18.17	4,256	15.18
Vested	(3,350)	16.92	(935)	13.65	(686)	13.70
Cancelled	(232)	15.98	(448)	16.42	(426)	13.45
<b>Outstanding at December 31</b>	<b>14,037</b>	<b>\$15.43</b>	<b>11,696</b>	<b>\$16.78</b>	<b>8,635</b>	<b>\$15.71</b>

At December 31, 2008, the aggregate intrinsic value of RSUs outstanding was \$112. The total intrinsic value of RSUs vested during 2008, 2007 and 2006 was \$54, \$16 and \$10, respectively. The actual tax benefit realized for the tax deductions for vested RSUs totaled \$18, \$3 and \$3 for the years ended December 31, 2008, 2007 and 2006, respectively.

At December 31, 2008, there was \$105 of total unrecognized compensation cost related to nonvested RSUs, which is expected to be recognized ratably over a remaining weighted-average contractual term of 1.6 years.

**Performance shares:** We grant officers and selected executives PSs whose vesting is contingent upon meeting pre-determined Diluted Earnings per Share ("EPS") and Core Cash Flow from Operations targets. These shares entitle the holder to one share of common stock, payable after a three-year period and the attainment of the stated goals. If the cumulative three-year actual results for EPS and Cash Flow from Operations exceed the stated targets, then the plan participants have the potential to earn additional shares of common stock. This overachievement can not exceed 50% for officers and 25% for non-officers of the original grant.

## Notes to the Consolidated Financial Statements

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

A summary of the activity for PSs as of December 31, 2008, 2007 and 2006, and changes during the years then ended, is presented below (shares in thousands):

	2008		2007		2006	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested Performance Shares						
Outstanding at January 1	6,585	\$16.16	4,571	\$15.04	2,052	\$14.87
Granted	3,696	13.67	2,160	18.48	2,588	15.17
Vested	(2,734)	14.87	—	—	—	—
Cancelled	(169)	16.05	(146)	15.41	(69)	14.95
<b>Outstanding at December 31</b>	<b>7,378</b>	<b>\$15.39</b>	<b>6,585</b>	<b>\$16.16</b>	<b>4,571</b>	<b>\$15.04</b>

At December 31, 2008, the aggregate intrinsic value of PSs outstanding was \$59. The total intrinsic value of PS's vested during 2008 was \$41. The actual tax benefit realized for the tax deductions for vested PS's totaled \$13 for the year ended December 31, 2008.

We account for PSs using fair value determined as of the grant date. If the stated targets are not met, any recognized compensation cost would be reversed. As of December 31, 2008, there was \$48 of total unrecognized compensation cost related to nonvested PSs; this cost is expected to be recognized ratably over a remaining weighted-average contractual term of 1.5 years.

**Stock options:** Stock options generally vest over a period of three years and expire between eight and ten years from the date of grant. We have not issued any new stock options since 2004 and all options currently outstanding are fully vested and exercisable. The following table provides information relating to the status of, and changes in, outstanding stock options for each of the three years ended December 31, 2008 (stock options in thousands):

	2008		2007		2006	
	Stock Options	Average Option Price	Stock Options	Average Option Price	Stock Options	Average Option Price
Employee Stock Options						
Outstanding at January 1	52,424	\$19.73	60,480	\$18.56	76,307	\$19.40
Cancelled/Expired	(6,559)	50.08	(922)	24.18	(5,478)	49.44
Exercised	(680)	8.89	(7,134)	9.22	(10,349)	8.46
<b>Outstanding at December 31</b>	<b>45,185</b>	<b>\$15.49</b>	<b>52,424</b>	<b>\$19.73</b>	<b>60,480</b>	<b>\$18.56</b>

Options outstanding and exercisable at December 31, 2008 were as follows (stock options in thousands):

	Number Outstanding and Exercisable	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
Range of Exercise Prices			
\$ 4.75 to \$6.98	2,526	2.01	\$ 4.97
7.13 to 10.69	18,493	3.37	9.23
10.72 to 15.27	8,024	2.99	13.68
16.91 to 21.78	11,092	1.00	21.76
25.38 to 27.00	3,536	0.94	26.19
47.50 to 60.44	1,514	1.00	48.00
	45,185		

At December 31, 2008, the aggregate intrinsic value of stock options outstanding and exercisable was \$8.

