Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis ("MD&A") is intended to help the reader understand the results of operations and financial condition of Xerox Corporation. MD&A is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and the accompanying notes.

Throughout this document, references to "we," "our," the "Company" and "Xerox" refer to Xerox Corporation and its subsidiaries. References to "Xerox Corporation" refer to the stand-alone parent company and do not include its subsidiaries.

Executive Overview

We are a technology and services enterprise and a leader in the global document market, developing, manufacturing, marketing, servicing and financing the industry's broadest portfolio of document equipment, solutions and services. Increasingly, businesses are digitally creating and storing documents and using the Internet to exchange electronic documents. More customers are seeking to gain efficiencies in their document management processes and are looking to us for document-related services to achieve those efficiencies. We believe these trends play to the strengths of our product and service offerings and represent opportunities for future growth in the $132 billion market we serve. These transformations also represent opportunities for future growth since our research and development investments have been focused on digital, color and services offerings and our acquisitions have focused on expanding our services, software and distribution capabilities.

We operate in a global business environment, serving a wide range of customers with about 50 percent of our revenue generated from customers outside the U.S. Our markets are competitive. Customers are demanding document services such as assessment consulting, managed services, imaging and hosting and document intensive business process improvements. Additionally, our customers demand improved technology solutions, such as the ability to print offset quality color documents on-demand; improved product functionality, such as the ability to print, copy, fax and scan from a single device; and lower prices for the same functionality.

Our business model is built upon an annuity model that yields consistent strong cash flow, expanded earnings and enables us to provide good returns to shareholders. The majority of our revenue (supplies, service, paper, outsourcing, rentals and financing) is recurring, which we collectively refer to as post sale revenue. This recurring revenue provides a significant degree of stability to our revenue, profits and cash flow. Post sale revenue currently represents more than 70 percent of the Company's revenue and is driven by the amount of equipment installed at customer locations and the utilization of that equipment. As such, our critical success factors include equipment installations, which stabilize and grow our installed base of equipment at customer locations, page volume growth and higher revenue per page. Key drivers to increase equipment usage are connected multifunction devices, new services and solutions. The transition to color is the primary driver to improve revenue per page, as color documents typically require significantly more toner coverage per page than traditional black-and-white printing. In addition, our growing services business, including offerings such as managed print services which help customers reduce their costs, also drives post sale revenue.

In 2008, we completed several acquisitions to further strengthen our distribution capacity and expand our reach in the small to mid-size business ("SMB") market. Global Imaging Systems, Inc. ("GIS") acquired Saxon Business Systems ("Saxon"), an office equipment supplier with offices throughout Florida, as well as three additional smaller businesses – Better Quality Business Systems, Precision Copier Service Inc. DBA Sierra Office Solutions and Inland Business Systems of Chico. We also acquired Veenman B.V. ("Veenman"), expanding our reach into the SMB market in Europe. Veenman is Netherlands' leading independent distributor of office printers, copiers and multifunction devices serving small and mid-size businesses.

Financial Overview

2008 was an extremely challenging year due to worldwide economic weakness, particularly in the second half of the year. The unfavorable economic conditions, as well as a rapid shift in currency exchange rates and the related impact on foreign currency revenue and purchases put significant pressure on the business in 2008. The downturn in the economy adversely impacted equipment sales to large enterprises, as well as revenues from high volume production systems. In the fourth quarter of 2008, the increasingly wide-spread economic concerns found customers and partners prioritizing cash and delaying decisions on major contracts. In addition, our distribution partners reduced their inventories of supplies at year end, which negatively impacted our post sale revenue.

Revenue from our developing markets were also negatively impacted by the dramatic weakening of the Russian and eastern European economies.

Despite the difficult economic conditions in the second half of 2008, total revenue in 2008 increased 2% over the prior year, reflecting 4% growth in post sale revenue offset by a 2% decline in equipment sales revenue. Total color revenue of $6.7 billion was up 5% over the prior year, benefiting from our investments in this market and post sale revenue for document management services (also referred to as "Xerox Global Services") of $3.5 billion increased 3% over 2007.

2008 total gross margin of 38.9% was 1.4-percentage points below the prior year. Pricing, product mix and unfavorable exchange rates on our Yen based inventory purchases were only partially offset by cost productivity improvements. Selling, administrative and general ("SAG") expenses as a percent of revenue were 25.7 percent or 0.7-percentage points higher than the prior year. SAG expenses increased due to the full year inclusion of GIS, higher bad debt provisions and increased marketing investments partially offset by restructuring savings. Additionally, we continued to invest in research and development and to prioritize our investments in the faster growing areas of the market. Research, development and engineering ("RD&E") expenses were 5% of revenue in 2008, which is consistent with the prior year. Our investments in the growing areas of digital production and office systems, particularly with respect to color products, contributed to more than two-thirds of our equipment sales being generated from products launched in the last two years.

Changes in our revenue mix – both from geographic and product line perspectives – have reduced our gross profit margins. This, combined with uncertain economic conditions, required us to take actions to adjust our cost and expense profile. Accordingly, we recognized pre-tax restructuring charges of $429 million for 2008 actions in order to reduce our cost base and provide increased flexibility in our business in this depressed or recessionary economy. Refer to Note 9 – Restructuring and Asset Impairment Charges in the Consolidated Financial Statements for further information.

Our balance sheet strategy focused on optimizing operating cash flows and returning value to shareholders through acquisitions, share repurchase and dividends. We continue to maintain debt levels primarily to support our customer financing operations. Cash flow from operations was $939 million in 2008 and included $615 million of net securities-related litigation payments as we resolved two long standing securities litigation cases. Cash used for investments was $441 million and included capital expenditures of $335 million and acquisitions of $155 million. Cash used for financing of $311 million reflected continued net repayments of secured borrowings of $227 million; $812 million for share repurchases; and $154 million for dividends, partially offset by net cash flows from new borrowings of $926 million. New borrowings included $1.4 billion of Senior Notes in an April 2008 public offering. We finished the year with cash and cash equivalents of $1.2 billion.

Our prospective balance sheet strategy includes: optimizing operating cash flows; maintaining our investment grade credit ratings; achieving an optimal cost of capital; and effectively deploying cash to deliver and maximize long-term shareholder value through acquisitions, share repurchase and dividends. However, due to the current economic uncertainty, we have no immediate plans for further share repurchases at this time. Our strategy also includes appropriately leveraging our financing assets (finance receivables and equipment on operating leases).

Currency Impacts

To understand the trends in our business, we believe that it is helpful to analyze the impact of changes in the translation of foreign currencies into U.S. Dollars on revenues and expenses. We refer to this analysis as "currency impact" or "the impact from currency". Revenues and expenses from our developing markets are analyzed at actual exchange rates for all periods presented, since these countries generally have volatile currency and inflationary environments, and our operations in these countries have historically implemented pricing actions to recover the impact of inflation and devaluation. We do not hedge the translation effect of revenues or expenses denominated in currencies where the local currency is the functional currency.

Approximately 50% of our consolidated revenues are derived from operations outside of the United States where the U.S. Dollar is not the functional currency. When compared with the average of the major European currencies and Canadian Dollar on a revenue-weighted basis, the U.S. Dollar was 3% weaker in 2008 and 9% weaker in 2007, each compared to the prior year. As a result, the foreign currency translation impact on revenue was a 1% benefit in 2008 and a 3% benefit in 2007.

Currency exchange rates fluctuated significantly in the fourth quarter 2008. The U.S. Dollar strengthened significantly in the fourth quarter 2008 as compared to the currencies of our major foreign operations – the Euro, Pound Sterling and Canadian Dollar. The foreign currency translation impact on revenue from this fluctuation in exchange rates was a 3% point benefit through the third quarter 2008 as compared to a 5% detriment in the fourth quarter 2008. If U.S. Dollar exchange rates against these major currencies remain at their current levels we expect it will have an estimated 5% to 6% negative impact on total revenue in the first half of 2009.

