

XEROX CORP  
Form 10-K/A  
January 27, 2003

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**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-K/A**  
**(Amendment No. 5)**

(Mark One)

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended: December 31, 2001

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from:            to

1-4471 (Commission File Number)

**XEROX CORPORATION**

(Exact name of registrant as specified in its charter)

**New York**  
(State of incorporation)

**16-0468020**  
(I.R.S. Employer Identification No.)

**P.O. Box 1600, Stamford, Connecticut**  
(Address of principal executive offices)

**06904**  
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, \$1 par value	New York Stock Exchange Chicago Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes:  No:

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of the voting stock of the registrant held by non-affiliates as of December 31, 2002 was: \$5,943,094,994.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

<u>Class</u>	<u>Outstanding at December 31, 2002</u>
Common Stock, \$1 par value	738,272,670 Shares

Documents Incorporated by Reference

Portions of the following documents are incorporated herein by reference:

<u>Document</u>	<u>Part of Form 10-K in Which Incorporated</u>
None.	

**PURPOSE OF AMENDMENT**

The principal purpose for this Amendment No. 5 to Xerox Corporation's Annual Report on Form 10-K, as announced on December 20, 2002, is to restate interest expense incurred during 2001 to correct an error in the calculation of interest expense related to a debt instrument and associated interest swap agreements. The reissuance of the 2001 financial statements, as restated, requires that we also reflect the adoption in early 2002 of two Statements of Financial Accounting Standards and adjustments to the presentation of operating segment financial information made in 2002.

Accordingly, this Amendment No. 5 relates solely to financial information and disclosures related to:

- (1) Such restatement of interest expense incurred during 2001\*;
- (2) Adoption of Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets (SFAS No. 142) on January 1, 2002 (proforma presentation of net income and earnings per share for those years prior to adoption)\*\*;
- (3) Adoption of Statement of Financial Accounting Standards No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections (SFAS No. 145) on April 1, 2002 (relating to reclassification of extraordinary gains from extinguishment of debt to operating income)\*\*; and
- (4) Adjustment to the presentation of operating segment financial information to reflect a change in measurement of operating segment structure that was made in 2002.

All other financial information and disclosures remain unchanged.

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

\* In December 2002, we discovered an error in the calculation of our interest expense related to a debt instrument and associated interest rate swap agreements. The error related to our application of SFAS No. 133 and resulted in an understatement of interest expense of \$34 million and an overstatement of the gain on early extinguishment of debt of \$3 million for the year ended December 31, 2001. Accordingly, we have restated our consolidated financial statements for these items within this amendment.

\*\* The application of these accounting standards is required to be disclosed in financial statements that are reissued in periods after such financial accounting standards are adopted.

### Forward Looking Statements

From time to time we and our representatives may provide information, whether orally or in writing, including certain statements in this Form 10-K/A, which are forward-looking. These forward-looking statements and other information are based on our beliefs as well as assumptions made by us based on information currently available.

The words anticipate, believe, estimate, expect, intend, will and similar expressions, as they relate to us, are intended to identify forward-looking statements. Such statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated or expected. We do not intend to update these forward-looking statements.

We are making investors aware that such forward-looking statements, because they relate to future events, are by their very nature subject to many important factors which could cause actual results to differ materially from those contained in the forward-looking statements. Such factors include, but are not limited to, the following:

**Competition** We operate in an environment of significant competition, driven by rapid technological advances and the demands of customers to become more efficient. There are a number of companies worldwide with significant financial resources which compete with us to provide document processing products and services in each of the markets we serve, some of whom operate on a global basis. Our success in future performance is largely dependent upon our ability to compete successfully in the markets we currently serve and to expand into additional market segments.

**Transition to Digital** Presently, black and white light-lens copiers represent between 15%-20% of our revenues. This segment of the market is mature with anticipated declining industry revenues as the market transitions to digital technology. Some of our new digital products replace or compete with our current light-lens equipment. Changes in the mix of products from light-lens to digital, and the pace of that change as well as competitive developments could cause actual results to vary from those expected.

**Expansion of Color** Color printing and copying represents an important and growing segment of the market. Printing from computers has both facilitated and increased the demand for color. A significant part of our strategy and ultimate success in this changing market is our ability to develop and market technology that produces color prints and copies quickly, easily and at reduced cost. Our continuing success in this strategy depends on our ability to make the investments and commit the necessary resources in this highly competitive market as well as the pace of color adoption by our prospective customers.

**Pricing** Our success is dependent upon our ability to obtain adequate pricing for our products and services which provide a reasonable return to our shareholders. Depending on competitive market factors, future prices we obtain for our products and services may vary from historical levels. In addition, pricing actions to offset the effect of currency devaluations may not prove sufficient to offset further devaluations or may not hold in the face of customer resistance and/or competition.

**Customer Financing Activities** On average, we have historically financed approximately 80 percent of our equipment sales. To fund these arrangements, we have accessed the credit markets and used cash generated from operations. The long-term viability and profitability of our customer financing activities is dependent on our ability to borrow and the cost of borrowing in these markets. This ability and cost, in turn, is dependent on our credit ratings. We are currently funding our customer financing activity from cash generated from operations as well as from cash on hand, unregistered capital markets offerings and securitizations. There is no assurance that we will be able to continue to fund our customer financing activity at present levels. We continue to negotiate and implement third-party vendor financing programs and possible monetizations of portions of our existing finance receivable portfolios, and we continue to actively pursue alternative forms of financing including securitizations and secured borrowings. These initiatives are expected to significantly improve our liquidity going forward. Our ability to continue to offer customer financing and be successful in the placement of equipment with customers is largely dependent upon successful implementation of our third party financing initiatives.

**Productivity** Our ability to sustain and improve profit margins is largely dependent on our ability to maintain an efficient, cost-effective operation. Productivity improvements through process re-engineering, design efficiency and supplier and manufacturing cost improvements are required to offset labor cost inflation, potential materials cost increases and competitive price pressures.

**International Operations** We derive approximately 40 percent of our revenue from operations outside the United States. In addition, we manufacture or acquire many of our products and/or their components outside the United States. Our future revenue, cost and results from operations could be affected by a number of factors, including changes in foreign currency exchange rates, changes in economic conditions from country to country, changes in a country's political conditions, trade protection measures, licensing requirements and local tax issues. Our ability to enter into new foreign exchange contracts to manage foreign exchange risk is currently severely limited given our below investment grade credit ratings, and we anticipate increased volatility in our results of operations due to changes in foreign exchange rates.

**New Products/Research and Development** The process of developing new high technology products and solutions is inherently complex and uncertain. It requires accurate anticipation of customers' changing needs and emerging technological trends. We must then make long-term investments and commit significant resources before knowing whether these investments will eventually result in products that achieve customer acceptance and generate the revenues required to provide anticipated returns from these investments.

**Revenue Trends** Our ability to return to and maintain a consistent trend of revenue growth over the intermediate to longer term is largely dependent upon expansion of our worldwide equipment placements as well as sales of services and supplies occurring after the initial equipment placement (post sale revenue) in the key growth markets of color and multifunction devices. Revenue growth will be further enhanced through our consulting services in the areas of document content and knowledge management. The ability to achieve growth in our equipment placements is subject to the successful implementation of our initiatives to provide advanced systems, industry-oriented global solutions and services for major customers, improved direct sales productivity and expansion of our indirect distribution channels in the face of global competition and pricing pressures. The ability to grow our customers' usage of our products may continue to be adversely impacted by the movement towards distributed printing and electronic substitutes. Our inability to return to and maintain a consistent trend of revenue growth could have a material adverse affect on the trend of our operating results.

**Liquidity** The adequacy of our continuing liquidity depends on our ability to successfully generate positive cash flow from an appropriate combination of operating improvements, financing from third parties, access to capital markets and additional asset sales including sales or securitizations of our receivables portfolios. We believe our liquidity is sufficient to meet current and anticipated needs, including all scheduled debt maturities; however, our ability to maintain positive liquidity is highly dependent on achieving our expected operating results, including capturing the benefits from restructuring activities, and completing several vendor financing and other initiatives that are discussed below. There is no assurance that these initiatives will be successful. Failure to successfully complete these initiatives could have a material adverse effect on our liquidity and our operations, and could require us to consider further measures, including deferring planned capital expenditures, modifying current restructuring plans, reducing discretionary spending and selling additional assets.

We have successfully completed the renegotiation of our \$7 billion Revolving Credit Agreement (the "Old Revolver"). Of the original \$7 billion in loans outstanding under the Old Revolver, \$2.8 billion has been repaid and the remaining \$4.2 billion has been refinanced under the terms of a new Amended and Restated Credit Agreement (the "New Credit Facility"), which is more fully discussed elsewhere in this Annual Report on Form 10-K. The New Credit Facility requires certain principal amortizations as well as prepayments in the case of certain events. A full discussion of all of these terms and the final maturity dates of the various loans is included in the Capital Resources and Liquidity section of this Annual Report on Form 10K. The New Credit Facility contains affirmative and negative covenants including limitations on issuance of debt and preferred stock; certain fundamental changes; investments and acquisitions; mergers; certain transactions with affiliates; creation of liens; asset transfers; hedging transactions; payment of dividends; inter-company loans and certain restricted payments; and a requirement to transfer excess foreign cash, as defined, and excess cash of Xerox Credit Corporation to Xerox Corporation in certain circumstances. It also contains additional financial

covenants, including minimum EBITDA, maximum leverage (total adjusted debt divided by EBIDTA, as defined) and, maximum capital expenditures limits.

Any failure to be in compliance with any material provision of the New Credit Facility could have a material adverse effect on our liquidity and operations.

**PART II**

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**INDEX TO FINANCIAL SECTION**

**FINANCIAL REVIEW**

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

Introduction

Restatement and Reclassification of 2001 Financial Statements

Restatement of 2000 and 1999 Financial Statements

Settlement with the Securities and Exchange Commission

Application of Critical Accounting Policies

Financial Overview

Summary of Total Company Results

Revenues by Type

Gross Margin

Research and Development

Selling, Administrative and General Expenses

Restructuring Programs

Other Expenses, Net

Gain on Affiliate's Sale of Stock

Income Taxes and Equity in Net Income of Unconsolidated Affiliates

Manufacturing Outsourcing

Divestitures

Acquisition of the Color Printing and Imaging Division of Tektronix, Inc.

Business Performance by Segment

New Accounting Standards

Capital Resources and Liquidity

Liquidity, Financial Flexibility and Funding Plans

Actions Taken to Address Liquidity Issues

Cash and Debt Positions

Plans to Strengthen Liquidity and Financial Flexibility Beyond 2002

Contractual Cash Obligations and Other Commercial Commitments and Contingencies

Other Funding Arrangements

Cash Management

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

**Introduction.** In this Management's Discussion and Analysis of Results of Operations and Financial Condition (MD&A) we begin by describing the matters considered by management to be important to an understanding of the results of our operations and our capital resources and liquidity as of and for the three years ended December 31, 2001. This section begins with a discussion of our recent settlement with the Securities and Exchange Commission (SEC) regarding accounting issues that had been under investigation since June 2000. The discussion includes the financial effects of the related restatement. Immediately following, is a new disclosure for most companies this year. It is an analysis of the critical accounting policies which affect the recognition and measurement of our transactions and the balances in our consolidated financial statements. In this section, we review the critical accounting judgments and estimates which we believe are most important to an understanding of the MD&A and the Consolidated Financial Statements. We then analyze the results of our operations for the last three years including the trends in the overall business and our operating segments including our Turnaround Program and important transactions and events such as asset sales. This section concludes with a summary of recent accounting pronouncements which will have an impact on our financial accounting practices. Thereafter, we discuss our cash flows and liquidity, capital markets events and transactions, debt ratings, our new credit facility, derivatives, our transition to vendor financing, special purpose entities, contractual commitments and related issues.

**Restatement and Reclassification of 2001 Financial Statements.** As more fully discussed in Note 21 to the Consolidated Financial Statements, we discovered an error during 2002 in the calculation of our interest expense for the year ended December 31, 2001, related to a debt instrument and associated interest rate swap agreements. The error had occurred in connection with the adoption of Statement of Financial Accounting Standards No. 133 in January 2001 and resulted in an understatement of interest expense of \$34 million and an overstatement of the gain on early extinguishment of debt of \$3 million for the year ended December 31, 2001. To adjust for these items, we have restated our 2001 financial statements.

In addition, as more fully discussed in Note 22 to the Consolidated Financial Statements, during 2002, in connection with the adoption of the provisions of Statement of Financial Accounting Standards No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections (SFAS No. 145), the gains on early extinguishment of debt previously reported in the Consolidated Statements of Operations as an extraordinary item were reclassified to Other expenses, net. After the effects of the restatement discussed in Note 21, the effect of this reclassification in the accompanying Consolidated Statements of Operations was a decrease to Other expenses, net of \$63 and an increase to Income taxes of \$25, from amounts previously reported, for the year ended December 31, 2001.

**Restatement of 2000 and 1999 Financial Statements.** We have determined that certain of our accounting practices misapplied U.S. generally accepted accounting principles (GAAP). Accordingly, we have restated our financial statements for the four years ended December 31, 2000 and revised our previously announced 2001 results included in our earnings release dated January 28, 2002. Throughout this MD&A, the term "previously reported" will be used to refer to our previously filed 1997-2000 Financial Statements as well as our 2001 results. The restatement adjustments relate almost exclusively to the timing of revenue and expense recognition. We reversed cumulative net revenue of \$1.9 billion that was recognized in prior years, of which \$1.3 billion is reflected in the years 1997 to 2001. This revenue adjustment is comprised of a reduction in equipment sales revenue, previously recognized from 1997 through 2001, of \$6.4 billion offset by \$5.1 billion of service, rental, document outsourcing and financing revenue now recognized from 1997 through 2001. The remaining net amount of revenue reversed, of \$600 million, represents the cumulative net revenue impacts of reversing equipment sales transactions that were previously recorded in periods prior to 1997. Based on the cumulative impacts of the revenue adjustments for all periods prior to December 31, 2001, including pre-1997 impacts, we anticipate the recognition of \$1.9 billion in revenues over the next several years through 2006. This represents sales-type lease revenue that had previously been recorded, that is expected to be earned over time as a component of our rental, service and finance revenue. In addition to the aforementioned revenue timing adjustments, and as more fully discussed below, we permanently reduced reported revenue by \$269 million, for the five-year period ended December 31, 2001, as a result of the deconsolidation of our South African affiliate. Revenues from 1997 through 2001 as originally reported were \$92.6 billion compared to \$91.0 billion after the restatement. Substantially all non-revenue items included in the restatement have reversed within the five-year period ended December 31, 2001; our liquidity is not impacted since the restatement items reflect timing differences. As of December 31, 2001 our restated

Common Shareholders Equity is \$1.8 billion versus \$3.1 billion as originally included in our January 28, 2002 earnings release.