# Notes to the Consolidated Financial Statements

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

The following table provides information relating to stock option exercises for the three years ended December 31, 2008:

	2008	2007	2006
Total intrinsic value	\$4	\$61	\$72
Cash received	6	65	82
Tax benefit realized for tax deductions	2	22	25

## Treasury Stock

The Board of Directors has cumulatively authorized programs for the repurchase of the Company's common stock totaling \$4.5 billion as of December 31, 2008. The \$4.5 billion includes additional authorizations of \$1.0 billion in both January and July of 2008.

Through December 31, 2008, we have repurchased a cumulative total of 194.1 million shares at a cost of \$2,945 (including associated fees of \$4) under these stock repurchase programs.

## Note 18 – Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share of common stock for the three years ended December 31, 2008 (shares in thousands):

	2008	2007	2006
<b>Basic Earnings per Share:</b>			
Net Income	\$ 230	\$ 1,135	\$ 1,210
Accrued dividends on Series C Mandatory Convertible Preferred Stock	—	—	(29)
Adjusted net income available to common shareholders	\$ 230	\$ 1,135	\$ 1,181
Weighted Average Common Shares Outstanding	885,471	934,903	943,852
<b>Basic Earnings per Share</b>	<b>\$ 0.26</b>	<b>\$ 1.21</b>	<b>\$ 1.25</b>
<b>Diluted Earnings per Share:</b>			
Net Income	\$ 230	\$ 1,135	\$ 1,210
Interest on Convertible securities, net	—	1	1
Adjusted net income available to common shareholders	\$ 230	\$ 1,136	\$ 1,211
Weighted Average Common Shares Outstanding	885,471	934,903	943,852
Common shares issuable with respect to:			
Stock options	3,885	8,650	9,300
Restricted stock and performance shares	6,186	7,396	3,980
Series C Mandatory Convertible Preferred Stock	—	—	37,398
Convertible securities	—	1,992	1,992
Adjusted Weighted Average Shares Outstanding	895,542	952,941	996,522
<b>Diluted Earnings per Share</b>	<b>\$ 0.26</b>	<b>\$ 1.19</b>	<b>\$ 1.22</b>

The 2008, 2007 and 2006 computation of diluted earnings per share did not include the effects of 29 million, 23 million and 27 million stock options, respectively, because their respective exercise prices were greater than the corresponding market value

per share of our common stock. In addition, the common shares issuable with respect to convertible securities were not included in the 2008 computation of diluted EPS because to do so would have been anti-dilutive.

# Reports of Management

## Management's Responsibility for Financial Statements

Our management is responsible for the integrity and objectivity of all information presented in this annual report. The consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include amounts based on management's best estimates and judgments. Management believes the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements fairly represent the Company's financial position and results of operations.

The Audit Committee of the Board of Directors, which is composed solely of independent directors, meets regularly with the independent auditors, PricewaterhouseCoopers LLP, the internal auditors and representatives of management to review accounting, financial reporting, internal control and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors and internal auditors have free access to the Audit Committee.



**Anne M. Mulcahy**  
Chief Executive Officer



**Lawrence A. Zimmerman**  
Chief Financial Officer



**Gary R. Kabureck**  
Chief Accounting Officer

## Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in the rules promulgated under the Securities Exchange Act of 1934. Under the supervision and with the participation of our management, including our principal executive, financial and accounting officers, we have conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in "*Internal Control – Integrated Framework*" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on the above evaluation, management has concluded that our internal control over financial reporting was effective as of December 31, 2008.