Summary Results

Revenue

Revenues for the three years ended December 31, 2008 were as follows:

	Year Ended December 31,			Percent Change	
(in millions)	2008	2007	2006	2008	2007
Equipment sales	$ 4,679	$ 4,753	$ 4,457	(2)%	7%
Post sale revenue[1]	12,929	12,475	11,438	4 %	9%
Total Revenue	**$17,608**	**$17,228**	**$15,895**	**2 %**	**8 %**

Reconciliation to Consolidated Statements of Income

	2008	2007	2006	2008	2007
Sales	$ 8,325	$ 8,192	$ 7,464		
Less: Supplies, paper and other sales	(3,646)	(3,439)	(3,007)		
Equipment sales	**$ 4,679**	**$ 4,753**	**$ 4,457**		
Service, outsourcing and rentals	$ 8,485	$ 8,214	$ 7,591		
Finance income	798	822	840		
Add: Supplies, paper and other sales	3,646	3,439	3,007		
Post sale revenue	**$12,929**	**$12,475**	**$11,438**		
Memo: Color[3]	**$ 6,669**	**$ 6,356**	**$ 5,578**	**5%**	**14%**

Total 2008 revenue increased 2% compared to the prior year and was flat when including GIS in our 2007 results.[2] Currency had a 1-percentage point positive impact on total revenues. Total revenues included the following:

- 4% increase in post sale revenue, or 2% including GIS in our 2007 results.[2] This included a 1-percentage point benefit from currency. Growth in GIS, color products and document management services offset the declines in high-volume black-and-white printing systems, black-and-white multifunction devices and light lens product revenue. The components of post sale revenue increased as follows:
  - 3% increase in service, outsourcing, and rentals revenue to $8,485 million reflected the full year inclusion of GIS, and growth in document management services.
  - Supplies, paper, and other sales of $3,646 million grew 6% year-over-year due to the full year inclusion of GIS as well as growth in color supplies and paper sales.
- 2% decrease in equipment sales revenue. There was no impact from currency on equipment sales revenue. When including GIS in our 2007 results,[2] equipment sales revenue decreased 5%, with a 1-percentage point benefit from currency. Overall price declines of between 5%-10% as well as product mix more than offset overall growth in install activity.
- 5% growth in color revenue.[3] Color revenue of $6,669 million in 2008 represented 41% of total revenue, excluding GIS, compared to 39% in 2007 reflecting:
  - 10% growth in color post sale revenue to $4,590 million. Color post sale revenue represented 37% and 35% of post sale revenue, in 2008 and 2007, respectively.[4]
  - Color equipment sales revenue declined 4% to $2,079 million. Color equipment sales represented 50% of total equipment sales, in 2008 and 2007,[4] respectively.
  - 24%[5] growth in color pages. Color pages represented 18%[5] and 12% of total pages in 2008 and 2007, respectively.

Total 2007 revenue increased 8% compared to the prior year and includes the results of GIS since May 9, 2007, the effective date of our acquisition. When including GIS in our 2006 results,[2] our 2007 total revenue increased 4%. Currency had a 3-percentage point positive impact on total revenues. Total revenues included the following:

- 9% increase in post sale revenue, or 6% including GIS in our 2006 results.[2] This included a 3-percentage point benefit from currency. Growth in GIS, color products, developing markets and document management services more than offset the decline in black-and-white digital office revenue and light lens product revenue. The components of post sale revenue increased as follows:
  - 8% increase in service, outsourcing and rentals revenue to $8,214 million reflected the inclusion of GIS, growth in document management services and technical service revenue.
  - Supplies, paper and other sales of $3,439 million grew 14% year-over-year due to the inclusion of GIS as well as growth in developing markets.
- 7% increase in equipment sales revenue, or a decrease of 1% when including GIS in our 2006 results.[2] This included a 3-percentage point benefit from currency. Growth in office multifunction color and production color install activity was offset by overall price declines of between 5%-10%, declines in production black-and-white products and color printers, as well as an increased proportion of equipment installed under operating lease contracts where revenue is recognized over-time in post sale.

- 14% growth in color revenue.[3] Color revenue of $6,356 million in 2007 comprised 39% of total revenue, compared to 35% in 2006 reflecting:
  - 18% growth in color post sale revenue to $4,180 million. Color post sale revenue represented 35% and 31% of post sale revenue, in 2007 and 2006, respectively.[4]
  - 7% growth in color equipment sales revenue to $2,176 million. Color equipment sales represented 49% and 45% of total equipment sales, in 2007 and 2006, respectively.[4]
  - 31% growth in color pages. Color pages represented 12% and 9% of total pages in 2007 and 2006, respectively.[4]

(1) Post sale revenue is largely a function of the equipment placed at customer locations, the volume of prints and copies that our customers make on that equipment, the mix of color pages and associated services.
(2) The percentage point impacts from GIS reflect the revenue growth year-over-year after including GIS's results for 2007 and 2006 on a proforma basis. See "Non-GAAP Financial Measures" section for an explanation of this non-GAAP measure.
(3) Color revenues represent a subset of total revenues and excludes the impact of GIS's revenues.
(4) As of December 31, 2008, total color, color post sale and color equipment sales revenues comprised 41%, 37% and 50%, respectively, if calculated on total, total post sale, and total equipment sales revenues, including GIS. GIS is excluded from the color information presented, because the breakout of the information required to make this computation for all periods is not available.
(5) Pages include estimates for developing markets, GIS and printers.

Net Income

Net income and diluted earnings per share for the three years ended December 31, 2008 were as follows:

(in millions, except per share amounts)	2008	2007	2006
Net income	$ 230	$1,135	$1,210
Diluted earnings per share	$0.26	$ 1.19	$ 1.22

2008 Net income of $230 million, or $0.26 per diluted share, included the following:

- $491 million after-tax charges ($774 million pre-tax) associated with securities-related litigation matters as well as other probable litigation-related losses including $36 million for the Brazilian labor-related contingencies.
- $292 million after-tax charge ($426 million pre-tax) for second, third and fourth quarter 2008 restructuring and asset impairment actions.
- $24 million after-tax charge ($39 million pre-tax) for an Office product line equipment write-off.
- $41 million income tax benefit from the settlement of certain previously unrecognized tax benefits.

2007 Net income of $1,135 million, or $1.19 per diluted share, included $30 million after-tax charge for our share of Fuji Xerox ("FX") restructuring charges.

2006 Net income of $1,210 million, or $1.22 per diluted share, included the following:

- $472 million income tax benefit related to the favorable resolution of certain tax matters from the 1999-2003 IRS audit.
- $68 million (pre-tax and after-tax) for probable losses on Brazilian labor-related contingencies.
- $46 million tax benefit resulting from the resolution of certain tax matters associated with foreign tax audits.
- $9 million after-tax ($13 million pre-tax) charge from the write-off of the remaining unamortized deferred debt issuance costs as a result of the termination of our 2003 Credit Facility.
- $257 million after-tax ($385 million pre-tax) restructuring and asset impairment charges.

Application of Critical Accounting Policies

In preparing our Consolidated Financial Statements and accounting for the underlying transactions and balances, we apply various accounting policies. Senior management has discussed the development and selection of the critical accounting policies, estimates and related disclosures, included herein, with the Audit Committee of the Board of Directors. We consider the policies discussed below as critical to understanding our Consolidated Financial Statements, as their application places the most significant demands on management's judgment, since financial reporting results rely on estimates of the effects of matters that are inherently uncertain. In instances where different estimates could have reasonably been used, we disclosed the impact of these different estimates on our operations. In certain instances, like revenue recognition for leases, the accounting rules are prescriptive; therefore, it would not have been possible to reasonably use different estimates. Changes in assumptions and estimates are reflected in the period in which they occur. The impact of such changes could be material to our results of operations and financial condition in any quarterly or annual period.

Specific risks associated with these critical accounting policies are discussed throughout the MD&A, where such policies affect our reported and expected financial results. For a detailed discussion of the application of these and other accounting policies, refer to Note 1 – Summary of Significant Accounting Policies, in the Consolidated Financial Statements.

Revenue Recognition for Leases

Our accounting for leases involves specific determinations under applicable lease accounting standards, which often involve complex and prescriptive provisions. These provisions affect the timing of revenue recognition for our equipment. If a lease qualifies as a sales-type capital lease, equipment revenue is recognized upon delivery or installation of the equipment as sale revenue as opposed to ratably over the lease term. 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 are for original terms longer than five years. There is no significant after-market for our used equipment. We believe five years is representative of the period during which the equipment is expected to be economically usable, with normal service, for the purpose for which it is intended.

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 monthly fixed price for all elements over the contractual lease term. Typically these arrangements 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. Revenues under these 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 supplies and non-maintenance services. Our revenue allocation for 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. We perform extensive analyses of available verifiable objective evidence of equipment fair value based on cash selling prices during the applicable period. The cash selling prices are compared to the range of values included in our lease accounting systems. The range of cash selling prices must be reasonably consistent with the lease selling prices, taking into account residual values, in order for us to determine that such lease prices are indicative of fair value.

Our pricing interest rates, which are used in determining customer payments, are developed based upon a variety of factors including local prevailing rates in the marketplace and the customer's credit history, industry and credit class. We reassess our pricing interest rates quarterly based on changes in the local prevailing rates in the marketplace. These interest rates have been historically adjusted if the rates vary by twenty-five basis points or more, cumulatively, from the last rate in effect. The pricing interest rates generally equal the implicit rates within the leases, as corroborated by our comparisons of cash to lease selling prices. In light of worldwide economic conditions prevailing at the end of 2008, we expect to continually review this methodology in 2009 to ensure that our pricing interest rates are reflective of changes in the local prevailing rates in the marketplace.

Allowance for Doubtful Accounts and Credit Losses

We perform ongoing credit evaluations of our customers and adjust credit limits based upon customer payment history and current creditworthiness. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that have been identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience credit loss rates similar to those we have experienced in the past. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers. We recorded bad debt provisions of $188 million, $134 million and $87 million in SAG expenses in our Consolidated Statements of Income for the years ended December 31, 2008, 2007 and 2006, respectively.

Historically, the majority of the bad debt provision relates to our finance receivables portfolio. This provision is inherently more difficult to estimate than the provision for trade accounts receivable because the underlying lease portfolio has an average maturity, at any time, of approximately two to three years and contains past due billed amounts, as well as unbilled amounts. The estimated credit quality of any given customer and class of customer or geographic location can significantly change during

the life of the portfolio. We consider all available information in our quarterly assessments of the adequacy of the provision for doubtful accounts.