**Settlement with the Securities and Exchange Commission.** On April 11, 2002, we reached a settlement with the SEC relating to matters that had been under investigation by the SEC since June 2000. We believe the settlement is in the best interests of our shareholders, customers, employees and other stakeholders because it resolves these matters eliminating the distraction and risk associated with potential SEC litigation thereby enabling us to focus on continuing to improve our operations and restore the Company's financial health. In addition, as a result of the settlement with the SEC, we are undertaking a review of our material internal accounting controls and accounting policies to determine whether any additional changes are required in order to provide additional reasonable assurance that the types of accounting errors that occurred are not likely to reoccur.

The restatement reflects adjustments which are corrections of errors made in the application of GAAP and includes (i) adjustments related to the application of the provisions of Statement of Financial Accounting Standards No. 13 Accounting for Leases (SFAS No. 13) and (ii) adjustments that arose as a result of other errors in the application of GAAP. In making these restatements we have conducted an extensive review of all significant transactions, accounting policies and procedures and disclosures for the period 1997 through 2001. The principal adjustments are discussed below.

*Application of SFAS No. 13:*

**Revenue allocations in bundled arrangements:** We sell most of our products and services under bundled lease arrangements which contain multiple deliverable elements. These multiple element arrangements typically include separate equipment, service, supplies and financing components for which a customer pays a single fixed negotiated price on a monthly basis, as well as a variable amount for page volumes in excess of stated minimums. The restatement primarily reflects adjustments related to the allocation of revenue and the resultant timing of revenue recognition for sales-type leases under these bundled lease arrangements.

The methodology we used in prior years for allocating revenue to our sales-type leases involved first, estimating the fair market value of the service and financing components of the leases. Specifically, with respect to the financing component, we estimated the overall interest rate to be applied to transactions to be the rate we targeted to achieve a fair return on equity for our financing operations. This is effectively a discounted cash flow valuation methodology. In estimating this interest rate we considered a number of factors including our cost of funds, debt levels, return on equity, debt to equity ratios, income generated subsequent to the initial lease term, tax rates, and the financing business overhead costs. We made service revenue allocations based, primarily, on an analysis of our service gross margins. After deducting service and finance values from the minimum payments due under the lease, the equipment value was derived. These allocation procedures resulted in adjustments to values initially reflected in our accounting systems, such that values attributed to the service and financing components were generally decreased and the values assigned to the equipment components were generally increased.

The SEC staff advised us of its view that our previous methodology, as described above, did not comply with the requirements of SFAS No. 13. SFAS No. 13 requires us to use the discount rate which causes the aggregate present value of the minimum lease payments, excluding executory and service income, and any unguaranteed residual value, to equal the fair value of the equipment. However, our revenue allocation processes with respect to the principal (i.e., equipment) and interest components of our leases did not begin with the estimated fair value of the equipment, and did not treat unearned finance income as the derived value.

We have determined that the previous allocation methodology was not in accordance with SFAS No. 13, therefore, we have utilized a different methodology to account for our sales-type leases involving multiple element arrangements. This methodology begins by determining the fair value of the service component, as well as other executory costs and any profit thereon, and second, by determining the fair value of the equipment based on a comparison of the equipment values in our accounting systems to a range of cash selling prices. The resultant implicit interest rate is then compared to fair market value rates to assess the reasonableness of the overall allocations to the multiple elements.

We conducted an extensive analysis of available verifiable objective evidence of fair value (VOE) based on cash sales prices and compared these prices to the range of equipment values recorded in our lease accounting systems. With the exception of Latin America, where operating lease accounting is applied as discussed below, the range of cash selling



prices supports the reasonableness of the range of equipment lease prices as originally recorded, at inception of the lease, in our accounting systems. In applying our new methodology described above, we have therefore concluded that the revenue amounts allocated by our accounting systems to the equipment component of a multiple element arrangement represents a reasonable estimate of the fair value of the equipment. As a consequence, \$2.4 billion of previously recorded equipment sale revenue during the five years ended December 31, 2001 has been reversed and we have recognized additional service revenue and finance income of \$1.7 billion, which represents the impact of reversing amounts previously recorded as equipment sales-type leases and recognizing such amounts over the lease term. The net cumulative reduction in revenue, as a result of this change, was \$641 million for the five-year period ended December 31, 2001. In total approximately \$840 million of revenue previously recognized has been reversed and will be recognized in future years, estimated as follows: \$410 million 2002, \$260 million 2003 and \$170 million thereafter.

Transactions not qualifying as sales-type leases: We re-evaluated the application of SFAS No. 13 for leases originally accounted for as sales-type leases in our Latin American operations, and we determined that these leases should have been recorded as operating leases. This determination was made after we conducted an in-depth review of the historical effective lease terms compared to the contractual terms of our lease agreements. Since, historically, and during all periods presented, a majority of leases were terminated significantly prior to the expiration of the contractual lease term, we concluded that such leases did not qualify as sales-type leases under certain provisions of SFAS No. 13. Specifically, because we generally do not collect the receivable from the initial transaction upon termination of the contract or during the subsequent lease term, the recoverability of the lease investment was not predictable at the inception of the original lease term. The accounting for these transactions as sales-type leases is further complicated due to our very high market shares in many of these countries, which makes it difficult to establish a reasonable basis for estimating the fair value of the equipment component of our leases due to a lack of available VOE. In addition historical and continuing economic and political instability in many of these countries also raises concerns about reasonable assurance of collectibility. As a consequence, \$2.8 billion of previously recorded equipment sale revenue during the five years ended December 31, 2001 has been reversed and we have recognized additional rental revenue of \$2.2 billion, which represents the impact of changing the classification of previously recorded sales-type leases to operating leases. The net cumulative reduction in revenue, as a result of this change, was \$633 million for the five-year period ended December 31, 2001. In total, approximately \$800 million of revenue previously recognized has been reversed and will be recognized in future years, estimated as follows: \$240 million 2002, \$240 million 2003 and \$320 million thereafter.

During the course of the restatement process, we concluded that the estimated economic life used for classifying leases for the majority of our products should have been five years versus the three to four years we previously utilized. This resulted from an in-depth review of our lease portfolios, for all periods presented, which indicated that the most frequent term of our lease contracts was 60 months. We believe that this has been and is representative of the period during which the equipment is expected to be economically usable, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease. As a consequence, many shorter duration leases did not meet the criteria of SFAS No. 13 to be accounted for as sales-type leases. Additionally, other lease arrangements were found to not meet other requirements of SFAS No. 13 for treatment as sales-type leases. As a consequence, \$588 million of equipment revenue recorded during the five years ended December 31, 2001 has been reversed and we have recognized additional rental revenue of \$387 million, which represents the impact of changing the classification of previously recorded sales-type leases to operating leases. The net cumulative reduction in revenue, as a result of this change, was \$201 million for the five-year period ended December 31, 2001. In total approximately \$140 million of revenue previously recognized has been reversed and will be recognized in future years, estimated as follows: \$70 million 2002, \$40 million 2003 and \$30 million thereafter.

Accounting for the sale of equipment subject to operating leases: We have historically sold pools of equipment subject to operating leases to third party finance companies (the counterparties) or through structured financings with third parties and recorded the transaction as a sale at the time the equipment is accepted by the counterparties. These transactions increased equipment sale revenue, primarily in Latin America, in 2000 and 1999 by \$148 million and \$400 million, respectively. Upon additional review of the terms and conditions of these contracts, it was determined that the form of the transactions at inception included retained ownership risk provisions or other contingencies that precluded these transactions from meeting the criteria for sale treatment under the provisions of SFAS No. 13. The form of the transaction notwithstanding, these risk of loss or contingency provisions have resulted in only minor impacts on our operating results during the five years ended December 31, 2001. These transactions have however been restated and

recorded as operating leases in our consolidated financial statements. As a consequence \$569 million of equipment revenue recorded during the five years ended December 31, 2001 has been reversed and we have recognized additional rental revenue of \$670 million, which represents the impact of changing the previously recorded transactions to operating leases. The net cumulative increase in revenue as a result of this change was \$101 million for the five-year period ended December 31, 2001. In total approximately \$110 million of revenue previously recognized has been reversed and will be recognized in future years, estimated as follows: \$80 million 2002 and \$30 million 2003. Additionally, for transactions in which cash proceeds were received up-front we have recorded these proceeds as secured borrowings. The remaining balance of these borrowings aggregated \$55 million at December 31, 2001.

In summary and in connection with the restatement of reported results of operations regarding accounting for leases, our policy is to now measure the reasonableness of estimates of fair values of leased equipment by comparison to VOE from cash sales of the same or similar equipment or on the basis of other objective evidence of fair value. Going forward, due to a change in business model, we expect equipment sales in Latin America will either be for cash or will be financed by third party financial institutions. In connection with negotiations underway with third parties, we anticipate substantially exiting our financing business. Our business processes and the terms of our third party financing contracts may result in our customer transactions being initially recorded as leases in our financial statements prior to being sold to the financing companies. The accounting effect may require us to account for transactions with third party finance companies as sales of the underlying leases, and to recognize gains or losses on the sales of such leases as they are sold.

*Other adjustments:*

In addition to the aforementioned revenue related adjustments, other errors in the application of GAAP were identified. These include the following:

**Sales of receivables transactions:** During 2001 and 1999, we sold approximately \$2.0 billion of U.S. finance receivables originating from sales-type leases (\$1.4 billion in 1999 and \$600 million in 2001). These transactions were originally accounted for as sales of receivables. These sales were made to special purpose entities (SPEs), which qualified for non-consolidation in accordance with then existing accounting requirements. As a result of the changes in the estimated economic life of our equipment to five years, certain leases transferred in these transactions did not meet the sales-type lease requirements and were accounted for as operating leases. This change in lease classification affected a number of the leases that were sold into the aforementioned SPEs resulting in these entities now holding operating leases as assets. This change disqualified the SPEs from non-consolidation and effectively required us to record the proceeds received on these sales as secured borrowings. This increased our debt by \$490 million, \$418 million and \$950 million as of December 31, 2001, 2000 and 1999, respectively. These transactions are also discussed in Note 6 to the Consolidated Financial Statements. This change has no effect on our liquidity or amounts due to the SPEs from the Company.

During 1999, we sold \$288 million of accounts receivables to financial institutions. Upon additional review of the terms and conditions of these transactions, we determined that \$57 million (including \$14 million which was restated in connection with the prior restatement of our financial statements) did not qualify for sale treatment as a result of our agreeing to reacquire the receivables in 2000. Accordingly, we have restated our previously reported results for these transactions and they are now reported in our Consolidated Financial Statements as short-term borrowings. This change increased Accounts receivable, net and debt by \$57 million as of December 31, 1999; the transactions were settled in early 2000. No similar transactions have occurred since 1999.

**South Africa deconsolidation:** We determined that we inappropriately consolidated our South African affiliate since 1998 as the minority joint venture partner has substantive participating rights. Accordingly, we have deconsolidated all assets, liabilities, revenues and expenses. We now account for this investment on the equity method of accounting. The cumulative reduction in revenues through December 31, 2001 was \$269 million and there was no impact on net income or Common Shareholder's Equity.

**Purchase accounting reserves:** In connection with the 1998 acquisition of XL Connect Solutions, Inc. (XLConnect), we recorded liabilities aggregating \$65 million for contingencies identified at the date of the acquisition. During 2000 and 1999, we determined that certain of these contingent liabilities were no longer required, and \$29 million of the liabilities were either reversed into income or we charged certain costs related to ongoing activities of the acquired business against these liabilities. Upon additional review we determined that approximately \$51 million of these contingent

liabilities did not meet the criteria to initially be recorded as acquisition liabilities. Accordingly, we have adjusted the goodwill and liabilities at the date of acquisition and corrected the 2000 and 1999 income statement impacts.

Restructuring reserves: During 2000 and 1998, we recorded restructuring charges associated with our decisions to exit certain activities of the business. Upon additional review we determined that certain adjustments made to the original charges were not in accordance with GAAP. The adjustments to increase pre-tax loss in 2001 of \$87 million and decrease pre-tax loss in 2000 of \$65 million consist primarily of corrections to the timing of the release of reserves originally recorded under the March 2000 restructuring program. We should have reversed the applicable reserves in late 2000 when the information was available that our original plan had changed indicating that such reserves were no longer necessary. Previously, the reversal was recorded in early 2001. Similarly, the adjustment of \$12 million to decrease 1999 pre-tax income relates primarily to the inappropriate release of restructuring reserves which should have been recorded in 1998 based on information available at the time. The adjustments to reduce the 1998 restructuring provisions of \$138 million related to charges which did not meet the criteria to be recorded as part of the initial restructuring reserves. Such charges did not qualify as exit costs or appropriate separation costs in accordance with the accounting guidance governing restructuring actions. In total, these adjustments increased pre-tax income by \$104 million for the five year period ended December 31, 2001.

Tax refunds: In 1995, we received a final favorable court decision that entitled us to refunds of certain tax amounts paid in the U.S., plus accrued interest on the tax. The court established the legal precedent upon which the refunds were to be based. We recorded the income associated with the tax refunds and the related interest from 1995 through 1999. We determined that the benefit should have been recorded in periods prior to 1997. These adjustments decreased pre-tax income by \$153 million for the five year period ended December 31, 2001.