# Report of Independent Registered Public Accounting Firm

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 shareholders' equity present fairly, in all material respects, the financial position of Xerox Corporation and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness

exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1 to the Consolidated Financial Statements, the Company adopted the recognition and disclosure provisions of Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)" as of December 31, 2006.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



**PricewaterhouseCoopers LLP**  
Stamford, Connecticut  
February 13, 2009

## Quarterly Results of Operations (Unaudited)

(in millions, except per share data)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
<b>2008</b>					
Revenues	\$4,335	\$4,533	\$4,370	\$4,370	\$17,608
Costs and Expenses <sup>(1)</sup>	4,853	4,288	4,132	4,449	17,722
(Loss) Income before Income Taxes and Equity Income	(518)	245	238	(79)	(114)
Income tax (benefits) expenses <sup>(2)</sup>	(246)	59	15	(59)	(231)
Equity in net income of unconsolidated affiliates <sup>(3)</sup>	28	29	35	21	113
<b>Net (Loss) Income</b>	<b>\$ (244)</b>	<b>\$ 215</b>	<b>\$ 258</b>	<b>\$ 1</b>	<b>\$ 230</b>
Basic (Loss) Earnings per Share <sup>(4)</sup>	\$ (0.27)	\$ 0.24	\$ 0.30	\$ —	\$ 0.26
Diluted (Loss) Earnings per Share <sup>(4)</sup>	\$ (0.27)	\$ 0.24	\$ 0.29	\$ —	\$ 0.26
<b>2007</b>					
Revenues	\$3,836	\$4,208	\$4,302	\$4,882	\$17,228
Costs and Expenses	3,507	3,893	3,978	4,412	15,790
Income before Income Taxes and Equity Income	329	315	324	470	1,438
Income tax expenses	102	76	97	125	400
Equity in net income of unconsolidated affiliates <sup>(3)</sup>	6	27	27	37	97
<b>Net Income</b>	<b>\$ 233</b>	<b>\$ 266</b>	<b>\$ 254</b>	<b>\$ 382</b>	<b>\$ 1,135</b>
Basic Earnings per Share <sup>(4)</sup>	\$ 0.25	\$ 0.28	\$ 0.27	\$ 0.41	\$ 1.21
Diluted Earnings per Share <sup>(4)</sup>	\$ 0.24	\$ 0.28	\$ 0.27	\$ 0.41	\$ 1.19

<sup>(1)</sup> Costs and expenses include charges for restructuring and asset impairments and an equipment write-off of \$63, \$14 and \$388 for the second, third and fourth quarters of 2008, respectively. In addition, the first and fourth quarters of 2008 include \$795 and \$(21) for litigation matters.

<sup>(2)</sup> The first, second, third and fourth quarters of 2008 include \$304, \$20, \$5 and \$124 of tax benefits, respectively, from the above noted charges. Third quarter 2008 also included a \$41 income tax benefit from the settlement of certain previously unrecognized tax benefits.

<sup>(3)</sup> The first, second, third and fourth quarters of 2008 include \$10, \$3, \$2 and \$1 of charges, respectively, for our share of Fuji Xerox restructuring charges. The first, third and fourth quarters of 2007 include \$23, \$5, and \$2 of charges, respectively, for our share of Fuji Xerox restructuring charges.

<sup>(4)</sup> The sum of quarterly earnings per share may differ from the full-year amounts due to rounding, or in the case of diluted earnings per share, because securities that are anti-dilutive in certain quarters may not be anti-dilutive on a full-year basis.

## Five Years in Review

(in millions, except per share data)