The current economic environment has increased the risk of non-collection of receivables. We have accordingly considered this increased risk in the evaluation and assessment of our allowance for doubtful accounts at year-end. Collection risk is somewhat mitigated by the fact that our receivables are fairly well dispersed among a diverse customer base both in size and geography. Days sales outstanding remained fairly flat year-over-year. In addition, the aging of receivables has not increased significantly. Accounts receivable balances greater than 60 days outstanding were 17% of total gross accounts receivables at December 31, 2008 as compared to 15% at December 31, 2007. However, we continue to assess our receivable portfolio in light of the current economic environment and its impact on our estimation of the adequacy of the allowance for doubtful accounts.

As discussed above, in preparing our Consolidated Financial Statements for the three year period ended December 31, 2008, we estimated our provision for doubtful accounts based on historical experience and customer-specific collection issues. This methodology has been consistently applied for all periods presented. During the five year period ended December 31, 2008, our reserve for doubtful accounts ranged from 3.0% to 4.2% of gross receivables. Holding all other assumptions constant, a 1-percentage point increase or decrease in the reserve from the December 31, 2008 rate of 3.4% would change the 2008 provision by approximately $98 million.

Pension and Post-Retirement Benefit Plan Assumptions

We sponsor defined benefit pension plans in various forms in several countries covering substantially all employees who meet eligibility requirements. Post-retirement benefit plans cover primarily U.S. employees for retirement medical costs. 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. Difference between these assumptions and actual experiences are reported as net actuarial gains and losses and are subject to amortization to net periodic pension cost over the average remaining service lives of the employees participating in the pension plan.

Cumulative actuarial losses for our pension plans as of December 31, 2008 were $1.8 billion, as compared to $1 billion at December 31, 2007. The change from December 31, 2007 relates primarily to actual losses on plan assets in 2008 as compared to expected returns partially offset by an increase in the discount rate. The total actuarial loss will be amortized in the future, subject to offsetting gains or losses that will change the future amortization amount.

We have utilized a weighted average expected rate of return on plan assets of 7.6% for 2008, 7.6% for 2007 and 7.8% for 2006, on a worldwide basis. In estimating this rate, we considered the historical returns earned by the plan assets, the rates of return expected in the future and our investment strategy and asset mix with respect to the plans' funds.

During 2008, the actual loss on plan assets was $1.5 billion, primarily as a result of the significant declines in the equity markets during the fourth quarter of 2008. In estimating the 2009 expected rate of return we considered this significant decline in the fair value of our plan assets as well as potential changes in our investment mix, partly in response to the significant volatility expected in the equity markets for the foreseeable future. The weighted average expected rate of return on plan assets we will utilize for 2009 will be 7.4% as compared to 7.6% in 2008.

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 a 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 can result from using the fair market value approach. The difference between the actual return on plan assets and the expected return on plan assets is added to, or subtracted from, any cumulative differences that arose in prior years. This amount is a component of the net actuarial gain or loss.

Another significant assumption affecting our pension and post-retirement benefit obligations and the net periodic pension and other post-retirement benefit cost is the rate that we use to discount our future anticipated benefit obligations. The discount rate reflects the current rate at which the pension liabilities could be effectively settled considering the timing of expected payments for plan participants. In estimating this rate, we consider rates of return on high quality fixed-income investments included in various published bond indices, adjusted to eliminate the effects of call provisions and differences in the timing and amounts of cash outflows related to the bonds. In the U.S. and the U.K., which comprise approximately 80% of our projected benefit obligations,

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. Due to the recent, unprecedented events in the financial markets associated with the current credit environment, there is a greater than usual disparity in yields among the bonds included in the various indices used to determine our pension discount rates. Given this disparity, we carefully evaluated our existing methodologies for determining our pension discount rates and refined those methodologies to the extent required to ensure we selected an appropriate discount rate. The weighted average discount rate we utilized to measure our pension obligation as of December 31, 2008 and to calculate our 2009 expense was 6.3%, which is an increase of 0.4% from 5.9% used in determining our 2008 expense. The increase is primarily driven by our U.K. and Canadian plans.

Assuming settlement losses in 2009 are consistent with 2008, our 2009 net periodic defined benefit pension cost is expected to be approximately $20 million higher than 2008, primarily as a result of the reduction in the expected return on plan assets due to lower asset values and increased amortization of actuarial gains and losses partially offset by an increase in the discount rate.

On a consolidated basis, we recognized net periodic pension cost of $254 million, $315 million and $425 million for the years ended December 31, 2008, 2007 and 2006, respectively. The costs associated with our defined contribution plans, which are included in net periodic pension cost, were $80 million, $80 million and $70 million for the years ended December 31, 2008, 2007 and 2006, respectively. Pension cost is included in several income statement components based on the related underlying employee costs. Pension and post-retirement benefit plan assumptions are included in Note 14 – Employee Benefit Plans in the Consolidated Financial Statements. Holding all other assumptions constant, a 0.25% increase or decrease in the discount rate would (decrease)/increase the 2009 projected net periodic pension cost by $(13) million or $18 million, respectively. Likewise, a 0.25% increase or decrease in the expected return on plan assets would change the 2009 projected net periodic pension cost by $11 million.

Income Taxes and Tax Valuation Allowances

We record the estimated future tax effects of temporary differences between the tax bases of assets and liabilities and amounts reported in our Consolidated Balance Sheets, as well as operating loss and tax credit carryforwards. We follow very specific and detailed guidelines in each tax jurisdiction regarding the recoverability of any tax assets recorded in our Consolidated Balance Sheets and provide valuation allowances as required. We regularly review our deferred tax assets for recoverability considering historical profitability, projected future taxable income, the expected timing of the reversals of existing temporary differences and tax planning strategies. If we continue to operate at a loss in certain jurisdictions or are unable to generate sufficient future taxable income, or if there is a material change in the actual effective tax rates or time period within which the underlying temporary differences become taxable or deductible, we could be required to increase the valuation allowance against all or a significant portion of our deferred tax assets resulting in a substantial increase in our effective tax rate and a material adverse impact on our operating results. Conversely, if and when our operations in some jurisdictions were to become sufficiently profitable to recover previously reserved deferred tax assets, we would reduce all or a portion of the applicable valuation allowance in the period when such determination is made. This would result in an increase to reported earnings in such period. Adjustments to our valuation allowance, through charges to income tax expense, were $17 million, $14 million and $12 million for the years ended December 31, 2008, 2007 and 2006, respectively. There were other (decreases) increases to our valuation allowance, including the effects of currency, of $(136) million, $86 million and $45 million for the years ended December 31, 2008, 2007 and 2006, respectively, that did not affect income tax expense in total as there was a corresponding adjustment to deferred tax assets or other comprehensive income. Gross deferred tax assets of $3.8 billion and $3.6 billion had valuation allowances of $628 million and $747 million at December 31, 2008 and 2007, respectively.

We are subject to ongoing tax examinations and assessments in various jurisdictions. Accordingly, we may incur additional tax expense based upon our assessment of the more-likely-than-not outcomes of such matters. In addition, when applicable, we adjust the previously recorded tax expense to reflect examination results. Our ongoing assessments of the more-likely-than-not outcomes of the examinations and related tax positions require judgment and can materially increase or decrease our effective tax rate as well as impact our operating results.

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 for years before 2000.

Legal Contingencies

We are involved in a variety of claims, lawsuits, investigations and proceedings concerning securities law, intellectual property law, environmental law, employment law and ERISA, as discussed in Note 16 – Contingencies in the Consolidated Financial Statements. 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.

Business Combinations and Goodwill

The application of the purchase method of accounting for business combinations requires the use of significant estimates and assumptions in the determination of the fair value of assets acquired and liabilities assumed in order to properly allocate purchase price consideration between assets that are depreciated and amortized from goodwill. Our estimates of the fair values of assets and liabilities acquired are based upon assumptions believed to be reasonable, and when appropriate, include assistance from independent third-party appraisal firms.

As a result of our acquisition of GIS, as well as other prior year acquisitions, we have a significant amount of goodwill. 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 for purposes of establishing a discount rate and relevant market data.

Our annual impairment test of goodwill is performed in the fourth quarter. The estimated fair values of the Company's reporting units were based on discounted cash flow models derived from internal earnings forecasts and assumptions. The assumptions and estimates used in those valuations incorporated the expected impact of the challenging economic environment that has persisted over the past year. In performing our 2008 impairment test, the following were the overall composite long-term assumptions regarding revenue and expense growth, which were the basis for estimating future cash flows used in the discounted cash flow model: 1) revenue growth 3%; 2) gross margin 39-40%; 3) RD&E 4-5%; 4) SAG 24-25%; and 5) return on sales 8-9%. We believe these estimated assumptions are appropriate for our circumstances, in-line with historical results and consistent with our forecasted long-term business model. These assumptions also have considered the current economic environment.