Other adjustments: In addition to the above items and in connection with our review of prior year's financial records we determined that other accounting errors were made with respect to the accounting for certain non-recurring transactions, the timing of recording and reversing certain liabilities and the timing of recording certain asset write-offs. We have restated our 2000 and 1999 Consolidated Financial Statements, and revised our previously announced 2001 results for such items. These adjustments decreased pre-tax income by \$290 million for the five year period ended December 31, 2001.

The following table presents the effects of the aforementioned adjustments on total revenue:

**Increase (decrease) to total revenue:**

(in millions)

	Year ended December 31,				
	2001	2000	1999	1998	1997
Revenue, previously reported	\$ 16,502	\$ 18,701	\$ 19,567	\$ 19,593	\$ 18,225
Application of SFAS No. 13:					
Revenue allocations in bundled arrangements	65	(78)	(257)	(284)	(87)
Latin America operating lease accounting	187	(58)	57	(358)	(461)
Other transactions not qualifying as sales-type leases	73	57	(60)	(119)	(152)
Sales of equipment subject to operating leases	197	124	(243)	67	(44)
Subtotal	522	45	(503)	(694)	(744)
Other revenue restatement adjustments:					
Sales of receivables transactions	42	61	(6)		
South Africa deconsolidation	(66)	(72)	(71)	(60)	
Other revenue items, net	8	16	8	(62)	(24)
Subtotal	(16)	5	(69)	(122)	(24)
Increase (decrease) in total revenue	506	50	(572)	(816)	(768)
Revenues, restated	\$ 17,008	\$ 18,751	\$ 18,995	\$ 18,777	\$ 17,457

The following table presents the effects of the aforementioned adjustments on sales revenue:

**Increase (decrease) to sales revenue:**

(in millions)

	Year ended December 31,				
	2001	2000	1999	1998	1997
Revenue allocations in bundled arrangements	\$ (440)	\$ (541)	\$ (650)	\$ (508)	\$ (233)
Latin America operating lease accounting	(125)	(459)	(300)	(902)	(1,007)
Other transactions not qualifying as sales type leases	(31)	(74)	(160)	(162)	(161)
Sales of equipment subject to operating leases	33	(111)	(342)	(20)	(129)
South Africa deconsolidation	(27)	(31)	(30)	(25)	
Other revenue items, net	5	(4)	8	(55)	(22)
Decrease in sales revenue	\$ (585)	\$ (1,220)	\$ (1,474)	\$ (1,672)	\$ (1,552)

In total, approximately \$1.9 billion of revenue recognized in years 2001 and prior has been reversed and is estimated to be recognized as follows: \$800 million 2002, \$570 million 2003 and \$530 million thereafter.

The following table presents the effects of the aforementioned adjustments on pre-tax income (loss):

**Increase (decrease) to pre-tax income (loss):**

(in millions)

	Year ended December 31,				
	2001	2000	1999	1998	1997
Pre-tax (loss) income, previously reported (1)	\$ (71)	\$ (384)	\$ 1,908	\$ 579	\$ 2,005
Revenue restatement adjustments:					
Revenue allocations in bundled arrangements	68	(74)	(252)	(281)	(87)
Latin America operating lease accounting	335	80	39	(238)	(354)
Other transactions not qualifying as sales-type leases	54	12	(50)	(74)	(100)
Sales of equipment subject to operating leases	91	11	(162)	19	(35)
Sales of receivables transactions	12	18	(32)		
South Africa deconsolidation	(10)	(11)	(8)	(6)	
Other revenue items, net	10	12	22	(31)	(21)
Subtotal	560	48	(443)	(611)	(597)
Other restatement adjustments:					
Purchase accounting reserves	(2)	(7)	(20)		
Restructuring reserves	(87)	65	(12)	138	
Tax refunds			(14)	(97)	(42)
Other, net	31	(89)	(131)	(22)	(79)
Subtotal	(58)	(31)	(177)	19	(121)
Restatement of interest expense	(37)				
Increase (decrease) to pre-tax income (loss)	465	17	(620)	(592)	(718)
Pre-tax income (loss), restated	\$ 394	\$ (367)	\$ 1,288	\$ (13)	\$ 1,287

(1) Amounts have been adjusted to reflect the reclassification of gains associated with extinguishments of debt from extraordinary items to pre-tax income (loss) required due to the adoption of SFAS No. 145. See Note 22 to these Consolidated Financial Statements for further discussion.

The impact of these adjustments on certain key ratios is as follows:

	Year ended December 31,				
	2001	2000	1999	1998	1997
<b>Sales Gross Margin:</b>					
- Previously reported	32.9%	37.5%	43.1%	43.8%	44.5%
- Adjusted and restated	30.5%	31.2%	37.2%	40.5%	39.5%
<b>Service, Outsourcing and Rentals Gross Margin:</b>					
- Previously reported	39.4%	37.6%	42.8%	44.4%	47.4%
- Adjusted and restated	42.2%	41.1%	44.7%	46.6%	48.4%
<b>Finance Gross Margin:</b>					
- Previously reported	34.6%	34.5%	49.4%	50.1%	48.8%
- Adjusted and restated	59.5%	57.1%	63.0%	58.2%	58.6%
<b>Total Gross Margin:</b>					
- Previously reported	36.0%	37.4%	43.3%	44.4%	46.9%
- As adjusted and restated	38.2%	37.4%	42.3%	44.3%	44.8%
<b>Selling, Administrative and General Expenses as a percentage of revenue:</b>					
- Previously reported	29.1%	30.2%	27.0%	27.3%	28.7%
- As adjusted and restated	27.8%	29.4%	27.4%	28.3%	29.8%

These adjustments resulted in the cumulative net reduction of Common Shareholders' Equity of \$1.3 billion as of December 31, 2001. The following table presents the impact of the restatement adjustments on Common Shareholders' Equity as of January 1, 1997:

Increase (decrease) in Common Shareholders' Equity (in millions):

<b>Common Shareholders' Equity balance</b>	
January 1, 1997, previously reported	\$ 4,352
Revenue allocations in bundled arrangements	(223)
Latin America operating lease accounting	(1,326)
Other transactions not qualifying as sales-type leases	8
Sales of equipment subject to operating leases	(49)
Other items, net	285
Income tax impacts of above adjustments	436
<b>Decrease in Common Shareholders' Equity</b>	<b>(869)</b>
<b>Common Shareholders' Equity balance</b>	
January 1, 1997, restated	\$ 3,483

The comparative impacts of changes to the amounts previously reported in our 2000 and 1999 financial statements are included in Note 2 to the consolidated financial statements. The following tables present the impact of the adjustments on our previously reported 2001 results on a condensed basis:

	<u>Previously Reported (1)</u>	<u>As Restated</u>
<b>Year ended December 31, 2001</b>		
(in millions, except per share data)		
<b>Statement of operations:</b>		
Total Revenues	\$ 16,502	\$ 17,008
Sales	8,028	7,443
Service, outsourcing, financing and rentals	8,474	9,565
Total Costs and Expenses (1)	16,573	16,614
Net Loss	(293)	(94)
Diluted Loss per Share	\$ (0.43)	\$ (0.15)
<b>Balance Sheet:</b>		
Accounts receivable and finance receivables, net	\$ 6,557	\$ 5,818
Inventories	1,345	1,364
Deferred taxes and other current assets	1,451	1,369
Total Current Assets	13,344	12,541
Finance receivables due after one year, net	6,336	5,756
Equipment on operating leases, net	521	804
Land, buildings and equipment, net	1,992	1,999
Other long-term assets	4,365	5,100
Goodwill, net	1,475	1,445
Total Assets	28,033	27,645
Short-term debt and current portion of long-term debt	9,737	6,637
Other current liabilities	3,671	3,623
Total Current Liabilities	13,408	10,260
Long-term debt	6,484	10,107
Other long-term liabilities	2,752	3,251
Total Liabilities	22,644	23,618
Common Shareholders' Equity	3,148	1,797
Total Liabilities and Equity	\$ 28,033	\$ 27,645

(1) Amounts have been adjusted to reflect the reclassification of gains associated with extinguishments of debt from extraordinary items to pre-tax income required due to the adoption of SFAS No. 145. See Note 22 to these Consolidated Financial Statements for further discussion.

**Application of Critical Accounting Policies.** In preparing our financial statements and accounting for the underlying transactions and balances, we apply our accounting policies as disclosed in our Notes to Consolidated Financial Statements. We consider the policies discussed below as critical to an understanding of our financial statements because their application places the most significant demands on management's judgment, with financial reporting results relying on estimation about the effect of matters that are inherently uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. The impact and any associated risks related to these policies on our business operations is discussed throughout this Management's Discussion and Analysis where such policies affect our reported and expected financial results. For a detailed discussion on the application of these and other accounting policies, see Note 1 to the consolidated financial statements. Senior management has discussed the development and selection of the critical accounting estimates and the related disclosure included herein with the Audit Committee of the Board of Directors. Preparation of this Annual Report on Form 10-K requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from those estimates.

*Revenue Recognition for Sales-Type Leases Under Bundled Arrangements:* We sell most of our products and services under bundled contract arrangements, which contain multiple deliverable elements. These arrangements typically include equipment, service and supplies, and financing components for which the customer pays a single negotiated price for all elements. These arrangements typically also include a variable service component for page volumes in excess of stated minimums. When separate prices are listed in multiple element customer contracts, they may not be representative of the fair values of those elements because the prices of the different components of the arrangement may be modified in customer negotiations, although the aggregate consideration may remain the same. Therefore, revenues under these arrangements are allocated based upon estimated fair values of each element. Our revenue allocation methodology first begins by determining the fair value of the service component, as well as other executory costs and any profit thereon and second, by determining the fair value of the equipment based on comparison of the equipment values in our accounting systems to a range of cash selling prices. The resultant implicit interest rate is then compared to fair market value rates to assess the reasonableness of the overall allocations to the multiple elements.

*Determination of Appropriate Revenue Recognition for Sales-Type Leases:* Our accounting for leases involves specific determination under SFAS No. 13 which often involve complex provisions and significant judgments. The general criteria for SFAS No. 13, at least one of which is required to be met in order to account for a lease as a sales-type lease versus as an operating lease, are (a) whether ownership transfers by the end of the lease term, (b) whether there is a bargain purchase option at the end of the lease term which is exercisable by the lessee, (c) whether the lease term is equal to or greater than at least 75 percent of the economic life of the equipment and (d) whether the present value of the minimum lease payments, as defined, are equal to or greater than 90 percent of the fair market value of the equipment. Criteria (a) and (b) are relatively minor considerations for qualifying our leases as sales, as we usually do not employ such contract terms. Under our current product portfolio and business strategies, generally a non-cancelable lease of 45 months or more qualifies under the economic life criteria as a sale. Certain of our lease contracts are customized for larger customers which result in complex terms and conditions and require significant judgment in applying the above criteria. In addition to these criteria, there are also other important criteria that are required to be assessed, including whether collectibility of the lease payments is reasonably predictable and whether there are important uncertainties related to costs that we have yet to incur with respect to the lease. In management's opinion, our sales-type lease portfolios contain only normal credit and collection risks and have no important uncertainties with respect to future costs.

The critical elements of SFAS No. 13 that we analyze with respect to our lease accounting are the determination of economic life and the fair value of equipment, including our estimates of residual values. Accounting for sales-type lease transactions requires management to make estimates with respect to economic lives and expected residual value of the equipment in accordance with specific criteria as set forth in generally accepted accounting principles. Those estimates are based upon historical experience with economic lives of all of our equipment products. We consider the most objective measure of historical experience for purposes of estimating the economic life to be the original contract term since most equipment is returned by lessees at or near the end of the contracted term. The most frequent contractual lease term for our principal products is five years and only a small percentage of our leases are for original terms longer than five years. Accordingly, we have estimated the economic life of most of our products to be five years. We believe that this is representative of the period during which the equipment is expected to be economically usable, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease. When we originally reported our 1999 and 2000 results, we had utilized an economic life for our principal products of three to four years. The increase to five years had the effect of reducing equipment sale revenue by \$37 million, \$66 million and \$115 million for the years ended December 31, 2001, 2000 and 1999, respectively. Residual values are established at lease inception using estimates of fair value at the end of the lease term. Our residual values are established with due consideration to forecasted supply and demand for our various products, product retirement and future product launch plans, end of lease customer behavior, remanufacturing strategies, used equipment markets (to the extent they exist for the particular product), competition and technological changes. Since we are the developer, servicer and frequently the manufacturer of our products, we do not believe we have any significant risks to recovery of our recognized residual values.

*Accounts and Finance Receivables 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, as determined by our review of our customers' current credit information. 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 we have identified. While such credit losses have historically been



within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we have 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. In addition to provisions related to the credit worthiness of our customers, we also record provisions for customer accommodations, among other things. We recorded \$506 million, \$613 million and \$450 million in provisions to the Consolidated Statements of Operations for doubtful accounts for both our accounts and finance receivables for the three years ended December 31, 2001, 2000 and 1999, respectively.

Historically about half of the 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 four years and contains both past due billed amounts, as well as unbilled amounts. Estimated credit quality of any given customer, 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 reserves for uncollectible accounts.

*Securitization and Transfers of Financial Assets:* From time to time, we engage in securitization activities in connection with our accounts and finance receivables. We enter into these transactions for the purposes of generating cash from these assets through sales or secured borrowings. In several of the countries where we have completed lease transaction funding arrangements with third party finance companies we have effectively transferred substantially all of the related collection risk to these financiers. Gains and losses from securitizations, accounted for as sales, are recognized in the Consolidated Statements of Operations when we surrender control of the transferred financial assets. The gain or loss on the sale of financial assets depends in part on the previous carrying amount of the assets involved in the transfer, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale.