(in millions, except per-share data)	2008	2007 <sup>(2)</sup>	2006	2005	2004
<b>Per-Share Data</b>					
Income from continuing operations					
Basic	\$ 0.26	\$ 1.21	\$ 1.25	\$ 0.91	\$ 0.84
Diluted	0.26	1.19	1.22	0.90	0.78
Earnings					
Basic	\$ 0.26	\$ 1.21	\$ 1.25	\$ 0.96	\$ 0.94
Diluted	0.26	1.19	1.22	0.94	0.86
Common stock dividends	\$ 0.17	\$ 0.0425	—	—	—
<b>Operations</b>					
Revenues	\$17,608	\$ 17,228	\$ 15,895	\$ 15,701	\$ 15,722
Sales	8,325	8,192	7,464	7,400	7,259
Service, outsourcing and rentals	8,485	8,214	7,591	7,426	7,529
Finance income	798	822	840	875	934
Research, development and engineering expenses	884	912	922	943	914
Selling, administrative and general expenses	4,534	4,312	4,008	4,110	4,203
Income from continuing operations	230	1,135	1,210	933	776
Net income	230	1,135	1,210	978	859
<b>Financial Position</b>					
Cash, cash equivalents and short-term investments	\$ 1,229	\$ 1,099	\$ 1,536	\$ 1,566	\$ 3,218
Accounts and finance receivables, net	9,462	10,505	10,043	9,886	10,573
Inventories	1,232	1,305	1,163	1,201	1,143
Equipment on operating leases, net	594	587	481	431	398
Land, buildings and equipment, net	1,419	1,587	1,527	1,627	1,759
Total Assets	22,447	23,543	21,709	21,953	24,884
<b>Consolidated Capitalization</b>					
Short-term debt and current portion of long-term debt	1,610	525	1,485	1,139	3,074
Long-term debt	6,774	6,939	5,660	6,139	7,050
Total Debt	8,384	7,464	7,145	7,278	10,124
Minorities' interests in equity of subsidiaries	120	103	108	90	80
Liabilities to subsidiary trusts issuing preferred securities <sup>(1)</sup>	648	632	624	724	717
Series C mandatory convertible preferred stock	—	—	—	889	889
Common shareholders' equity	6,238	8,588	7,080	6,319	6,244
<b>Total Consolidated Capitalization</b>	<b>\$15,390</b>	<b>\$16,787</b>	<b>\$14,957</b>	<b>\$15,300</b>	<b>\$18,054</b>
<b>Selected Data and Ratios</b>					
Common shareholders of record at year-end	46,541	48,261	40,372	53,017	55,152
Book value per common share	\$ 7.21	\$ 9.36	\$ 7.48	\$ 6.79	\$ 6.53
Year-end common stock market price	\$ 7.97	\$ 16.19	\$ 16.95	\$ 14.65	\$ 17.01
Employees at year-end	57,100	57,400	53,700	55,220	58,100
Gross margin	38.9%	40.3%	40.6%	41.2%	41.6%
Sales gross margin	33.7%	35.9%	35.7%	36.6%	37.4%
Service, outsourcing and rentals gross margin	41.9%	42.7%	43.0%	43.3%	43.0%
Finance gross margin	61.8%	61.6%	63.7%	62.7%	63.1%
Working capital	\$ 2,700	\$ 4,463	\$ 4,056	\$ 4,390	\$ 4,628
Current ratio	1.5	2.1	1.9	2.0	1.7
Cost of additions to land, buildings and equipment	\$ 206	\$ 236	\$ 215	\$ 181	\$ 204
Depreciation on buildings and equipment	\$ 257	\$ 262	\$ 277	\$ 280	\$ 305

<sup>(1)</sup> For 2005, the amount includes \$98 reported in other current liabilities.

<sup>(2)</sup> 2007 results include the acquisition of GIS. Refer to Note 3 – Acquisitions in the Consolidated Financial Statements.

# Corporate Information

## Stock Listed and Traded

Xerox common stock (XRX) is listed on the New York Stock Exchange and the Chicago Stock Exchange. It is also traded on the Boston, Cincinnati, Pacific Coast, Philadelphia and Switzerland exchanges.

## Xerox Common Stock Prices and Dividends

New York Stock Exchange composite prices*	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>2008</b>				
High	\$ 15.82	\$ 15.36	\$ 14.39	\$ 11.30
Low	13.10	13.28	11.05	5.25
Dividends Paid	0.0425	0.0425	0.0425	0.0425
<b>2007</b>				
High	\$ 18.09	\$ 19.40	\$ 19.90	\$ 17.68
Low	16.53	17.08	15.79	15.82
Dividends Paid <sup>(1)</sup>	—	—	—	—

\* Prices as of close of business

<sup>(1)</sup> In the fourth quarter of 2007, the Board of Directors declared a 4.25 cent per share dividend on common stock payable January 31, 2008 to shareholders of record on December 31, 2007. The Board of Directors did not declare any other dividends on common stock in 2006 or 2007.

## Certifications

We have filed with the SEC the certification required by Section 302 of the Sarbanes-Oxley Act as an exhibit to our 2008 Annual Report on Form 10-K, and have submitted to the NYSE in 2008 the CEO certification required by the NYSE corporate governance rules.