Based on those valuations, we determined that the fair values of our reporting units exceeded their carrying values and no goodwill impairment charge was required during the fourth quarter. In light of the continued difficult economic conditions and the fact that the Company's stock has been generally trading below net book value per share over the past quarter, we reassessed our assumptions as of December 31, 2008. We do not believe the recent general downturn in the U.S. equity markets is representative of any fundamental change in our business. Based on current results and expectations, we determined that the fair values of our reporting units continue to exceed their carrying values and determined that no goodwill impairment charge was required as of December 31, 2008.

Refer to Note 1 – Summary of Significant Accounting Policies – "Goodwill and Intangible Assets" for further information regarding our goodwill impairment testing, as well as Note 8 – Goodwill and Intangible Assets, Net in the Consolidated Financial Statements for further information regarding goodwill by operating segment.

Operations Review

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. See Note 2 – Segment Reporting in the Consolidated Financial Statements for further discussion on our segment operating revenues and segment operating profit.

Revenues by segment for the years ended 2008, 2007 and 2006 were as follows:

	Year Ended December 31,			
(in millions)	Production	Office	Other	Total
2008				
Equipment sales	**$ 1,325**	**$ 3,105**	**$ 249**	**$ 4,679**
Post sale revenue	**3,912**	**6,723**	**2,294**	**12,929**
Total Revenues	**$ 5,237**	**$ 9,828**	**$ 2,543**	**$17,608**
Segment Profit (Loss)	**$ 394**	**$ 1,062**	**$ (165)**	**$ 1,291**
Operating Margin	**7.5%**	**10.8%**	**(6.5)%**	**7.3%**
2007				
Equipment sales	$ 1,471	$ 3,030	$ 252	$ 4,753
Post sale revenue	3,844	6,443	2,188	12,475
Total Revenues	**$ 5,315**	**$ 9,473**	**$ 2,440**	**$17,228**
Segment Profit (Loss)	**$ 562**	**$ 1,115**	**$ (89)**	**$ 1,588**
Operating Margin	**10.6%**	**11.8%**	**(3.7)%**	**9.2%**
2006				
Equipment sales	$ 1,491	$ 2,786	$ 180	$ 4,457
Post sale revenue	3,564	5,926	1,948	11,438
Total Revenues	**$ 5,055**	**$ 8,712**	**$ 2,128**	**$15,895**
Segment Profit (Loss)	**$ 504**	**$ 1,010**	**$ (124)**	**$ 1,390**
Operating Margin	**10.0%**	**11.6%**	**(5.8)%**	**8.7%**

In 2008 we revised our segment reporting to integrate the Developing Markets Operations ("DMO") into the Production, Office and Other segments. DMO is a geographic region that has matured to a level where we now manage it on the basis of products sold, consistent with our North American and European geographic regions. All prior periods presented have been restated accordingly.

Note: Install activity percentages include the Xerox-branded product shipments to GIS.

Segment Revenue and Operating Profit

Production

Revenue

2008 Production revenue of $5,237 million decreased 1%, including a 1-percentage point benefit from currency, reflecting:

- 2% increase in post sale revenue as growth from color, continuous feed and light production products offset declines in revenue from black-and-white high-volume printing systems and light lens devices.
- 10% decrease in equipment sales revenue, primarily reflecting pricing declines in both black-and-white and color production systems, driven in part by weakness in the U.S.
- 1% increase in installs of production color products driven in part by Xerox 700 and iGen4™ activity as well as color continuous feed.
- 6% decline in installs of production black-and-white systems driven primarily by declines in installs of light production systems.

2007 Production revenue of $5,315 million increased 5%, including a 4-percentage point benefit from currency, reflecting:

- 8% increase in post sale and other revenue, including a 4-percentage point benefit from currency, as growth from digital products more than offset declines in revenue from older light lens technology.
- 1% decrease in equipment sales revenue, including a 3-percentage point benefit from currency, reflecting growth in production color systems offset by declines in black-and-white production printing systems and light production and an increased proportion of equipment installed under operating lease contracts where revenue is recognized over-time in post sale.
- 6% growth in installs of production color products driven by DocuColor® 242/252/260 family, DocuColor 5000 and iGen3® activity.
- 8% decline in installs of production black-and-white systems reflecting declines in installs of both high-volume and light production systems.

Operating Profit

2008 Operating profit of $394 million decreased $168 million from 2007. The decrease is primarily the result of lower revenue and lower gross margins due to pricing and product mix as well as increased SAG expenses.

2007 Operating profit of $562 million increased $58 million from 2006. The increase is primarily the result of higher gross profit and lower R,D&E, partially offset by an increase in bad debt expense.

Office

Revenue

2008 Office revenue of $9,828 million increased 4%, including a 1-percentage point benefit from currency, as well as the benefits from our expansion in the SMB market through GIS and Veenman. Revenue for 2008 reflects:

- 4% increase in post sale revenue, reflecting the full year inclusion of GIS as well as growth from color multifunction devices and color printers partially offset by declines in black-and-white digital devices. Office post sale revenue was negatively impacted in the fourth quarter of 2008 by declines in channel supply purchases, including lower purchases within developing markets.
- 2% increase in equipment sales revenue, reflecting the full year inclusion of GIS as well as growth from color digital products which more than offset declines from black-and-white devices primarily due to price declines and product mix.
- 24% color multifunction device install growth led by strong demand for Xerox WorkCentre® and Phaser® products.
- 8% increase in installs of black-and-white copiers and multifunction devices, including 8% growth in Segment 1&2 products (11-30 ppm) and 8% growth in Segment 3-5 products (31-90 ppm). Segment 3-5 installs include the Xerox 4595, a 95 ppm device with an embedded controller.
- 12% increase in color printer installs.

2007 Office revenue of $9,473 million increased 9%, including a 3-percentage point benefit from currency, reflecting:

- 9% increase in post sale revenue, reflecting the inclusion of GIS since May 2007 as well as growth from color multifunction devices and color printers.
- 9% increase in equipment sales revenue, reflecting the inclusion of GIS since May 2007 as well as color multifunction products install growth.
- 65% color multifunction device install growth led by strong demand for Xerox WorkCentre products.
- 5% increase in installs of black-and-white copiers and multifunction devices, including 4% growth in Segment 1&2 products (11-30 ppm) and 7% growth in Segment 3-5 products (31-90 ppm) that includes the 95 ppm device with an embedded controller.
- 10% decline in color printer installs due to lower OEM sales.

Operating Profit

2008 Operating profit of $1,062 million decreased $53 million from 2007. The decrease was primarily due to lower gross profits reflecting lower margins as well as higher SAG expenses partially offset by the full year inclusion of GIS.

2007 Operating profit of $1,115 million increased $105 million from 2006. The increase was primarily due to the inclusion of GIS since May 2007 and higher gross profits partially offset by higher SAG expenses.

Other

Revenue

2008 Other revenue of $2,543 million increased 4% primarily reflecting the full year inclusion of GIS and increased paper revenue partially offset by lower revenue from wide format systems. There was no impact from currency. Paper comprised approximately 50% of Other segment revenue.

2007 Other revenue of $2,440 million increased 15%, including a 3-percentage point benefit from currency, primarily reflecting the inclusion of GIS since May 2007 as well as increased paper and value-added services revenues. Paper comprised approximately 50% of Other segment revenue.

Operating Loss

2008 Operating loss of $165 million increased $76 million from 2007 reflecting lower wide format revenue, higher foreign exchange losses and lower interest income partially offset by gains on sales of assets.

2007 Operating loss of $89 million decreased $35 million from 2006 reflecting higher revenue as well as lower currency exchange losses and litigation charges, partially offset by higher interest expense and lower gains on the sales of businesses and assets.

Costs, Expenses and Other Income

Gross Margin

Gross margins by revenue classification were as follows:

	Year Ended December 31,		
	2008	2007	2006
Sales	**33.7%**	35.9%	35.7%
Service, outsourcing and rentals	**41.9%**	42.7%	43.0%
Finance income	**61.8%**	61.6%	63.7%
Total Gross margin	**38.9%**	**40.3%**	**40.6%**

2008 Total gross margin decreased 1.4-percentage points compared to 2007 as price declines and mix of approximately 2.0-percentage points were only partially offset by cost productivity improvements. Cost improvements were limited by an unfavorable impact on product costs of approximately 0.5-percentage points from the significant strengthening of the Yen versus the U.S. Dollar and Euro. The negative impact of 0.3-percentage points from an Office product line equipment write-off was offset by positive adjustments related to the capitalized costs for equipment on operating leases and European product disposal costs.

- Sales gross margin decreased 2.2-percentage points primarily due to the approximately 2.5-percentage point impact of price declines as well as channel and product mix. Cost improvements, which historically tend to offset price declines, were limited in 2008 by the adverse impact of the strengthening Yen on our inventory purchases.
- Service, outsourcing and rentals margin decreased 0.8-percentage points primarily due to mix as price declines of 1.3-percentage points were offset by cost improvements. Mix reflects margin pressure from document management services.
- Financing income margin of approximately 62% remained comparable to 2007.

Since a large portion of our inventory procurement is from Japan, the strengthening of the Yen versus the U.S. Dollar and Euro in 2008 significantly impacted our product cost. The Yen strengthened approximately 14% against the U.S. Dollar and 6% against the Euro in 2008 as compared to 2007. A significant portion of that strengthening occurred in the fourth quarter 2008 when the Yen strengthened 17% against the U.S. Dollar and 29% against the Euro as compared to prior year. We expect product costs and gross margins to continue to be negatively impacted in 2009 if Yen exchange rates remain at current levels.