As part of the transactions accounted for as sales, the receivables are typically sold to a special purpose entity that meets the applicable accounting standards for non-consolidation. When special purpose entities are involved neither we, nor any of our employees has any involvement in the management of such entity. When we sell receivables, we may retain servicing rights, beneficial interests, and in some cases, a cash reserve account, all of which are retained interests in the securitized receivables. The retained interest is initially recorded at carrying value, which approximates fair value in our Consolidated Balance Sheets. Subsequently, decreases in the value of such interests, if any, are recognized in our Consolidated Statements of Operations. The securitization gain or loss involves our best estimates of key assumptions, consisting of receivable amounts, anticipated credit losses, and discount rates commensurate with the risks involved. The use of different estimates or assumptions could produce different financial results. For those transactions accounted for as secured borrowings, we have made the determination that the criteria for surrender of control were not met, or that the receivables were sold into a special purpose entity that did not meet the requirements for deconsolidation.

These transactions are often complex, involve highly structured contracts between us and the buyer or transferee and involve strict accounting rules application. The key distinction in the application of the accounting rules to the structured contracts and similar transactions (sale versus a secured borrowing) is the inclusion or exclusion of the related receivables and or associated obligations that would or would not be included in our Consolidated Balance Sheets, as well as any gain or loss that would result from a sale transaction. In order for a transaction to qualify as a sale, several accounting requirements must be met including the surrender of control over the receivables and the existence of a bankruptcy remote contract structure. Transactions not meeting these requirements must be accounted for as secured borrowings. See Note 6 to the consolidated financial statements for a discussion of our securitization transactions.

*Provisions for Excess and Obsolete Inventory Losses and Residual Value Losses:* We value our inventory at the lower of average cost or net realizable values. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast of product demand and production requirements for the next twelve months. Several factors may influence the realizability of our inventories, including our decisions to exit a product line (e.g., SOHO), technological change and new product development. These factors could result in an increase in the amount of obsolete inventory quantities on hand. Additionally, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. In the future, if we determine that our inventory was overvalued, we would be required to recognize such costs in Cost of sales at the time of such determination. Likewise, if we determine that our

inventory is undervalued, we may have overstated Cost of sales in previous periods and would be required to recognize such additional operating income at the time of sale. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product demand, including the impact of planned future product launches, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and our reported operating results. We recorded \$242 million, \$235 million and \$144 million in inventory write-down charges for the three years ended December 31, 2001, 2000 and 1999, respectively. These amounts include \$42 million and \$84 million in 2001 and 2000, respectively, associated with our restructuring programs. At this time, management does not believe that anticipated product launches will have a material effect on the recovery of our existing net inventory balances.

We have a similar accounting policy relating to unguaranteed residual values associated with equipment on lease, which totaled \$414 million and \$508 million in our Consolidated Balance Sheets at December 31, 2001 and 2000 respectively. We review residual values regularly and, when appropriate, adjust them based on estimates of forecasted demand including the impacts of future product launches. Impairment charges are recorded when available information indicates that the decline in recorded value is other than temporary and we would not therefore be able to fully recover the recorded values. We recorded \$14 million, \$17 million and \$4 million in residual value impairment for the years ended December 31, 2001, 2000 and 1999, respectively.

*Estimates Used Relating to Restructuring and Asset Impairments:* Over the last several years we have engaged in significant restructuring actions, which have required us to develop formalized plans as they relate to exit activities. These plans have required us to utilize significant estimates related to salvage values of assets that were made redundant or obsolete. In addition, we have had to record estimated expenses for severance and other employee separation costs, lease cancellation and other exit costs. Given the significance of, and the timing of the execution of such actions, this process is complex and involves periodic reassessments of estimates made at the time the original decisions were made. The accounting for restructuring costs and asset impairments requires us to record provisions and charges when we have a formal and committed plan. Our policies, as supported by current authoritative guidance, require us to continually evaluate the adequacy of the remaining liabilities under our restructuring initiatives. As management continues to evaluate the business, there may be supplemental charges for new plan initiatives as well as changes in estimates to amounts previously recorded as payments are made or actions are completed.

*Discontinued Operations:* In the fourth quarter of 1995, we announced our planned disengagement from our insurance operations. From 1995 to 1998 all our insurance operations were sold. As part of the sales of these insurance operations, we were required to continue to provide aggregate excess of loss reinsurance coverage (the Reinsurance Agreements) to two former insurance entities through Ridge Reinsurance Limited (Ridge Re), a wholly owned subsidiary. The coverage limits for these two remaining Reinsurance Agreements total \$578 million, which is exclusive of \$234 million in coverage that Ridge Re reinsured in 1998. We have guaranteed that Ridge Re will meet all its financial obligations under the two remaining Reinsurance Agreements. As of December 31, 2001, Ridge Re has \$684 million of cash and investments held in restricted trusts as collateral for their potential liability under these reinsurance obligations. Our remaining net investment in Ridge Re was \$348 million, net of our expected liability of \$336 million, at December 31, 2001. Based on Ridge Re's current projections of investment portfolio returns and reinsurance obligation payments, all of which are based on actuarial estimates, we expect to fully recover our remaining net investment of \$348 million. Our ongoing evaluation of the insurance liabilities, and estimates thereof, could result in a significant change in our estimate of recoverability of this net investment. The expected liability is a discounted value, consistent with accounting standards applicable to insurance companies. A material change in the timing of the estimated payments could materially affect the liability recognized but not to an amount greater than our coverage limit as described above.

*Pension and Postretirement Benefit Plan Assumptions:* We sponsor pension plans in various forms covering substantially all employees who meet eligibility requirements. Postretirement benefit plans primarily only cover U.S. employees for retirement medical costs. Several statistical and other factors that attempt to anticipate future events are used in calculating the expense and liability related to the plans. These factors include assumptions we make about, among others, the discount rate, expected return on plan assets, rate of increase of health care costs and rate of future compensation increases. In addition, our actuarial consultants also use subjective factors such as withdrawal and mortality rates to estimate these factors. The actuarial assumptions we use may differ materially from actual results due to changing market and economic conditions, higher or lower withdrawal rates or longer or shorter life spans of participants. These differences may result in a significant impact to the amount of pension or postretirement benefits expenses we have recorded or may record. Assuming a constant employee base, the most important estimate associated with our post retirement plan is the assumed health care cost trend rate. A one-percentage-point increase in this

estimate would increase the expense by approximately \$5 million. A similar analysis for the expense associated with our pension plans is more difficult due to the variety of assumptions, plan types and regulatory requirements for these plans around the world. However, by way of example, for the U.S. plans, which represent approximately 70 percent of the consolidated projected benefit obligation at December 31, 2001, a 0.25 percent change in the discount rate would change the annual pension expense by approximately \$6 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 on the balance sheet and provide necessary valuation allowances as required. We regularly review our deferred tax assets for recoverability based on historical taxable income, 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. Valuation allowance provisions were \$247 million, \$12 million, and \$92 million for the years ended December 31, 2001, 2000 and 1999, respectively.

*Goodwill and Other Acquired Intangible Assets:* We have made acquisitions in the past that included the recognition of a significant amount of goodwill and other intangible assets. Under generally accepted accounting principles in effect through December 31, 2001, these assets were amortized over their estimated useful lives and were tested periodically to determine if they were recoverable from estimated future pre-tax cash flows on an undiscounted basis over their useful lives. Effective in 2002, goodwill will no longer be amortized but will be subject to an annual (or under certain circumstances more frequent) impairment test based on its estimated fair value. Other intangible assets that meet certain criteria will continue to be amortized over their useful lives and will also be subject to an impairment test based on estimated fair value. Estimated fair value is typically less than values based on undiscounted operating earnings because fair value estimates include a discount factor in valuing future cash flows. There are many assumptions and estimates underlying the determination of an impairment loss.

*Legal Contingencies:* We are a defendant in numerous litigation and regulatory matters including those involving securities law, patent law, environmental law, employment law and ERISA, as discussed in Note 16 to the consolidated financial statements. As required by SFAS No. 5, we determine whether an estimated loss from a loss contingency should be accrued by assessing whether a loss is deemed probable and can be reasonably estimated. We analyze our litigation and regulatory matters based on available information to assess potential liability. 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 these matters result in an 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 judgment or settlement occurs.

*Other Significant Accounting Policies:* Other significant accounting policies, not involving the same level of uncertainties as those discussed above, are nevertheless important to an understanding of the financial statements. See Note 1 to the consolidated financial statements, Summary of Significant Accounting Policies, which discusses accounting policies that must be selected by management when there are acceptable alternatives.

#### **Other accounts affected by management estimates.**

The following table summarizes other significant areas which require management estimates:

	Year ended December 31		
	2001	2000	1999
(in millions)	Restated	Restated	Restated
Amortization of goodwill and intangible assets	\$ 94	\$ 86	\$ 50
Depreciation of equipment on operating leases	657	626	560
Depreciation of land, buildings and equipment	402	417	416
Amortization of capitalized software	179	115	64
Pension benefits net periodic benefit cost	99	44	102
Other benefits net periodic benefit cost	130	109	107

## Financial Overview

As previously discussed we have restated our prior year's financial statements and our previously released 2001 results. All dollar and per share amounts, and financial ratios have been revised, as appropriate, to reflect these restatements. In 2001 we reduced our net loss to \$94 million or \$(0.15) per share from a net loss of \$273 million, or \$(0.48) per share in 2000. In 2001 we executed aggressive plans to exit certain businesses, outsource some internal functions and substantially reduce our cost base in order to restore our financial strength and significantly improve our core operations while effectively positioning ourselves to exploit future opportunities in the production, office and services markets. These actions resulted in strong 2001 fourth quarter performance including the highest gross margin in the past two years; lower year over year selling, administrative and general expenses; reduction of inventory to historically low levels; improved cash and reduced net debt. We believe the combination of actions already implemented, continuing cost reduction activities and our focus on more profitable revenue positions us for continued improvement and builds a solid foundation for future growth.

The 2001 net loss of \$94 million included \$507 million of after-tax charges (\$715 million pre-tax) for restructuring and asset impairments associated with our Turnaround Program, aimed at creating a leaner, faster and more flexible enterprise, and our disengagement from our worldwide Small Office/Home Office (SOHO) business. 2001 results also included a \$304 million after-tax gain (\$773 million pre-tax) from the sale of half of our interest in Fuji Xerox, a \$38 million after-tax gain related to the early retirement of debt, and \$21 million of after-tax gains associated with unhedged foreign currency. Unhedged foreign currency exposures are the result of net unhedged positions largely caused by our restricted access to the derivatives markets since the fourth quarter 2000. This limitation has increased our risk to financial volatility associated with currency gains and losses. Further discussion of the restructuring charges and sale of half our interest in Fuji Xerox is included below and in Notes 3 and 5, respectively, to the consolidated financial statements.

The \$273 million net loss in 2000 was substantially worse than 1999 net income of \$844 million. The 2000 net loss was largely attributable to \$339 million of after-tax charges (\$475 million pre-tax) for restructuring and asset impairments and our \$37 million share of a Fuji Xerox restructuring charge, partially offset by after-tax gains of \$119 million (\$200 million pre-tax) from the sale of our China operations and \$69 million of unhedged foreign currency after-tax gains.

## Results of Operations

	For the Year Ended		
	2001	2000	1999
	Restated	Restated	Restated
Revenue	\$ 17,008	\$ 18,751	\$ 18,995
Net (loss) income	\$ (94)	\$ (273)	\$ 844
Diluted (loss) earnings per share	\$ (0.15)	\$ (0.48)	\$ 1.17

In 1999, we faced several business challenges, which adversely impacted our performance beginning in the second half of that year and continued into 2001. Many of the business challenges were company specific and included increased sales force turnover, open sales territories and lower sales productivity resulting from the realignment of our sales force from a geographic to an industry structure. Further disruption and incremental costs were associated with the consolidation of our U.S. customer administration centers and changes in our European infrastructure. In addition, there were significant competitive and industry changes, and adverse economic conditions affecting our operations toward the latter part of 2000. These challenges were exacerbated by significant technology and acquisition spending negatively impacting our cash availability, credit rating downgrades, limited access to capital markets and marketplace concerns regarding our liquidity.

To counter these challenges, we implemented actions beginning in mid-2000 to stabilize our sales force and minimize further disruption to our operations. In October 2000, we announced a Turnaround Program designed to help ensure adequate liquidity, re-establish profitability and build a solid foundation for future growth. The Turnaround Program encompassed four major components: (i) asset sales of \$2 to \$4 billion; (ii) accelerated cost reductions designed to reduce costs by at least \$1 billion annually; (iii) the transition of equipment financing to third party vendors and (iv) a focus on our core business of providing document processing systems, solutions and services to our customers. By the end of 2001, we had made significant progress executing this program and achieving these goals.

By year-end 2001, we had completed asset sales of \$2.3 billion, comprised of the March 2001 sale of half our ownership interest in Fuji Xerox Co., Ltd. (Fuji Xerox) to Fuji Photo Film Co., Ltd. (FujiFilm) for \$1,283 million, the December 2000 sale of our China Operations to Fuji Xerox for \$550 million, the April 2001 sale of our Nordic leasing businesses to Resonia AB for approximately \$370 million, and in the fourth quarter 2001 the first in a series of asset sales to transfer our office product manufacturing operations to Flextronics for approximately \$118 million. We believe the asset sale component of our Turnaround Program has been largely completed.

We also intensified cost reductions to improve our competitiveness. During 2001, we implemented work force resizing and cost reduction actions that we believe will result in approximately \$1.1 billion in annualized savings. These savings are expected to result from reducing layers of management, consolidating operations where prudent, reducing administrative and general spending, capturing service productivity savings from our digital products and tightly managing discretionary spending. We are reducing costs in our Office segment by moving to lower cost indirect sales and service channels and by outsourcing our office products manufacturing. Our worldwide employment declined by approximately 13,600 to 78,900 at December 31, 2001. In our ongoing efforts to reduce our cost base, we will continue to implement restructuring actions and incur substantial restructuring charges throughout 2002; although less than the amounts recorded in 2001.

Our transition to third party financing will significantly improve our liquidity while ensuring equipment financing is still provided to our customers. In 2001, we entered into framework agreements with General Electric Capital Corporation (GE Capital) for them to manage our customer administrative functions and become the primary equipment financing provider for Xerox customers in the U.S., Canada, France and Germany. On May 1, 2002, Xerox Capital Services LLC (XCS), our U.S. venture with GE Capital Vendor Financial Services, became operational. XCS manages our customer administration and leasing activities in the U.S., including financing administration, credit approval, order processing, billing and collections. We are currently in the process of completing the negotiation of definitive agreements with GE Capital for the implementation of the Canadian joint venture which is expected in the second half of 2002. These agreements are subject to the completion of due diligence on GE's part as well as the fulfillment of various regulatory requirements.