2007 Total Gross margin was down slightly as compared to 2006 as cost improvements were offset by price and product mix.

- Sales gross margin increased 0.2-percentage points primarily as cost improvements and other variances more than offset the 2.0-percentage point impact of price declines.
- Service, outsourcing and rentals margin decreased 0.3-percentage points as cost improvements and other variances did not fully offset price declines and unfavorable product mix of approximately 2.0-percentage points.
- Financing income margin declined 2.1-percentage points reflecting additional interest expense due to higher interest rates.

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

We invest in technological development, particularly in color, and believe our R,D&E spending is sufficient to remain technologically competitive.

	Year Ended December 31,			Change	
(in millions)	**2008**	2007	2006	**2008**	2007
Total R,D&E expenses	**$884**	$912	$922	**$28**	$10
R,D&E % revenue	**5.0%**	5.3%	5.8%	**(0.3)pts**	(0.5)pts

2008 R,D&E of $884 million decreased $28 million from 2007. We expect our 2009 R,D&E spending to approximate 4% to 5% of total revenue.

- R&D of $750 million decreased $14 million from 2007. Our R&D is strategically coordinated with that of Fuji Xerox, which invested $788 million and $672 million in R&D in 2008 and 2007, respectively. Much of the reported Fuji Xerox R&D increase was caused by changes in foreign exchange rates.
- Sustaining engineering costs of $134 million were $14 million lower than 2007 due primarily to lower spending related to environmental compliance activities and maturing product platforms in the Production segment.
- R,D&E as a percentage of revenue declined 0.3-percentage points reflecting the capture of efficiencies following a significant number of new product launches over the past two years as well as leveraging our current R,D&E investments to support our GIS operations.

2007 R,D&E of $912 million decreased $10 million from 2006.

- R&D of $764 million increased $3 million from 2006. Our R&D is strategically coordinated with that of Fuji Xerox, which invested $672 million and $660 million in R&D in 2007 and 2006, respectively.
- Sustaining engineering costs of $148 million were $13 million lower than 2006 due primarily to lower spending related to environmental compliance activities and maturing product platforms in the Production segment.
- R,D&E as a percentage of revenue declined 0.5-percentage points as we leveraged our current R,D&E investments to support GIS operations.

Selling, Administrative and General Expenses ("SAG")

	Year Ended December 31,			Change	
(in millions)	**2008**	2007	2006	**2008**	2007
Total SAG expenses	**$4,534**	$4,312	$4,008	**$222**	$304
SAG % revenue	**25.7%**	25.0%	25.2%	**0.7pts**	(0.2)pts

2008 SAG expenses of $4,534 million were $222 million higher than 2007, including a $12 million unfavorable impact from currency. The SAG expense increase was the result of the following:

- $94 million increase in selling expenses primarily reflecting the full year inclusion of GIS, investments in selling resources and marketing communications and unfavorable currency partially offset by lower compensation.
- $75 million increase in general and administrative ("G&A") expenses primarily from the full year inclusion of GIS and unfavorable currency.
- $54 million increase in bad debt expense reflecting increased write-offs, particularly in the fourth quarter 2008, which included several high value account bankruptcies in the U.S., U.K. and Germany.

2007 SAG expenses of $4,312 million were $304 million higher than 2006, including a $141 million negative impact from currency. The SAG expense increase was the result of the following:

- $93 million increase in selling expenses primarily reflecting the negative impact from currency and the inclusion of GIS. This increase was partially offset by lower costs reflecting the benefits from the 2006 restructuring programs intended to realign our sales infrastructure.
- $164 million increase in G&A expenses primarily from the inclusion of GIS, unfavorable currency and information technology investments.
- $47 million increase in bad debt expense primarily as a result of an increase in reserves for several customers in Europe as well as a 2006 reduction in expense due to adjustments to the reserves to reflect improvement in write-offs and aging.

Bad debt expense included in SAG was $188 million, $134 million and $87 million in 2008, 2007 and 2006, respectively. Bad debt expense as a percent of total revenue increased in the fourth quarter 2008 but was 1.1% in 2008 as compared to 0.8% and 0.5% for 2007 and 2006, respectively. Despite the fourth quarter 2008 increase in the provision and write-offs, days sales outstanding at December 31, 2008 remained fairly flat year-over-year and the aging of receivables as compared to historical levels has not increased significantly. However, due to the current economic conditions, there is an increased risk for our provision for bad debts to trend higher in 2009 as compared to 2008. At December 31, 2008, bad debt reserves, as a percentage of receivables, were comparable to year end 2007.

Restructuring and Asset Impairment Charges

For the years ended December 31, 2008, 2007 and 2006 we recorded net restructuring and asset impairment charges (credits) of $429 million, $(6) million and $385 million, respectively. The 2008 net charge included $357 million related to headcount reductions of approximately 4,900 employees primarily in North America and Europe and lease termination and asset impairment charges of $72 million primarily reflecting the exit from certain leased and owned facilities resulting from a rationalization of our worldwide operating locations. These actions applied equally to both North America and Europe with approximately half focused on SAG expense reductions, approximately a third on gross margin improvements and the remainder focused on the optimization of R,D&E investments. We expect to realize savings in 2009 of approximately $250 million as a result of the 2008 restructuring actions. Restructuring activity was minimal in 2007 and the related credit of $6 million primarily reflected changes in estimates for prior years' severance costs. The 2006 net charge included $318 million related to headcount reductions of approximately 3,400 employees in North America and Europe, and lease termination and asset impairment charges of $67 million primarily reflecting the relocation of certain manufacturing operations and the exit from certain leased and owned facilities. The restructuring reserve balance as of December 31, 2008, for all programs was $352 million of which approximately $325 million is expected to be spent over the next twelve months. Refer to Note 9 – Restructuring and Asset Impairment Charges in the Consolidated Financial Statements for further information regarding our restructuring programs.

Worldwide Employment

Worldwide employment of 57,100 as of December 31, 2008 decreased approximately 300 from December 31, 2007, primarily reflecting the reductions from restructuring partially offset by additions as a result of 2008 acquisition activity. Worldwide employment was approximately 57,400 and 53,700 at December 31, 2007 and 2006, respectively.

Other Expenses, Net

Other expenses, net for each of the three years ended December 31, 2008, 2007 and 2006 consisted of the following:

	Year Ended December 31,		
(in millions)	**2008**	2007	2006
Non-financing interest expense	**$ 262**	$263	$239
Interest income	**(35)**	(55)	(69)
Gain on sales of businesses and assets	**(21)**	(7)	(44)
Currency losses, net	**34**	8	39
Amortization of intangible assets	**54**	42	41
Legal matters	**781**	(6)	89
All other expenses, net	**47**	50	41
Total Other expenses, net	**$1,122**	**$295**	**$336**

Non-financing interest expense: 2008 non-financing interest expense was flat compared to 2007, as the benefit of lower interest rates was offset by higher average non-financing debt balances. In 2007 non-financing interest expense increased primarily due to higher average non-financing debt balances as well as higher interest rates.

Interest income: Interest income is derived primarily from our invested cash and cash equivalent balances. The decline in interest income in 2008 was primarily due to lower average cash balances and rates of return. The decline in 2007 was primarily due to lower average cash balances partially offset by higher rates of return.

Gain on sales of businesses and assets: 2008 gain on sales of business and assets primarily consisted of the sale of certain surplus facilities in Latin America.

The 2006 gain on sales of businesses and assets primarily consisted of $15 million on the sale of our Corporate headquarters, $11 million on the sale of a manufacturing facility and $10 million receipt from escrow of additional proceeds related to our 2005 sale of Integic.

Currency losses net: Currency losses primarily result from the re-measurement of foreign currency-denominated assets and liabilities, the cost of hedging foreign currency-denominated assets and liabilities, the mark-to-market of foreign exchange contracts utilized to hedge those foreign currency-denominated assets and liabilities and the mark-to-market impact of hedges of anticipated transactions, primarily future inventory purchases, for those that we do not apply cash flow hedge accounting treatment.

The 2008 currency losses were primarily due to net re-measurement losses associated with our Yen-denominated payables, foreign currency denominated assets and liabilities in our developing markets and the cost of hedging. The currency losses on Yen-denominated payables were largely limited to the first

quarter 2008 as a result of the significant and rapid weakening of the U.S. Dollar and Euro versus the Yen.

The 2006 currency losses primarily reflected the mark-to-market of derivative contracts which are economically hedging anticipated foreign currency denominated payments. The mark-to-market losses were primarily due to the strengthening of the Euro against other currencies, in particular the Canadian Dollar, U.S. Dollar and the Yen, as compared to the weakening Euro in 2005.

Amortization of intangible assets: 2008 amortization of intangible assets expense of $54 million reflects amortization expense of $33 million for intangible assets acquired as part of our recent acquisitions.

2007 amortization of intangible assets expense of $42 million reflects amortization expense of $16 million associated with intangible assets acquired as part of our acquisition of GIS, partially offset by reduced amortization from prior years due to the full amortization of certain intangible assets from previous acquisitions.

Legal matters: In 2008 legal matters consisted of the following:

- $721 million reflecting provisions for the $670 million court approved settlement of *Carlson v. Xerox Corporation* ("Carlson") and other pending securities-related cases, net of expected insurance recoveries. On January 14, 2009, the United States Court for the District of Connecticut entered a Final Order and Judgment approving the settlement in the Carlson litigation.
- $36 million for probable losses on Brazilian labor-related contingencies. Following an 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 million in the fourth quarter of 2008.
- $24 million associated with probable losses from various other legal matters.

In 2006 legal matters consisted of the following:

- $68 million for probable losses on Brazilian labor-related contingencies.
- $33 million associated with probable losses from various legal matters partially offset by $12 million of proceeds from the Palm litigation matter.

Refer to Note 16 – Contingencies in the Consolidated Financial Statements for additional information regarding litigation against the Company.

Income Taxes

	Year Ended December 31,		
(in millions)	**2008**	2007	2006
Pre-tax (loss) income	**$(114)**	$1,438	$ 808
Income tax (benefits) expenses	**(231)**	400	(288)
Effective tax rate	**202.6%**	27.8%	(35.6)%

The 2008 effective tax rate of 202.6% reflected the tax benefits from certain discrete items including the net provision for litigation matters; the second, third and fourth quarter restructuring and asset impairment charges; the product line equipment write-off; and the settlement of certain previously unrecognized tax benefits. Excluding these items, the adjusted effective tax rate was 21.5%*. The adjusted 2008 effective tax rate was lower than the U.S. statutory tax rate primarily reflecting the benefit to taxes from the geographical mix of income before taxes and the related effective tax rates in those jurisdictions, the utilization of foreign tax credits and tax law changes.

The 2007 effective tax rate of 27.8% was lower than the U.S. statutory rate primarily reflecting tax benefits from the geographical mix of income before taxes and the related effective tax rates in those jurisdictions and the utilization of foreign tax credits as well as the resolution of other tax matters. These benefits were partially offset by changes in tax law.

The 2006 effective tax rate of (35.6%) was lower than the U.S. statutory rate primarily due to the tax benefits of $518 million from the resolution of tax issues associated with the 1999-2003 IRS audits and other domestic and foreign tax audits; tax benefits of $19 million as a result of tax law changes and tax treaty changes; and $11 million from the reversal of a valuation allowance on deferred tax assets associated with foreign net operating loss carryforwards, as well as the geographical mix of income before taxes and related effective tax rates in those jurisdictions. These benefits were partially offset by losses in certain jurisdictions where we are not providing tax benefits and continue to maintain deferred tax valuation allowances.

Our effective tax rate will change based on nonrecurring events as well as recurring factors including the geographical mix of income before taxes and the related effective tax rates in those jurisdictions and available foreign tax credits. In addition, our effective tax rate will change based on discrete or other nonrecurring events (such as audit settlements) that may not be predictable. We anticipate that our effective tax rate for 2009 will approximate 28%, excluding the effect of any discrete items.

* See the "Non-GAAP Measures" section for additional information.

Equity in Net Income of Unconsolidated Affiliates

2008 equity in net income of unconsolidated affiliates of $113 million is principally related to our 25% share of Fuji Xerox ("FX") income. The $16 million increase from 2007 is primarily due to a $14 million reduction in our share of FX restructuring charges.

2007 equity in net income of unconsolidated affiliates reflects a reduction from 2006 of $17 million, primarily due to $30 million for our after-tax share of FX restructuring charges.

Recent Accounting Pronouncements

Refer to Note 1 – Summary of Significant Accounting Policies in the Consolidated Financial Statements for a description of recent accounting pronouncements including the respective dates of adoption and the effects on results of operations and financial condition.

Capital Resources and Liquidity

Cash Flow Analysis

The following summarizes our cash flows for each of the three years ended December 31, 2008, as reported in our Consolidated Statements of Cash Flows in the accompanying Consolidated Financial Statements:

				Change	
(in millions)	2008	2007	2006	2008	2007
Net cash provided by operating activities	$ 939	$ 1,871	$ 1,617	$ (932)	$ 254
Net cash used in investing activities	(441)	(1,612)	(143)	1,171	(1,469)
Net cash used in financing activities	(311)	(619)	(1,428)	308	809
Effect of exchange rate changes on cash and cash equivalents	(57)	60	31	(117)	29
Increase (decrease) in cash and cash equivalents	130	(300)	77	430	(377)
Cash and cash equivalents at beginning of period	1,099	1,399	1,322	(300)	77
Cash and cash equivalents at end of period	**$1,229**	**$ 1,099**	**$ 1,399**	**$ 130**	**$ (300)**

Cash Flows from Operating Activities

Net cash provided by operating activities was $939 million for the year ended December 31, 2008. The $932 million decrease in cash was primarily due to the following:

- $330 million decrease in pre-tax income before litigation and restructuring.
- $615 million decrease due to net payments for the settlement of the securities-related litigation.
- $90 million decrease due to higher net income tax payments, primarily resulting from the absence of prior year tax refunds.
- $74 million decrease primarily due to lower benefit and compensation accruals.
- $71 million decrease due to higher inventory levels as a result of lower equipment and supplies sales in 2008.
- $136 million increase from accounts receivable due to strong collection effectiveness throughout 2008.
- $107 million increase from derivatives, primarily due to the termination of certain interest rate swaps in fourth quarter 2008.

Net cash provided by operating activities was $1,871 million for the year ended December 31, 2007. The $254 million increase in cash was primarily due to the following:

- $348 million increase in pre-tax income before restructuring, depreciation, other provisions and net gains.
- $108 million increase in other liabilities primarily reflecting the absence of the prior year payment of $106 million related to the MPI litigation.
- $57 million increase reflecting lower pension contributions to our U.S. pension plans.
- $30 million increase as a result of lower restructuring payments due to minimal activity in 2007.
- $114 million decrease due to year-over-year inventory growth of $54 million primarily related to increased product launches in 2007, as well as a $60 million increase in equipment on operating leases reflecting higher operating lease install activity.
- $73 million decrease due to a lower net run-off of finance receivables.
- $49 million decrease primarily due to higher accounts receivable reflecting increased revenue, partially offset by $110 million year-over-year benefit from increased receivables sales.

- $45 million decrease due to lower benefit accruals, partially offset by higher accounts payable due to the timing of payments to vendors and suppliers.

Cash Flows from Investing Activities

Net cash used in investing activities was $441 million for the year ended December 31, 2008. The $1,171 million increase in cash was primarily due to the following:

- $1,460 million increase due to less cash used for acquisitions. 2008 acquisitions included $138 million for Veenman B.V. and Saxon Business Systems as compared to $1,568 million for GIS and its additional acquisitions in the prior year.
- $192 million decrease due to lower funds from escrow and other restricted investments in 2008. The prior year reflected funds received from the run-off of our secured borrowing programs.
- $134 million decrease in other investing cash flows due to the absence of proceeds from liquidations of short-term investments.

Net cash used in investing activities was $1,612 million for the year ended December 31, 2007. The $1,469 million decrease in cash was primarily due to the following:

- $1,386 million decrease due to $1,615 million in 2007 acquisitions primarily comprised of $1,568 for GIS and its additional acquisitions and $30 million for Advectis, Inc., as compared to $229 million in acquisitions in 2006 comprised of Amici, LLC and XMPie, Inc.
- $123 million decrease in other investing cash flows reflecting the absence of the 2006 $122 million distribution related to the sale of investments held by Ridge Re.
- $65 million decrease due to higher capital and internal use software investments in 2007.
- $57 million decrease due to higher 2006 proceeds from sales of land, buildings and equipment, which included the sale of our corporate headquarters and a parcel of vacant land.
- $162 million increase due to a reduction in escrow and other restricted investments in 2007, as we continue to run-off our secured borrowing programs.

Cash Flows from Financing Activities

Net cash used in financing activities was $311 million for the year ended December 31, 2008. The $308 million increase in cash was primarily due to the following:

- $1,642 million increase from lower net repayments on secured debt. 2007 reflects termination of our secured financing programs with GE in the United Kingdom and Canada of $634 million and Merrill Lynch in France for $469 million as well as the repayment of secured borrowings to DLL of $153 million. The remainder reflects lower payments associated with our GE U.S. secured borrowings.
- $888 million decrease from lower net cash proceeds from unsecured debt. 2008 reflects the issuance of $1.4 billion in Senior Notes, $250 million from a private placement borrowing and net payments of $354 million on the Credit Facility and $370 million on other debt. 2007 reflects the issuance of $1.1 billion Senior Notes, $400 million from private placement borrowings and net proceeds of $600 million on the Credit Facility, offset by net payments of $286 million on other debt.
- $180 million decrease due to additional purchases under our share repurchase program.
- $154 million decrease due to common stock dividend payments.
- $79 million decrease due to lower proceeds from the issuance of common stock, reflecting a decrease in stock option exercises as well as lower related tax benefits.
- $33 million decrease due to share repurchases related to employee withholding taxes on stock-based compensation vesting.