Ongoing funding for new leases by GE Capital and its affiliates in both the U.S. and Canada is expected to be in place later this year upon development and completion of systems and process modifications. In Europe, a number of initiatives are under way and have been implemented. In Germany, we received a \$77 million loan in May 2002 secured by certain finance receivables, as we continue to complete our vendor financing transition this year. In France we are completing due diligence, fulfilling regulatory requirements, consulting with local works councils and expect to complete the agreement with GE Capital in the third quarter 2002. We have fully transitioned our leasing businesses in the Nordic countries, the Netherlands and Italy. Our Nordic leasing business was sold to Resonia AB in April 2001. In the first quarter 2002, we formed a joint venture with De Lage Landen International BV (DLL) in which they provide funding and manage equipment financing for our customers in the Netherlands. In April 2002, we sold our equipment financing operations in Italy for approximately \$207 million in cash plus the assumption of \$20 million of debt. We have made significant progress in our Developing Markets Operations (DMO), beginning in April 2002, with Banco Itau S.A. in Brazil and collectively with the Capita Corporation de Mexico S.A. de C.V., Organizacion Auxiliar Del Credito and Arrendadora Capita Corporation, S.A. de C.V. in Mexico becoming the primary equipment financing providers in their respective countries. By the end of 2002, we expect that approximately two-thirds of all new financed lease originations will be funded by third parties, through a combination of structures including direct financing, finance receivable securitizations and ongoing secured borrowings.

In addition to the vendor financing agreements, in 2001 and through the first half of 2002, we borrowed approximately \$3.1 billion in the U.S., Canada and U.K. from GE Capital through the securitization of certain existing lease contracts. We and GE Capital are parties to a loan agreement dated November 2001 which provides for a series of secured loans in the U.S. up to an aggregate of \$2.6 billion. Through June 2002, approximately \$1.9 billion of loans have been funded under this GE Capital agreement including a \$499 million loan which closed on May 12, 2002.

In line with our strategy to focus on our core business, we announced the disengagement from our worldwide SOHO business in June 2001. By the end of the year, we had sold the remaining equipment inventory and in the fourth quarter achieved profitability in this business through the sale of supplies to our current base of SOHO customers. We expect this profitable supplies revenue stream to decline over time as the equipment is eventually replaced.

## Summary of Total Company Results

To understand the trends in our business, we believe that it is helpful to adjust revenue and expense (except for ratios) to exclude the impact of changes in the translation of European and Canadian currencies into U.S. dollars. We refer to this adjustment as pre-currency.

A substantial portion of our consolidated revenues is derived from operations outside of the United States where the U.S. dollar is not the functional currency. We generally do not hedge the translation effect of revenues denominated in currencies where the local currency is the functional currency. When compared with the average of the major European and Canadian currencies on a revenue-weighted basis, the U.S. dollar in 2001 was approximately 3 percent stronger than in 2000. The U.S. dollar was approximately 10 percent stronger in 2000 than in 1999. As a result, foreign currency translation unfavorably impacted revenue growth by approximately one percentage point in 2001 and 3 percentage points in 2000.

Latin American currencies are shown at actual exchange rates for both pre-currency and post-currency reporting, since these countries generally have volatile currency and inflationary environments. In 2001, currency devaluations in Brazil continued to impact our results, as the Brazilian Real devalued 22 percent against the U.S. dollar. The devaluation was 2 percent in 2000 and 35 percent in 1999.

Total revenues of \$17.0 billion in 2001 declined 9 percent (8 percent pre-currency) from 2000. Approximately 25 percent of the decline reflected the loss in revenues resulting from the 2000 sale of our China operations and our exit from the SOHO business in the second half of 2001. The remaining revenue decline occurred in all operating segments, but was most pronounced in the Developing Markets segment, which declined by \$330 million or 14 percent from 2000 and the Production segment which declined by \$433 million or 7 percent from 2000. Revenues in all geographies were impacted by marketplace competition, further weakening of the worldwide economy and our reduced participation in aggressively priced bids and tenders as we focus on improved profitability. We expect total revenues to decline in 2002, reflecting the effects of our exit from the SOHO business, lower equipment population in all geographies, competitive pressures and the weak economic environment, partially offset by the benefit of new product launches in the second half 2002. We expect finance income will decline over time as we transition equipment financing to third parties.

In 2000, revenues of \$18.8 billion declined one percent (grew 2 percent pre-currency) from 1999. 2000 revenues declined 5 percent (one percent pre-currency) excluding the beneficial impact of the January 1, 2000 acquisition of the Tektronix, Inc. Color Printing and Imaging Division (CPID). CPID is discussed in Note 4 to the consolidated financial statements. Revenues in 2000 were impacted by a combination of the previously mentioned company specific issues, increased competitive environment and some weaker European and Latin American economies toward the latter part of the year.

**Revenues by Type.** Revenues and year-over-year changes by type of revenues were as follows:

	Revenues			% Change	
	2001	2000	1999	2001	2000
		Restated (\$ in billions)	Restated		
Equipment Sales	\$ 4.3	\$ 5.3	\$ 5.7	(18)%	(9)%
Post Sale and Other Revenue	11.6	12.3	12.1	(6)	2
Financing Income	1.1	1.2	1.2	(3)	(1)
<b>Total Revenues</b>	<b>\$ 17.0</b>	<b>\$ 18.8</b>	<b>\$ 19.0</b>	<b>(9)%</b>	<b>(1)%</b>

Note 1: Post sale and other revenue include service, document outsourcing, rentals, supplies and paper, which represent the revenue streams that follow equipment placement, as well as other revenue not associated with equipment placements, such as royalties.

Note 2: Revenue from document outsourcing arrangements of \$3.7, \$3.8 and \$3.2 billion in 2001, 2000 and 1999, respectively, are included in all revenue categories.

Note 3: Total Sales revenue in the Consolidated Statement of Operations includes equipment sales noted above as well as \$3.1, \$3.5 and \$3.3 billion of supplies and paper and other revenue for 2001, 2000 and 1999, respectively.

2001 equipment sales declined 18 percent (17 percent pre-currency) from 2000. Over one third of the decline was due to our exit from the SOHO business and the sale of our China operations. Equipment sales in North America and Europe declined 5 percent and 21 percent respectively from 2000, reflecting increased marketplace competition, continued

economic weakness and pricing pressures in many major market segments. In Europe equipment sales also declined due to our decision to reduce participation in aggressively priced bids and tenders as we reorient our focus from market share to profitable revenue.

2000 equipment sales declined 9 percent (5 percent pre-currency) from 1999 due to the combination of company specific business challenges, including sales force disruption and turnover, increased competition and some weaker economies. Excluding the beneficial impact of the CPID acquisition, 2000 equipment sales declined 12 percent (9 percent pre-currency).

2001 post sale and other revenue declined 6 percent (5 percent pre-currency) or 5 percent (4 percent pre-currency) excluding the impact of the 2000 sale of our China operations. Post sale and other revenue grew 2 percent (5 percent pre-currency) in 2000 including the beneficial impact of the CPID acquisition. Post sale and other revenues have been adversely affected by reduced equipment populations and lower page print volumes.

Financing income declined 3 percent (2 percent pre-currency) in 2001 reflecting lower equipment sales and the initial effects of our transition to third party finance providers. Financing income declined one percent (grew 2 percent pre-currency) in 2000. Financing income is determined by the discount rate that is implicit in the lease agreements with our customers, after determination of the fair value of the services and equipment included in a bundled lease agreement with multiple deliverable elements. Refer to a discussion of our leasing policies above in the Application of Critical Accounting Policies section for more information. Financing income will generally be dependent on the amount of new equipment leases that we enter. We expect finance income will decline over time as we transition equipment financing to third parties.

Total document outsourcing revenues of \$3.7 billion declined 2 percent (one percent pre-currency) in 2001 and grew 19 percent in 2000. The backlog of future estimated document outsourcing revenues was approximately \$7.6 billion at the end of 2001, a reduction of 7 percent from the end of 2000 and in line with trends experienced elsewhere in our business. Our backlog is determined as the estimated post-sale services and financing to be provided under committed contracts as of a point in time.

### Gross Margin

The trend in gross margin was as follows:

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Total Gross Margin(1)	38.2%	37.4%	42.3%
Gross Margin by revenue stream:			
Sales(2)	30.5	31.2	37.2
Service, Outsourcing(2), and Rentals	42.2	41.1	44.7
Finance Income	59.5	57.1	63.0

(1) Includes inventory charges of \$42 million and \$84 million associated with 2001 and 2000 restructuring actions. These changes impacted 2001 and 2000 total gross margin by 0.2 points and 0.4 points, respectively and sales gross margin by 0.6 points and 1.0 point, respectively.

(2) The equipment sales gross margin for document outsourcing is included in the sales gross margin.

The 2001 gross margin of 38.2 percent increased by 0.8 percentage points from 2000, as improved manufacturing and service productivity more than offset unfavorable mix and competitive price pressures, particularly in the production monochrome business. Gross margin improved during 2001 from 34.7 percent in the first quarter to 40.8 percent in the fourth quarter reflecting the benefits of our cost base restructuring and exit from the SOHO business. We expect the 2002 gross margin will approximate 40 percent, reflecting the beneficial impacts of continuing cost base restructuring, and our SOHO exit, partially offset by competitive price pressures.

2000 gross margin of 37.4 percent was 4.9 percentage points below 1999. Approximately half the decline was the result of production monochrome weakness reflecting initial competitive product entry during a time when our sales force was weakened as we realigned from a geographic to an industry structure. Higher revenue growth in the lower margin document outsourcing business and SOHO inkjet investments to build equipment population also contributed to the decline. Finally, gross margin was also adversely impacted by competitive price pressure, unfavorable transaction

currency and temporary pricing actions implemented to reduce inventory on certain products in the latter part of the year. Manufacturing and other productivity improvements only partially offset the above items.

Finance margins reflect interest expense related to our financing operations based on our overall cost of funds, applied against the level of debt required to support the Company's financed receivables.

**Research and Development.** 2001 Research and development (R&D) spending of \$997 million declined 6 percent from 2000 primarily due to the SOHO disengagement. 2001 R&D spending represented approximately 6 percent of total revenues as we continued to invest in technological development, particularly color, to maintain our position in the rapidly changing document processing market. Including CPID, R&D expense grew 4 percent in 2000 reflecting increased program spending primarily for solid ink, solutions and the DocuColor iGen3, a next-generation digital printing press technology which is scheduled to launch in the second half 2002. We believe our R&D remains technologically competitive and is strategically coordinated with Fuji Xerox, which invested \$548 million in R&D in 2001, for a combined total of \$1,545 million. We are planning to launch five new platforms this year, compared with two per year during the last several years. We expect 2002 R&D spending will represent approximately 5 to 6 percent of revenue, a level that we believe is adequate to remain technologically competitive.

**Selling, Administrative and General Expenses.**

Selling, administrative and general (SAG) expenses as a percent of revenue were as follows:

	<u>2001</u>	<u>2000</u>	<u>1999</u>
SAG% Revenue	27.8%	29.4%	27.4%

SAG declined \$790 million or 14 percent (13 percent pre-currency) in 2001 to \$4,728 million reflecting significantly lower labor costs and other benefits derived from our Turnaround Program, temporarily lower advertising and marketing communications spending and reduced SOHO spending, partially offset by increased professional costs related to litigation, SEC issues and related matters. In 2001, SAG represented 27.8 percent of revenue, a 1.6 percentage point improvement from 2000. We expect a mid-single digit decline in 2002 SAG spending as we continue to implement cost cutting actions.

In 2000, SAG increased \$314 million or 6 percent (9 percent pre-currency) to \$5,518 million. Excluding the CPID acquisition, SAG grew 3 percent (6 percent pre-currency) reflecting increased sales force payscale and incentive compensation, significant transition costs associated with implementation of the European shared services organization, continued effects of the U.S. customer administration issues and significant marketing, advertising and promotional investments for our SOHO inkjet printer initiative.

Bad debt expense, which is included in SAG, was \$438 million, \$473 million and \$386 million in 2001, 2000 and 1999, respectively. Reduced 2001 provisions reflect lower equipment sales partially offset by some reserve increases due to the weakened worldwide economy. Provisions increased in 2000 due to continued resolution of aged billing and receivables issues in the U.S. and Europe resulting from the consolidation of our customer administration centers and infrastructure changes and unsettled business and economic conditions in many Latin American countries. Bad debt provisions as a percent of total revenue were 2.6 percent, 2.5 percent, and 2.0 percent for 2001, 2000 and 1999, respectively.

The agreements with GE Capital in the U.S. and Canada include new approaches to managing most of our customer administrative functions. On May 1, 2002, XCS, our U.S. venture with GE Capital Vendor Financial Services, became operational. XCS manages our customer administration and leasing activities, including financing administration, credit approval, order processing, billing and collections. We will consolidate the operations of XCS in our financial statements and include the XCS headcount with our employee statistics. We are completing the negotiation of definitive agreements with GE Capital for the implementation of the Canadian joint venture which is expected in the second half of 2002. Over time we expect these arrangements will facilitate reduced back office and infrastructure expenses and improve collection discipline. We expect this will improve sales force productivity and customer satisfaction through improved billing practices as well as reduce bad debt expense.

**Restructuring Programs.** Since early 2000, we have been restructuring our cost base. We have implemented a series of plans to resize our workforce and reduce our cost structure through three restructuring initiatives: the October 2000 Turnaround Program, the June 2001 SOHO disengagement and the March 2000 restructuring action. The execution of



these actions and payment of obligations continued through December 31, 2001, with each initiative in various stages of completion. In total, we recorded restructuring provisions of \$715 million in 2001 and \$475 million in 2000, including \$205 million and \$64 million of asset impairment charges in 2001 and 2000, respectively. As management continues to evaluate the business, there may be supplemental charges for new plan initiatives as well as changes in estimates to amounts previously recorded as payments are made or actions are completed. We expect to complete the initiatives associated with the programs in 2002 and will have new initiatives going forward under the Turnaround Program. The restructuring programs are discussed below and in Note 3 to the consolidated financial statements.