Net cash used in financing activities was $619 million in year ended December 31, 2007. The $809 million increase in cash was primarily due to the following:

- $538 million increase due to higher net cash proceeds from unsecured debt. This reflects the May 2007 issuance of the $1.1 billion Senior Notes, the issuances of two zero coupon bonds in 2007 resulting in net proceeds of approximately $400 million, and the net drawdown of $600 million under the 2007 Credit Facility. These higher net proceeds were partially offset by the March 2006 issuance of the $700 million Senior Notes and the August 2006 issuance of an additional $650 million of Senior Notes, as well as, higher repayments on other unsecured debt in 2007 as compared to 2006.
- $437 million increase due to lower purchases under our share repurchase program as cash was invested in acquisitions.
- $100 million increase relating to the 2006 payment of our liability to Xerox Capital LLC in connection with their redemption of Canadian deferred preferred shares.
- $278 million decrease due to higher net repayments of secured financing. Refer to Note 4-Receivables, net in the consolidated financial statements for further information.

Financing Activities

Customer Financing Activities

We provide equipment financing to the majority of our customers. Because finance leases allow our customers to pay for equipment over time rather than at the date of installation, we maintain a certain level of debt to support our investment in these customer finance leases. We currently fund our customer financing activity through cash generated from operations, cash on hand, borrowings under bank credit facilities and proceeds from capital markets offerings. We also have funding available through a secured borrowing arrangement with General Electric Capital Corporation ("GECC") referred to as the Loan Agreement.

We have arrangements in certain international countries and domestically through the acquisition of GIS, where third party financial institutions originate lease contracts directly with our customers. In these arrangements, we sell and transfer title of the equipment to these financial institutions. Generally, we have no continuing ownership rights in the equipment subsequent to its sale; therefore, the related receivable and debt are not included in our Consolidated Financial Statements.

The following represents total finance assets associated with our lease or finance operations as of December 31, 2008 and 2007:

(in millions)	2008	2007
Total Finance receivables, net[1]	$7,278	$ 8,048
Equipment on operating leases, net	594	587
Total finance assets, net	**$7,872**	**$8,635**

The reduction of $763 million in Total finance assets, net includes unfavorable currency of $473 million.

[1] Includes (i) billed portion of finance receivables, net, (ii) finance receivables, net and (iii) finance receivables due after one year, net as included in the Consolidated Balance Sheets as of December 31, 2008 and 2007.

The following tables summarize our debt as of December 31, 2008 and 2007:

(in millions)	2008	2007
Debt secured by finance receivables	$ 56	$ 275
Capital leases	9	19
Total Secured Debt	65	294
Senior Notes	7,574	5,781
Credit Facility	246	600
Other Debt	499	789
Total Unsecured Debt	8,319	7,170
Total Debt	**$8,384**	$7,464

At December 31, 2008, less than 1% of total debt was secured by finance receivables and other assets compared to 4% at December 31, 2007.

(in millions)	2008	2007
Principal Debt Balance	$ 8,201	$7,465
Less: Net unamortized discount	(6)	(13)
Add: FAS 133 fair value adjustments	189	12
Total Reported Debt	8,384	7,464
Less: Current maturities and short-term debt	(1,610)	(525)
Total long-term debt	**$ 6,774**	$6,939

Principal debt balance at December 31, 2008 and 2007 includes short-term debt of $61 million and $99 million, respectively. Refer to Note 11 – Debt in the Consolidated Financial Statements for additional information regarding the above balances.

Liquidity, Financial Flexibility and Other Financing Activity

Liquidity

We manage our worldwide liquidity using internal cash management practices, which are subject to (1) the statutes, regulations and practices of each of the local jurisdictions in which we operate, (2) the legal requirements of the agreements to which we are a party and (3) the policies and cooperation of the financial institutions we utilize to maintain and provide cash management services.

Our liquidity is a function of our ability to successfully generate cash flows from a combination of efficient operations and improvement therein, access to capital markets, securitizations, funding from third parties and borrowings secured by our finance receivables portfolios. Our ability to maintain positive liquidity going forward depends on our ability to continue to generate cash from operations and access to financial markets, both of which are subject to general economic, financial, competitive, legislative, regulatory and other market factors that are beyond our control.

The following is a discussion of our liquidity position as of December 31, 2008:

- As of December 31, 2008, total cash and cash equivalents was $1.2 billion and our borrowing capacity under our Credit Facility was $1.7 billion, reflecting $246 million outstanding borrowings and no outstanding letters of credit. In addition we currently have approximately $1.0 billion available under the Loan Agreement through 2010, which has not been accessed in almost three years.
- We have consistently delivered strong cash flow from operations over the past three years driven by the strength of our annuity based revenue model. Cash flows from operations were $939

million, $1,871 million and $1,617 million for the years ended December 31, 2008, 2007 and 2006, respectively. Cash flows from operations in 2008 included $615 million in net payments for our securities litigation.

- Our debt maturities are in line with historical and projected cash flows and are spread over the next ten years as follows (in millions):

Year	Amount
2009	$1,610
2010	962
2011	802
2012	1,169
2013	1,138
2014	69
2015	—
2016	950
2017	501
2018 and thereafter	1,000
Total	**$8,201**

On January 15, 2009, we repaid in-full at maturity, our outstanding U.S. Dollar and Euro-denominated 9.75% Senior Notes. The total repayment of approximately $900 million was made using cash on hand and the proceeds of a $400 million borrowing under our Credit Facility.

Debt Activity

Credit facility: In February 2008, we exercised our right under our $2.0 billion Credit Facility to request a one-year extension of the maturity date. Lenders representing approximately $1.4 billion (or approximately 70%) of the commitments under the Credit Facility 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.

In October 2008, we amended our Credit Facility to increase the permitted leverage ratio (debt/consolidated EBITDA) to a fixed ratio of 3.75x. The amendment also included a re-pricing of the Credit Facility such that borrowings will bear interest at LIBOR plus an all-in spread that will vary between 1.25% and 4.00% subject to our credit rating and percent of Credit Facility utilization at the time of borrowing. Based upon our current rating and utilization, the all-in spread is 1.75%.

Capital markets offerings and other: In 2008, we raised net proceeds of $1.4 billion through the issuance of Senior Notes and $250 million from a private placement transaction.

Loan covenants and compliance: At December 31, 2008, we were in full compliance with the covenants and other provisions of the Credit Facility, our Senior Notes and the Loan Agreement. We have the right to prepay any outstanding loans or to terminate the Credit Facility without penalty. Failure to be in compliance with any material provision or covenant of these agreements could have a material adverse effect on our liquidity and operations and our ability to continue to fund our customers' purchase of Xerox equipment.

Refer to Note 11 – Debt and Note 4 – Receivables, Net in the Consolidated Financial Statements for additional information regarding the above noted transactions and Loan Agreement, respectively.

Share Repurchase Programs

The Board of Directors has authorized share repurchase programs totaling $4.5 billion through December 31, 2008, which included additional authorizations of $1.0 billion in both January and July of 2008. Since launching this program in October 2005, we have repurchased 194.1 million shares, totaling approximately $2.9 billion. Refer to Note 17 – Shareholders' Equity – "Treasury Stock" in the Consolidated Financial Statements for further information regarding our share repurchase programs.

Although we have $1.6 billion of remaining authorization, at the current time, we have no immediate plans for further share repurchases.

Dividends

The Board of Directors declared a 4.25 cent per share dividend on common stock in each quarter of 2008.

Financial Instruments

Refer to Note 13 – Financial Instruments in the Consolidated Financial Statements for additional information regarding our derivative financial instruments.

Credit Ratings

We are currently rated investment grade by all major rating agencies. As of January 31, 2009 the ratings were as follows:

	Senior Unsecured Debt	Outlook
Moody's	Baa2	Positive
Standard & Poors ("S&P")	BBB	Stable
Fitch	BBB	Stable

Contractual Cash Obligations and Other Commercial Commitments and Contingencies

At December 31, 2008, we had the following contractual cash obligations and other commercial commitments and contingencies:

(in millions)	2009	2010	2011	2012	2013	Thereafter
Long-term debt, including capital lease obligations[1]	$ 1,610	$ 962	$ 802	$ 1,169	$ 1,138	$ 2,520
Minimum operating lease commitments[2]	223	188	151	100	84	123
Liability to subsidiary trust issuing preferred securities[3]	—	—	—	—	—	648
Retiree Health Payments	105	99	99	98	97	445
Purchase Commitments						
Flextronics[4]	700	—	—	—	—	—
EDS Contracts[5]	239	137	77	77	77	16
Other[6]	17	12	11	—	—	—
Total contractual cash obligations	**$2,894**	**$1,398**	**$1,140**	**$1,444**	**$1,396**	**$3,752**

(1) Refer to Note 11– Debt in our Consolidated Financial Statements for additional information and interest payments related to long-term debt (amounts above include principal portion only).

(2) Refer to Note 6 – Land, Buildings and Equipment, Net in our Consolidated Financial Statements for additional information related to minimum operating lease commitments.

(3) Refer to Note 12 – Liability to Subsidiary Trust Issuing Preferred Securities in our Consolidated Financial Statements for additional information and interest payments (amounts above include principal portion only).

(4) Flextronics: We outsource certain manufacturing activities to Flextronics and are currently in the second year of the Master Supply Agreement. The term of this agreement is three years, with two additional one year extension periods at our option. The amounts discussed in the table reflect our estimate of purchases over the next year and are not contractual commitments.