*Turnaround Program:* In October 2000, we announced our Turnaround Program and recorded a restructuring provision of \$105 million in connection with finalized initiatives. This charge included estimated costs of \$71 million for severance associated with the worldwide resizing of our work force and \$34 million associated with the disposition of a non-core business. Over half of these charges related to our Production segment with the remainder related to our Office, DMO and Other segments. In 2001, we provided an incremental \$403 million, net of reversals, for initiatives for which we had a formal and committed plan. This provision included \$339 million for severance and other employee separation costs associated with the resizing of our work force worldwide, \$36 million for lease cancellation and other exit costs and \$28 million for asset impairments. The aggregate severance and other employee separation costs in 2001 and 2000 of \$410 million were for the elimination of approximately 7,800 positions worldwide. The majority of these charges related to our Production and Office segments. The Turnaround Program restructuring reserve balance at December 31, 2001 was \$223 million.

*SOHO Disengagement:* In June 2001, we announced our disengagement from our worldwide SOHO business. In connection with exiting this business, during 2001 we recorded a net charge of \$239 million. The charge included provisions for the elimination of approximately 1,200 positions worldwide, the closing of facilities and the write-down of certain assets to net realizable value. The charge consisted of \$164 million of asset impairments, \$49 million for lease cancellation and other exit costs and \$26 million in severance and related costs. During the fourth quarter 2001, we sold our remaining inventory of personal inkjet and xerographic printers, copiers, facsimile machines and multi-function devices which were distributed primarily through retail channels to small offices, home offices and personal users (consumers). We will continue to provide current SOHO customers with service, support and supplies, including the manufacturing of such supplies, during a phase-down period to meet customer commitments, which will result in a declining revenue base over the next few years. The SOHO disengagement restructuring reserve balance at December 31, 2001 was \$23 million.

*March 2000 and 1998 Restructurings:* In March 2000, we recorded a provision of \$489 million as part of a worldwide restructuring program including asset impairments of \$30 million. During 2001 and 2000, we recorded net changes in estimates for both the March 2000 and the 1998 restructuring programs which reduced restructuring expense by \$25 million and \$125 million, respectively. As of December 31, 2001, these programs had been substantially completed.

As a direct result of the various restructuring actions, we determined that certain products were not likely to be sold in their product life cycle. For this reason, in 2001 we recorded a \$42 million charge to write-down excess and obsolete inventory, \$34 million of which resulted from the disengagement from our SOHO operations. In 2000, we recorded a charge of \$84 million primarily as a result of the consolidation of distribution centers and warehouses and the exit from certain product lines. These charges are included in Cost of sales in the Consolidated Statement of Operations.

Worldwide employment declined by approximately 13,600 in 2001 to approximately 78,900, largely as a result of our restructuring programs and the transfer of approximately 2,500 employees to Flextronics as part of our office manufacturing outsourcing. Worldwide employment was approximately 92,500 and 94,600 at December 31, 2000 and 1999, respectively.

**Other Expenses, Net.** Other expenses, net for the three years ended December 31, 2001 were as follows:

	<u>2001</u>	<u>2000</u>	<u>1999</u>
	<b>Restated</b>	<b>Restated</b>	<b>Restated</b>
		<b>(in millions)</b>	
Non-financing interest expense	\$ 480	\$ 592	\$ 407
Currency gains, net	(29)	(103)	(7)
Gain on early extinguishment of debt	(63)		
Amortization of goodwill and intangibles	94	86	50
Business divestiture and asset sale (gains) losses	10	(67)	(78)

Interest income	(101)	(77)	(20)
Year 2000 costs		2	47
All other, net	53	91	108
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$ 444	\$ 524	\$ 507
	<u>          </u>	<u>          </u>	<u>          </u>

In 2001, non-financing interest expense was \$112 million lower than 2000, reflecting lower interest rates and lower debt levels. Non-financing interest expense in 2001 included net losses of \$2 million from the mark-to-market of our remaining interest rate swaps required to be recorded as a result of applying SFAS No. 133. Differences between the contract terms of our interest rate swaps and the underlying related debt restricts hedge accounting treatment in accordance with SFAS No. 133, which requires us to record the mark-to-market valuation of these derivatives directly to earnings. Non-financing interest expense was \$185 million higher in 2000 than in 1999 as a result of the CPID acquisition, which resulted in incremental borrowings of \$852 million, generally higher debt levels and increased interest rates.

Net currency (gains) losses result from the re-measurement of unhedged foreign currency-denominated assets and liabilities. In 2001, exchange gains on yen debt of \$107 million more than offset losses on euro loans of \$36 million, a \$17 million exchange loss resulting from the peso devaluation in Argentina and other currency exchange losses of \$25 million. In 2000, large gains on both the yen and euro loans in the fourth quarter contributed to the \$103 million gain. These currency exposures are the result of net unhedged positions largely caused by our restricted access to the derivatives markets since the fourth quarter 2000. Due to the inherent volatility in the interest rate and foreign currency markets, we are unable to predict the amount of the above noted re-measurement and mark-to-market gains or losses in future periods. Such gains or losses could be material to the financial statements in any reporting period.

Goodwill and other intangible asset amortization relates primarily to our acquisitions of the remaining minority interest in Xerox Limited in 1995 and 1997, XL Connect in 1998 and CPID in 2000. Effective January 1, 2002 and in connection with the adoption of SFAS No. 142, we no longer record amortization of goodwill. However, in lieu of amortization, goodwill is tested at least annually for impairment using a fair value methodology. Intangible assets continue to be amortized. Further discussion is provided in Note 1 and Note 22 to the consolidated financial statements.

(Gains) losses on business divestitures and asset sales include the sales of our Nordic leasing business in 2001, the North American paper business and a 25 percent interest in ContentGuard in 2000, and various Xerox Technology Enterprise businesses in 1999, as well as miscellaneous land, buildings and equipment in all years. Further discussion of our divestitures follows and is also contained in Note 5 to the consolidated financial statements.

Interest income is derived primarily from our significant invested cash balances since the latter part of 2000 and from tax audit refunds. 2001 interest income was \$24 million higher than 2000 due to higher investment interest resulting from a full year of invested cash balances in 2001, partially offset by lower interest from tax audit refunds. The increases in our invested cash balances reflect our decision, beginning in the second half of 2000, to accumulate cash to maintain financial flexibility rather than continue our historical practice of paying down debt with available cash.

All other, net includes many additional items, none of which are individually significant.

**Gain on Affiliate's Sale of Stock.** In 2001 and 2000, gain on affiliate's sale of stock of \$4 million and \$21 million, respectively, reflects our proportionate share of the increase in equity of ScanSoft Inc. (NASDAQ: SSFT) resulting from ScanSoft's issuance of stock in connection with acquisitions. The 2000 gain was partially offset by a \$5 million charge reflecting our share of ScanSoft's write-off of in-process research and development associated with one of the acquisitions, which is included in equity in net income of unconsolidated affiliates. ScanSoft, an equity affiliate, is a developer of digital imaging software that enables users to leverage the power of their scanners, digital cameras, and other electronic devices.

**Income Taxes and Equity in Net Income of Unconsolidated Affiliates.** The effective tax rates were 126.1 percent in 2001, 19.1 percent in 2000 and 34.6 percent in 1999. The difference between the 2001 effective tax rate and the U.S. federal statutory income tax rate of 35 percent relates primarily to the recognition of deferred tax asset valuation allowances resulting from our recoverability assessments, the taxes incurred in connection with the sale of our partial interest in Fuji Xerox and continued losses in low tax jurisdictions. The gain for tax purposes on the sale of Fuji Xerox was disproportionate to the gain for book purposes as a result of a lower tax basis in the investment. Other items

favorably impacting the tax rate included a tax audit resolution of approximately \$140 million and additional tax benefits arising from prior period restructuring provisions. On a loss basis, the difference between the 2000 effective tax rate of 19.1 percent and the U.S. federal statutory income tax rate of 35 percent relates primarily to continued losses in low tax jurisdictions, the recognition of deferred tax asset valuation allowances resulting from our recoverability assessments and additional tax benefits arising from the favorable resolution of tax audits of approximately \$125 million. The 1999 effective tax rate benefited from increases in foreign tax credits as well as a shift in the mix of our worldwide profits, partially offset by the recognition of deferred tax asset valuation allowances. Please refer to Note 15 to the consolidated financial statements for further information. Our effective tax rate will change year to year based on nonrecurring events (such as new Turnaround Program initiatives) as well as recurring factors including the geographical mix of income before taxes. In the normal course of business, we expect that our 2002 effective tax rate will be in the low to mid 40 percent range.

Equity in net income of unconsolidated affiliates is principally related to our 25 percent share of Fuji Xerox income. Equity income was \$53 million in 2001, \$66 million in 2000 and \$48 million in 1999. The 2001 reduction primarily reflects our reduced ownership in Fuji Xerox. The 2000 improvement reflected improved Fuji Xerox operating results and the absence in 2000 of a prior year \$21 million unfavorable tax adjustment relating to an increase in Fuji Xerox tax rates. These favorable items were partially offset by our \$37 million share of a 2000 Fuji Xerox restructuring charge and reductions in income from several smaller equity investments.

**Manufacturing Outsourcing.** In October 2001, we announced a manufacturing agreement with Flextronics, a global electronics manufacturing services company. The agreement provides for a five-year supply contract for Flextronics to manufacture certain office equipment and components; the purchase of inventory, property and equipment at a premium over book value; and the assumption of certain liabilities. The premium will be amortized over the life of the five-year supply contract, as we will continue to benefit from the property transferred to Flextronics. Inventory purchased from us by Flextronics remains on our balance sheet until it is sold to an end user with a corresponding liability recognized for the proceeds received. This inventory and the corresponding liability was approximately \$27 million at December 31, 2001. In total, the agreement with Flextronics represents approximately 50 percent of our overall worldwide manufacturing operations. In the 2001 fourth quarter, we completed the sales of our plants in Toronto, Canada; Aguascalientes, Mexico and Penang, Malaysia to Flextronics for approximately \$118 million, plus the assumption of certain liabilities. The sale is subject to certain closing adjustments. Approximately 2,500 Xerox employees in these operations transferred to Flextronics upon closing. In January 2002, we completed the sale our office manufacturing operations in Venray, the Netherlands and Resende, Brazil for \$29 million plus the assumption of certain liabilities. Approximately 1,600 Xerox employees in these operations transferred to Flextronics upon closing. By the end of the third quarter 2002, we anticipate all production at our printed circuit board factories in El Segundo, California and Mitcheldean, England and our customer replaceable unit plant in Utica, New York will be fully transferred to Flextronics facilities which will complete the plans that we announced in October. Included in the 2001 Turnaround Program are restructuring charges of \$24 million related to the closing of these facilities.

**Divestitures.** In December 2001, we sold Delphax Systems and Delphax Systems, Inc. (Delphax) to Check Technology Corporation for \$14 million in cash, subject to purchase price adjustments. Delphax designs, manufactures and supplies high-speed electron beam imaging digital printing systems and related parts, supplies and maintenance services. There was no gain or loss recorded related to this sale.

In April 2001, we sold our leasing businesses in the four Nordic countries to Resonia Leasing AB (Resonia) for proceeds of approximately \$370 million, which approximated book value. The assets sold included the leasing portfolios in the respective countries, title to the underlying equipment included in the lease portfolios and the transfer of certain employees and systems used in the operations of the businesses. Under terms of the agreement, Resonia will provide on-going exclusive equipment financing to Xerox customers in those countries.

In March 2001, we sold half our ownership interest in Fuji Xerox to FujiFilm for \$1,283 million in cash. The sale resulted in a pre-tax gain of \$773 million. Income taxes of approximately \$350 million related to this transaction were paid in the first quarter 2002. Under the agreement, FujiFilm's ownership interest in Fuji Xerox increased from 50 percent to 75 percent. While Xerox's ownership interest decreased to 25 percent, we retain significant rights as a minority shareholder. All product and technology agreements between Fuji Xerox and us continue, ensuring that the two companies retain uninterrupted access to each other's portfolio of patents, technology and products. With its business scope focused on document processing activities, Fuji Xerox will continue to provide office products to us and

collaborate with us on research and development. We maintain our agreement with Fuji Xerox to provide them production publishing and solid ink technology.

In December 2000, we completed the sale of our China operations to Fuji Xerox for \$550 million cash and the assumption of \$118 million of debt for which we recorded a \$200 million pre-tax gain. Revenues from our China operations were \$262 million in 2000.

In June 2000, we entered into an agreement to sell our U.S. and Canadian commodity paper product line and customer list, for \$40 million. We also entered into an exclusive license agreement for the Xerox brand name. Additionally, we earn commissions on Xerox originated sales of commodity paper as an agent for Georgia Pacific.

In April 2000, we sold a 25 percent ownership interest in our wholly owned subsidiary, ContentGuard, to Microsoft, Inc. for \$50 million and recognized a gain of \$23 million. An additional gain of \$27 million was deferred pending the achievement of certain performance criteria. In May 2002, we paid Microsoft \$25 million as the performance criteria had not been achieved. In connection with the sale, ContentGuard also received \$40 million from Microsoft for a non-exclusive license of its patents and other intellectual property and a \$25 million advance against future royalty income from Microsoft on sales of products incorporating ContentGuard's technology. The license payment is being amortized over the ten year life of the license agreement and the royalty advance will be recognized in income as earned.

**Acquisition of the Color Printing and Imaging Division of Tektronix, Inc.** In January 2000, we acquired the Color Printing and Imaging Division of Tektronix, Inc. (CPID) for \$925 million in cash including \$73 million paid by Fuji Xerox for the Asia/Pacific operations of CPID. CPID manufactures and sells color printers, ink and related products and supplies. The acquisition accelerated us to the number two market position in office color printing, improved our reseller and dealer distribution network and provided us with scalable solid ink technology. The acquisition also enabled significant product development and expense synergies with our monochrome printer organization.

#### **Business Performance by Segment.**

As discussed in Note 22 to the Consolidated Financial Statements, operating segment information for 2001 has been restated to reflect a change in operating segment structure that was made in 2002. The nature of the changes related primarily to corporate expense and other allocations associated with internal reorganizations made in 2002, as well as decisions concerning direct applicability of certain overhead expenses to the segments. The adjustments increased (decreased) full year 2001 revenues as follows (\$ in millions): Production (\$16), Office (\$16), DMO (\$1), SOHO \$3 and Other \$30. The full year 2001 segment profit was increased (decreased) as follows: Production \$12, Office \$24, DMO \$32, SOHO \$2 and Other (\$70). However, the operating segment information for 2000 and 1999 has not been adjusted as it was impracticable to do so, and is therefore is not presented on the new basis. We have, however, presented comparative segment information on the old basis for 2001, 2000 and 1999.

In 2001, we realigned our reportable segments to be consistent with how we manage the business and to reflect the markets we serve. Our business segments are as follows: Production, Office, DMO, SOHO, and Other. The table below summarizes our business performance by segment for the three-year period ended December 31, 2001. Revenues and associated percentage changes, along with operating profits and margins by segment are included. Segment operating profit (loss) excludes certain non-segment items, such as restructuring and gains on sales from businesses, as further described in Note 10 to the consolidated financial statements.

**Business Segment Performance**

Operating segment selected financial information, using the new basis of presentation, for the year ended December 31, 2001 was as follows:

	<u>Revenue</u>	<u>Operating Profit (Loss)(2)</u>	<u>Operating Margin</u>
	(\$ in millions)		
Production	\$ 5,883	\$ 466	7.9%
Office	6,910	365	5.3
DMO	2,026	(125)	(6.2)
SOHO	410	(195)	(47.6)
Other	1,779	(143)	(8.0)
	<u>          </u>	<u>          </u>	
Total	\$ 17,008	368	2.2
	<u>          </u>	<u>          </u>	
Memo: Color(1)	\$ 2,759		

(1) Same as below.

(2) Same as below.

Operating segment selected financial information, using the prior year's basis of presentation, for the years ended December 31, 2001, 2000 and 1999 was as follows:

				<u>% Change</u>	
	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>2001</u>	<u>2000</u>
	<u>Restated</u>	<u>Restated</u>	<u>Restated</u>		
	(\$ in millions)				
Revenue					
Production	\$ 5,899	\$ 6,332	\$ 6,933	(7)%	(9)%
Office	6,926	7,060	6,853	(2)	3
DMO	2,027	2,619	2,450	(23)	7
SOHO	407	599	575	(32)	4
Other	1,749	2,141	2,184	(17)	(2)
	<u>          </u>	<u>          </u>	<u>          </u>		
Total	\$ 17,008	\$ 18,751	\$ 18,995	(9)%	(1)%
	<u>          </u>	<u>          </u>	<u>          </u>		
Memo: Color(1)	\$ 2,762	\$ 2,612	\$ 1,619	6%	61%
Operating Profit (Loss)(2)					
Production	\$ 454	\$ 463	\$ 1,236		
Office	341	(180)	49		
DMO	(157)	(93)	48		
SOHO	(197)	(293)	(188)		
Other	(73)	225	203		
	<u>          </u>	<u>          </u>	<u>          </u>		
Total	\$ 368	\$ 122	\$ 1,348		
	<u>          </u>	<u>          </u>	<u>          </u>		
Operating Margin					
Production	7.7%	7.3%	17.8%		
Office	4.9	(2.5)	0.7		
DMO	(7.7)	(3.6)	2.0		
SOHO	(48.4)	(48.9)	(32.7)		
Other	(4.2)	10.5	9.3		
Total	2.2%	0.7%	7.1%		
	<u>          </u>	<u>          </u>	<u>          </u>		

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- (1) Color revenue is included in all segments except Other.
- (2) Segment operating profit (loss) includes allocation of certain corporate expenses such as research, finance, business strategy, marketing, legal, and human resources. The Other segment includes certain expenses which have not been allocated to the businesses such as non-financing interest expense.

### *Basis of presentation:*

All operating segment information discussed below is in the context of the prior year's basis of presentation.

*Production:* Production revenues include production publishing, production printing, color products for the production and graphic arts markets and light-lens copiers over 90 pages per minute sold predominantly through direct sales channels in North America and Europe. Revenues declined 7 percent (6 percent pre-currency) in 2001 and 9

percent (6 percent pre-currency) in 2000. The monochrome production revenue decline reflected competitive product introductions, movement to distributed printing and electronic substitutes, and weakness in the worldwide economy. Revenue from our DocuTech production publishing family, which had been continually refreshed and expanded since its 1990 launch, declined in both 2001 and 2000 reflecting the 1999 introduction of a competitive product. While Xerox remained the market leader, our production publishing market share declined in 2000, but improved significantly in the U.S. in 2001. In production printing, Xerox maintained its strong market leadership in both 2001 and 2000, however, revenue decreased reflecting declines in the transaction printing market.

2001 production color revenues grew 2 percent from 2000 including continued strong DocuColor 2000 series growth, partially offset by declines in older products reflecting introduction of competitive offerings and the effects of the weakened economy in the second half of the year. The DocuColor 2000 series, launched in 2000, at speeds of 45 and 60 pages per minute established an industry standard by producing near-offset quality, full color prints including customized one-to-one printing at a variable cost of less than 10 cents per page. Production color revenues grew significantly in 2000 largely due to the very successful launch of the DocuColor 2000 series. Production revenues represented 35 percent of 2001 revenues compared with 34 percent in 2000.

2001 Production operating profit continued to decline, but significantly less than the rate of decline experienced in 2000. Lower 2001 revenue combined with reduced monochrome gross margin reflecting competitive pressures were only partially offset by a substantial improvement in SAG expenses generated by our Turnaround Program. 2000 operating profit was significantly below 1999 due to lower revenue and gross margin, reflecting increased competition. Expenses increased due to the earlier sales realignment and administrative transition and higher DocuColor iGen3 R&D investments.

*Office:* Office revenues include our family of Document Centre digital multifunction products, color laser, solid ink and monochrome laser desktop printers, digital and light-lens copiers under 90 pages per minute, and facsimile products sold through direct and indirect sales channels in North America and Europe. 2001 revenues declined 2 percent (one percent pre-currency) from 2000 as strong office color revenue growth was not sufficient to offset monochrome declines. Color revenue growth was driven by the Document Centre Color Series 50 and strong color printer equipment sales including the Phaser 860 solid ink and Phaser 7700 laser printers which use single pass color technology. 2001 monochrome revenues declined as growth in digital multifunction was more than offset by declines in light lens as the market continues to transition to digital technology. This decline was exacerbated further by our reduced participation in very aggressively priced competitive customer bids and tenders in Europe, as we reorient our focus from market share to profitable revenue. These declines were only slightly offset by the very successful North American launch of the Document Centre 490 in September 2001. In 2001, digital multifunction equipment sales represented approximately 91 percent of our monochrome copier equipment sales compared with 82 percent in 2000.

2000 revenues increased 3 percent from 1999 including the January 2000 acquisition of CPID. Excluding CPID, revenues declined 6 percent. Office revenues represented 41 percent of 2001 revenues compared with 38 percent in 2000.

Operating profit in the Office segment increased significantly in 2001 reflecting lower SAG spending, benefiting from our Turnaround Program and improved gross margins. Gross margin improvement includes the benefit of our reduced participation in very aggressively priced European bids and tenders, significantly improved document outsourcing margins, improving Document Centre margins facilitated by favorable mix due to the Document Centre 480 and 490 launches, improved manufacturing and service productivity, and favorable currency. 2000 operating profit was significantly lower than 1999 reflecting lower gross margins, higher R&D spending associated with the CPID acquisition and increased SAG expenses due to the sales realignment, administrative transition and CPID spending.

*DMO:* DMO includes operations in Latin America, the Middle East, India, Eurasia, Russia and Africa. DMO included our China operation, which generated revenues of \$262 million in 2000, prior to the December 2000 sale. In Latin America most equipment transactions are recorded as operating leases. 2001 DMO revenue declined 23 percent from 2000, with approximately 45 percent of the decline due to the sale of our China operation. The balance of the decline was due to lower equipment populations, implementation of a new business model that places greater emphasis on liquidity and profitable revenue rather than market share as well as general economic weakness in many of the countries. Revenues in Brazil, which represented approximately 5 percent of our total revenues in 2001, declined 18 percent from 2000 primarily as a result of an average 22 percent currency devaluation of the Brazilian Real and implementation of the new business model. In 2001, DMO incurred a \$157 million loss reflecting lower revenue and

gross margins only partially offset by initial cost restructuring benefits. In addition, results were adversely impacted by higher aggregate exchange losses including the Argentinean devaluation.

2000 revenues grew 7 percent reflecting growth in Brazil and most countries outside Latin America. Revenues in Brazil grew 5 percent as an improved economic environment was partially offset by increased competitive activity and lower prices during the latter half of the year as the operation focused on reducing inventory. DMO incurred an \$93 million loss in 2000 compared to a profit of \$48 in 1999 reflecting lower margins and an increase in SAG expenses, including higher bad debt provisions.

*SOHO:* We announced our disengagement from our worldwide SOHO business in June 2001 and sold our remaining equipment inventory by the end of the year. SOHO revenues now consist primarily of profitable consumables for the inkjet printers and personal copiers previously sold through indirect channels in North America and Europe. SOHO revenues represented 2 percent of 2001 revenues compared with 3 percent in 2000, and declined 32 percent in 2001 from 2000. Despite a gross margin decline, significant SAG and R&D reductions following our June 2001 disengagement resulted in substantially lower operating losses in 2001 and a return to profitability in the fourth quarter. We expect profits to continue in 2002 as we sell high-margin consumables for the existing equipment population. We also expect SOHO revenues and profits to decline over time as the existing equipment population is replaced.

*Other:* Other includes revenues and costs associated with paper sales, Xerox Engineering Systems (XES), Xerox Connect, Xerox Technology Enterprises (XTE), our investment in Fuji Xerox, consulting and other services. Other also includes corporate items such as non-financing interest expense and other non-allocated central costs.

2001 revenue declined 18 percent from 2000 and operating losses increased principally reflecting lower paper, XES, Xerox Connect, and XTE revenues, and lower income related to our reduced investment in Fuji Xerox, partially offset by lower net non-financing interest expense. The 2001 operating loss also reflects the additional ESOP funding necessitated by the elimination of the ESOP dividend; higher professional fees related to litigation, SEC issues and related matters; employee retention compensation; and lower pension settlement gains. 2000 results benefited from gains on the sales of our North American paper business, a 25 percent interest in ContentGuard, and a gain on our ScanSoft affiliate's sale of stock.

**New Accounting Standards.** Effective January 1, 2001, we adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133), which requires companies to recognize all derivatives as assets or liabilities measured at their fair value regardless of the purpose or intent of holding them. Gains or losses resulting from changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, depending on the type of hedge transaction. Changes in fair value for derivatives not designated as hedging instruments and for the ineffective portions of hedges are recognized in earnings of the current period. The adoption of SFAS No. 133 resulted in a net cumulative after-tax loss of \$2 million in the first quarter Consolidated Statement of Operations and a net cumulative after-tax loss of \$19 million in Accumulated Other Comprehensive Income. Further, as a result of recognizing all derivatives at fair value, including the differences between the carrying values and fair values of related hedged assets, liabilities and firm commitments, we recognized a \$361 million increase in assets and a \$382 million increase in liabilities (amounts have been restated to reflect the effects of the correction of fair value assigned to certain derivative instruments upon adoption of SFAS No. 133 of \$42 million. See Note 21 to the Consolidated Financial Statements for additional information).

In 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141, *Business Combinations* (SFAS No. 141). SFAS No. 141 requires the use of the purchase method of accounting for business combinations and prohibits the use of the pooling of interests method. We have not historically engaged in transactions that qualify for the use of the pooling of interests method and therefore, this aspect of the new standard will not have an impact on our financial results. SFAS No. 141 also changes the definition of intangible assets acquired in a purchase business combination, providing specific criteria for the initial recognition and measurement of intangible assets apart from goodwill. As a result, the purchase price allocation of future business combinations may be different than the allocation that would have resulted under the previous rules. SFAS No. 141 also requires that upon adoption of Statement of Financial Accounting Standards No. 142 *Goodwill and Other Intangible Assets* (SFAS No. 142), we reclassify the carrying amounts of certain intangible assets into or out of goodwill, based on certain criteria (see the discussion of the impacts of the adoption of SFAS No. 142 below). All business acquisitions initiated after June 30, 2001 must apply provisions of this standard.



SFAS No. 142, also issued in 2001, addresses financial accounting and reporting for acquired goodwill and other intangible assets subsequent to their initial recognition. This statement recognizes that goodwill has an indefinite useful life and will no longer be subject to periodic amortization. However, goodwill will be tested at least annually for impairment, using a fair value methodology, in lieu of amortization. The provisions of this standard also require that amortization of goodwill related to equity method investments be discontinued, and that these goodwill amounts continue to be evaluated for impairment in accordance with Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The provisions of SFAS No. 142 were adopted on January 1, 2002. Upon adoption of SFAS No. 142, we reclassified \$61 of intangible assets related to acquired workforce that was required to be included in goodwill by this standard.