(5) 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.

(6) Other Purchase Commitments: We enter into other purchase commitments with vendors in the ordinary course of business. Our policy with respect to all purchase commitments is to record losses, if any, when they are probable and reasonably estimable. We currently do not have, nor do we anticipate, material loss contracts.

Pension and Other Post-Retirement Benefit Plans

We sponsor pension and other post-retirement benefit plans that may require periodic cash contributions. Our 2008 cash fundings for these plans were $299 million for pensions and $105 million for our retiree health plans. Our required cash fundings for 2009 are approximately $108 million for pensions and approximately $105 million for our retiree health plans. Cash contribution requirements for our domestic tax qualified pension plans are governed by the Employment Retirement Income Security Act ("ERISA") and the Internal Revenue Code. Cash contribution requirements for our international plans are subject to the applicable regulations in each country. The expected 2009 pension contributions do not include contributions to the domestic tax-qualified plans because none are required due to the availability of a credit balance which resulted 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 assessed. Based on these results, we may voluntarily decide to contribute to these plans, even though no contribution is required. In prior years, after making this assessment, we decided to contribute $165 million and $158 million in 2008 and 2007, respectively, to our domestic tax qualified plans in order to make them 100% funded on a current liability basis under the ERISA funding rules.

Our retiree health benefit plans are non-funded and are almost entirely related to domestic operations. Cash contributions are made each year to cover medical claims costs incurred in that year. The amounts reported in the above table as retiree health payments represent our estimated future benefit payments.

Fuji Xerox

We purchased products, including parts and supplies, from Fuji Xerox totaling $2.1 billion, $1.9 billion and $1.7 billion in 2008, 2007 and 2006, respectively. Our purchase commitments with Fuji Xerox are in the normal course of business and typically have a lead time of three months. We do not anticipate 2009 purchases from Fuji Xerox to exceed 2008 levels. Related party transactions with Fuji Xerox are discussed in Note 7 – Investments in Affiliates, at Equity in the Consolidated Financial Statements.

Brazil Tax and Labor Contingencies

As of December 31, 2008, our Brazilian operations are involved in various litigation matters and have 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 trends in the outcomes of these matters, we reassessed the probable estimated loss and, as a result, recorded an additional reserve of $36 million 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 million, with the decrease from the 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 million of escrow cash deposits for matters we are disputing and there are liens on certain Brazilian assets with a net book value of $30 million and additional letters of credit of approximately $88 million. 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.

Other Contingencies and Commitments

As more fully discussed in Note 16 – Contingencies in the Consolidated Financial Statements, 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. In addition, guarantees, indemnifications and claims may arise during the ordinary course of business from relationships with suppliers, customers and nonconsolidated affiliates. Nonperformance under a contract including a guarantee, indemnification or claim could trigger an obligation of the Company. 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. Should developments in any of these areas 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.

Unrecognized Tax Benefits

As of December 31, 2008, we had $170 million of unrecognized tax benefits. This represents the tax benefits associated with various tax positions taken, or expected to be taken, on domestic and international tax returns that have not been recognized in our financial statements due to uncertainty regarding their resolution. The resolution or settlement of these tax positions with the taxing authorities is at various stages and therefore we are unable to make a reliable estimate of the eventual cash flows by period that may be required to settle these matters. In addition, certain of these matters may not require cash settlement due to the existence of credit and net operating loss carryforwards as well as other offsets, including the indirect benefit from other taxing jurisdictions that may be available.

Off-Balance Sheet Arrangements

Although we rarely utilize off-balance sheet arrangements in our operations, we enter into operating leases in the normal course of business. The nature of these lease arrangements is discussed in Note 6 – Land, Buildings and Equipment, Net in the Consolidated Financial Statements. Additionally, we have utilized special purpose entities ("SPEs") in conjunction with certain financing transactions. The SPEs utilized in conjunction with these transactions are consolidated in our financial statements. These transactions, which are discussed further in Note 4 – Receivables, Net in the Consolidated Financial Statements, have been accounted for as secured borrowings with the debt and related assets remaining on our balance sheets. Although the obligations related to these transactions are included in our balance sheet, recourse is generally limited to the secured assets and no other assets of the Company.

Refer to Note 16 – Contingencies in the Consolidated Financial Statements for further information regarding our guarantees, indemnifications and warranty liabilities.

Financial Risk Management

We are exposed to market risk from 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 reduce earnings and cash flow volatility resulting from shifts in market rates. Refer to Note 13 –Financial Instruments in the Consolidated Financial Statements for further discussion on our financial risk management.

Assuming a 10% appreciation or depreciation in foreign currency exchange rates from the quoted foreign currency exchange rates at December 31, 2008, the potential change in the fair value of foreign currency-denominated assets and liabilities in each entity would not be significant because all material currency asset and liability exposures were economically hedged as of December 31, 2008. A 10% appreciation or depreciation of the U.S. Dollar against all currencies from the quoted foreign currency exchange rates at December 31, 2008 would have an $824 million impact on our cumulative translation adjustment portion of equity. The amount permanently invested in foreign subsidiaries and affiliates, primarily Xerox Limited, Fuji Xerox, Xerox Canada Inc. and Xerox do Brasil, and translated into Dollars using the year-end exchange rates, was $8.2 billion at December 31, 2008.

Interest Rate Risk Management

The consolidated weighted-average interest rates related to our debt and liabilities to subsidiary trust issuing preferred securities for 2008, 2007 and 2006 approximated 6.6%, 7.1%, and 6.8%, respectively. Interest expense includes the impact of our interest rate derivatives.

Virtually all customer-financing assets earn fixed rates of interest. The interest rates on a significant portion of the Company's term debt are fixed.

As of December 31, 2008, approximately $1.1 billion of our debt and liability to subsidiary trust issuing preferred securities carried variable interest rates, including the effect of pay-variable interest rate swaps we are utilizing with the intent to reduce the effective interest rate on our high coupon debt.

The fair market values of our fixed-rate financial instruments are sensitive to changes in interest rates. At December 31, 2008, a 10% change in market interest rates would change the fair values of such financial instruments by approximately $317 million. The recent market events have not required us to materially modify or change our financial risk management strategies with respect to our exposures to interest rate and foreign currency risk.

Non-GAAP Financial Measures

We have reported our financial results in accordance with generally accepted accounting principles ("GAAP"). A reconciliation of the following non-GAAP financial measures to the most directly comparable financial measures calculated and presented in accordance with GAAP are set forth below:

Adjusted Revenue

We discussed the revenue growth for the year ended December 31, 2008 using non-GAAP financial measures. To understand trends in the business, we believe that it is helpful to adjust the revenue growth rates to illustrate the impact of the acquisition of GIS by including their estimated revenue for the comparable 2007 and 2006 periods. We refer to this adjusted revenue as "As Adjusted" in the following reconciliation table. Revenue "As Adjusted" adds GIS's revenues from January 1, 2006 to May 8, 2007 to our 2006 and 2007 reported revenue. Management believes these measures give investors an additional perspective on revenue trends, as well as the impact to the Company of the acquisition of GIS that was completed in May 2007.

	Year Ended December 31			% Change	
(in millions)	2008	2007	2006	2008	2007
Equipment Sales Revenue:					
As Reported	$ 4,679	$ 4,753	$ 4,457	(2)%	7%
As Adjusted	$ 4,679	$ 4,938	$ 4,992	(5)%	(1)%
Post Sale Revenue:					
As Reported	$12,929	$12,475	$11,438	4%	9%
As Adjusted	$12,929	$12,681	$12,000	2%	6%
Total Revenues:					
As Reported	$17,608	$17,228	$15,895	2%	8%
As Adjusted	$17,608	$17,619	$16,992	—	4%

Adjusted Effective Tax Rate

The effective tax rate for the year ended December 31, 2008 is discussed using non-GAAP financial measures that exclude the effects of charges associated with an equipment write-off; second, third and fourth quarter 2008 restructuring and asset impairments; certain litigation matters and the settlement of certain previously unrecognized tax benefits. Management believes that it is helpful to exclude these effects to better understand and analyze the current period's effective tax rate given the discrete nature of these items.

	Year Ended December 31, 2008		
(in millions)	Pre-Tax Income	Income Taxes	Effective Tax Rate
As Reported	$ (114)	$(231)	202.6%
Restructuring and asset impairment charges	426	134	
Equipment write-off	39	15	
Litigation	774	283	
Tax settlements	—	41	
As Adjusted	$1,125	$ 242	21.5%

Management believes that these non-GAAP financial measures provide an additional means of analyzing the current period results against the corresponding prior period results. However, these non-GAAP financial measures should be viewed in addition to, and not as a substitute for, the Company's reported results prepared in accordance with GAAP.

Forward Looking Statements

This Annual Report contains forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. The words "anticipate," "believe," "estimate," "expect," "intend," "will," "should" and similar expressions, as they relate to us, are intended to identify forward-looking statements. These statements reflect management's current beliefs, assumptions and expectations and are subject to a number of factors that may cause actual results to differ materially. Information concerning these factors is included in our 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC"). We do not intend to update these forward-looking statements, except as required by law.