SFAS No. 142 also requires performance of annual and transitional impairment tests on goodwill using a two-step approach. The first step is to identify a potential impairment and the second step is to measure the amount of any impairment loss. During the second quarter of 2002, we completed the first step of the transitional goodwill impairment test. This test required us to compare the carrying value of our reporting units to the fair value of these units. The standard requires that if reporting units' fair value is below its carrying value, a potential goodwill impairment exists and we would be required to complete the second step of the transitional impairment test to quantify the amount of the potential goodwill impairment charge. Based on the results of the first step of the transitional impairment test, we have identified potential goodwill impairments in the reporting units included in our DMO operating segment. The second step of the transitional goodwill impairment test requires that the implied fair value of goodwill be estimated by allocating the fair value of a reporting unit to all of the assets and liabilities of that reporting unit. The excess of the fair value of the reporting unit over the amounts allocated to the assets and liabilities represents the implied fair value of the goodwill. Any excess of the carrying amount of reporting unit goodwill over the implied fair value of goodwill will be recorded as a goodwill impairment charge. We are in the process of finalizing the second step of the impairment test and expect to record an impairment charge of \$63 million. This non-cash charge will be retroactively recorded as a cumulative effect of change in accounting principle in the first quarter of 2002.

In 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. The Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and associated asset retirement costs. We are required to implement this standard on January 1, 2003. We do not expect this Statement will have a material effect on our financial position or results of operations.

In 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Statement primarily supercedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of*. The Statement retains the previously existing accounting requirements related to the recognition and measurement of the impairment of long-lived assets to be held and used, while expanding the measurement requirements of long-lived assets to be disposed of by sale to include discontinued operations. It also expands on the previously existing reporting requirements for discontinued operations to include a component of an entity that either has been disposed of or is classified as held for sale. We implemented this standard on January 1, 2002, and do not expect this Statement will have a material effect on our financial position or results of operations.

On April 1, 2002, we adopted the provisions of Statement of Financial Accounting Standards No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections* (SFAS No. 145). The applicable portion of this Statement rescinds Statement of Financial Accounting Standards No. 4 *Reporting Gains and Losses from Extinguishment of Debt* which required all gains and losses from extinguishment of debt to be aggregated and, when material, classified as an extraordinary item, net of related income tax effect. Accordingly, any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods presented and that does not meet the criteria in APB Opinion No. 30 *Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* for classification as an extraordinary item, was reclassified. As a result of adopting SFAS No. 145, all the extraordinary gains on extinguishment of debt previously reported in the Consolidated Statements of Operations were reclassified to Other expenses, net. After considering the effects of the restatement as discussed in Note 21 to the Consolidated Financial Statements, the effect of this reclassification in the accompanying Condensed Consolidated Statements of Operations was a decrease to Other expenses, net of \$63 and an increase to income taxes of \$25, from amounts previously reported, for the year ended December 31, 2001. SFAS No. 145 also amends Statement of Financial Accounting Standards No. 13 *Accounting for Leases* (SFAS No. 13) to require that certain lease modifications having economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback

transactions. This portion of SFAS No. 145 did not have any effect on our financial position or results of operations for any periods presented.

**Capital Resources and Liquidity**

*Liquidity, Financial Flexibility and Funding Plans:*

Historically, our primary sources of funding have been cash flows from operations, borrowings under our commercial paper and term funding programs, and securitizations of accounts and finance receivables. We used these funds to finance customers' purchases of our equipment and for working capital requirements, capital expenditures and business acquisitions. Our operations and liquidity began to be negatively impacted in 2000 by Company-specific business challenges, which have been previously discussed. These challenges were exacerbated by significant competitive and industry changes, adverse economic conditions, and significant technology and acquisition spending. Together, these challenges and conditions negatively impacted our cash availability and created marketplace concerns regarding our liquidity, which led to credit rating downgrades and restricted our access to capital markets.

In addition to the limited access to capital markets which resulted from our credit rating downgrades, we have been unable to access the public capital markets. This is because, as a result of the ongoing SEC investigation since June 2000 and the accounting issues raised by the SEC, the SEC Staff advised us that we could not make any public registered securities offerings. This additional constraint had the effect of limiting our means of raising funds to those of unregistered capital markets offerings and private lending or equity sources. Our credit ratings became even more important, since credit rating agencies often include access to other capital sources in their rating criteria.

During 2000, 2001, and 2002, these rating downgrades, together with the recently concluded review by the SEC, adversely affected our liquidity and financial flexibility, as follows:

Since October 2000, uncommitted bank lines of credit and the unsecured public capital markets have been largely unavailable to us.

On December 1, 2000, Moody's reduced its rating of our senior debt to below investment grade, significantly constraining our ability to enter into new foreign-currency and interest rate derivative agreements, and requiring us to immediately repurchase certain of our then-outstanding derivative agreements for \$108 million.

In the fourth quarter 2000, as a result of our lack of access to unsecured bank and public credit sources, we drew down the entire \$7.0 billion available to us under our Revolving Credit Agreement (the "Old Revolver"), primarily to maintain financial flexibility and pay down debt obligations as they came due.

On October 23, 2001, Standard & Poors (S&P) reduced its rating of our senior debt to below investment grade, further constraining our ability to enter into new derivative agreements, and requiring us to immediately repurchase certain of our then-outstanding out-of-the-money interest-rate and cross-currency interest-rate derivative agreements for a total of \$148 million.

To minimize the resulting interest and currency exposures from these events, we have subsequently restored some derivative trading, with several counterparties, on a limited basis. However, virtually all such new arrangements either require us to post cash collateral against all out-of-the-money positions, or else have very short terms (e.g., as short as one week). Both of these types of arrangements potentially use more cash than standard derivative arrangements would otherwise require.

On May 1, 2002, Moody's further reduced its rating of our senior debt, requiring us to post additional collateral against certain derivative agreements currently in place. This downgrade also constituted a termination event under our existing \$290 million U.S. trade receivable securitization facility, which we are currently renegotiating with the counterparty, as described more fully below.

On June 11 and 21, 2002, S&P lowered and affirmed its rating of our senior unsecured and senior secured debt, which to date has not had any incremental adverse effects on our liquidity.

As of June 26, 2002, our senior and short-term debt ratings and outlooks were as follows:

	<u>Senior Debt Rating</u>	<u>Short Term Debt Rating</u>	<u>Outlook</u>
Moody's	B1	Not Prime	Negative
S&P*	BB-/B+	B*	Negative*
Fitch	BB	B	Stable

\* Effective June 11, 2002, S&P lowered our Corporate credit rating, and downgraded our senior debt, to BB- and maintained us on CreditWatch with Negative implications. Upon receipt of commitments from the banks who are party to our New Credit Facility, S&P affirmed the Corporate credit rating and our senior secured debt at BB- with a Negative Outlook, and downgraded our senior unsecured debt to B+.

We expect our limited access to unsecured credit sources to result in higher borrowing costs going forward, and to potentially result in Xerox Corporation having to increase its level of intercompany lending to affiliates and/or to guarantee portions of their debt.

*Actions Taken to Address Liquidity Issues:*

In the fourth quarter of 2000, as a result of the various factors described above, we began accumulating cash in an effort to maintain financial flexibility, rather than continuing our historical practice of using available cash to voluntarily pay down debt. To the extent possible, and except as otherwise prohibited under the New Credit Facility described below, we expect to continue this practice of accumulating cash for the foreseeable future.

New Credit Facility:

On June 21, 2002, we entered into an Amended and Restated Credit Agreement (the *New Credit Facility*) with a group of lenders, replacing the Old Revolver. At that time, we permanently repaid \$2.8 billion of the \$7 billion Revolving Credit Agreement (the *Old Revolver*). Accordingly, there is currently \$4.2 billion outstanding under the New Credit Facility, consisting of three tranches of term loans totaling \$2.7 billion and a \$1.5 billion revolving facility that includes a \$200 million letter of credit sub-facility. The three term loan tranches include a \$1.5 billion amortizing *Tranche A* term loan, a \$500 million *Tranche B* term loan, and a \$700 million *Tranche C* term loan maturing on September 15, 2002. Xerox Corporation is currently, and will remain, the borrower of all of the term loans. The revolving loans are available, without sub-limit, to Xerox Corporation, Xerox Canada Capital Limited (XCCL), Xerox Capital Europe plc (XCE) and other foreign subsidiaries, as requested by us from time to time, that meet certain qualifications. We are required to repay a total of \$400 million of the *Tranche A* loan and \$5 million of the *Tranche B* loan in semi-annual installments in 2003, and a total of \$600 million of the *Tranche A* loan and \$5 million of the *Tranche B* loan in semi-annual installments in 2004. The remaining portions of the *Tranche A* and *Tranche B* term loans and the revolving facility contractually mature on April 30, 2005. We could be required to repay portions of the loans earlier than their scheduled maturities upon the occurrence of certain events, as described below. In addition, all loans under the New Credit Facility mature upon the occurrence of a change in control.

Subject to certain limits described in the following paragraph, all obligations under the New Credit Facility are secured by liens on substantially all domestic assets of Xerox Corporation and by liens on the assets of substantially all of our U.S. subsidiaries (excluding Xerox Credit Corporation), and are guaranteed by substantially all of our U.S. subsidiaries. In addition, revolving loans outstanding from time to time to XCE (currently \$605 million) are also secured by all of XCE's assets and are also guaranteed on an unsecured basis by certain foreign subsidiaries that directly or indirectly own all of the outstanding stock of XCE. Revolving loans outstanding from time to time to XCCL (currently \$300 million) are also secured by all of XCCL's assets and are also guaranteed on an unsecured basis by our material Canadian subsidiaries, as defined (although the guaranties of the Canadian subsidiaries will become secured by their assets in the future if certain events occur).

Under the terms of certain of our outstanding public bond indentures, the outstanding amount of obligations under the New Credit Facility that can be secured by assets (the *Restricted Assets*) of (i) Xerox Corporation and (ii) our non-financing subsidiaries that have a consolidated net worth of at least \$100 million, without triggering a requirement to also secure these indentures, is limited to the excess of (a) 20 percent of our consolidated net worth (as defined in the public bond indentures) over (b) a portion of the outstanding amount of certain other debt that is secured by the *Restricted Assets*. Accordingly, the amount of the debt secured under the New Credit Facility by the *Restricted Assets* (the *Restricted Asset Security Amount*) will vary from time to time with changes in our consolidated net worth. The *Restricted Assets* secure the *Tranche B* loan up to the *Restricted Asset Security Amount*; any *Restricted Asset Security Amount* in excess of the outstanding *Tranche B* loan secures, on a ratable basis, the other outstanding loans under the New Credit Facility. The assets of XCE, XCCL and many of the subsidiaries guarantying the New Credit Facility are not *Restricted Assets* because those entities are not restricted subsidiaries as defined in our public bond indentures. Consequently, the amount of debt under the New Credit Facility secured by their assets is not subject to the foregoing limits.

The New Credit Facility loans generally bear interest at LIBOR plus 4.50 percent, except that the Tranche B loan bears interest at LIBOR plus a spread that varies between 4.00 percent and 4.50 percent depending on the Restricted Asset Security Amount in effect from time to time. Specified percentages of any net proceeds we receive from capital market debt issuances, equity issuances or asset sales during the term of the New Credit Facility must be used to reduce the amounts outstanding under the New Credit Facility, and in all cases any such amounts will first be applied to reduce the Tranche C loan. Once the Tranche C loan has been repaid, or to the extent that such proceeds exceed the outstanding Tranche C loan, any such prepayments arising from debt and equity proceeds will first permanently reduce the Tranche A loans, and any amount remaining thereafter will be proportionally allocated to repay the then-outstanding balances of the revolving loans and the Tranche B loans and to reduce the revolving commitment accordingly. Any such prepayments arising from asset sale proceeds will first be proportionally allocated to permanently reduce any outstanding Tranche A loans and Tranche B loans, and any amounts remaining thereafter will be used to repay the revolving loans and to reduce the revolving commitment accordingly (except that the revolving loan commitment cannot be reduced below \$1 billion as a result of such prepayments).

The New Credit Facility contains affirmative and negative covenants including limitations on issuance of debt and preferred stock, certain fundamental changes, investments and acquisitions, mergers, certain transactions with affiliates, creation of liens, asset transfers, hedging transactions, payment of dividends, intercompany loans and certain restricted payments, and a requirement to transfer excess foreign cash, as defined, and excess cash of Xerox Credit Corporation to Xerox Corporation in certain circumstances. The New Credit Facility does not affect our ability to continue to monetize receivables under the agreements with GE Capital and others, which are discussed below. No cash dividends can be paid on our Common Stock for the term of the New Credit Facility. Cash dividends may be paid on preferred stock provided there is then no event of default. In addition to other defaults customary for facilities of this type, defaults on debt of, or bankruptcy of, Xerox Corporation or certain subsidiaries would constitute a default under the New Credit Facility.

The New Credit Facility also contains financial covenants which the Old Revolver did not contain, including:

Minimum EBITDA (rolling four quarters, as defined)

Maximum Leverage (total adjusted debt divided by EBITDA, as defined)

Maximum Capital Expenditures (annual test)

Minimum Consolidated Net Worth (quarterly test, as defined)

Failure to be in compliance with any material provision of the New Credit Facility could have a material adverse effect on our liquidity, financial position and results of operations.

We expect total fees and expenses incurred in connection with the New Credit Facility to approximate \$125 million, the majority of which was paid at closing. These amounts will be deferred and amortized over the three year term of the New Credit Facility.

Turnaround Program:

In 2000 we announced a global Turnaround Program which included initiatives to sell certain assets, improve operations and liquidity, and reduce annual costs by at least \$1 billion. Through December 31, 2001, and since that time, we have made significant progress toward these objectives.

With respect to asset sale initiatives:

In the fourth quarter of 2000 we sold our China operations to Fuji Xerox, generating \$550 million of cash and transferring \$118 million of debt to Fuji Xerox.

In March 2001, we sold half of our interest in Fuji Xerox to Fuji Photo Film Co., Ltd. for \$1,283 million in cash.

In the fourth quarter of 2001, we received cash proceeds of \$118 million related to the sales to Flextronics of certain of our manufacturing facilities, and in 2002 we received additional net cash proceeds of \$29 million related to the sales of additional facilities under that agreement.

With respect to operational and liquidity improvements, we have announced major initiatives with GE Capital and other vendor financing partners, and we have completed several transactions, including (1) implementation of third-party vendor financing programs in the Netherlands, the Nordic countries, Brazil, Mexico, and Italy and (2) monetizations of portions of our existing finance receivables portfolios. We have several other similar transactions currently being negotiated, and we continue to actively pursue alternative forms of financing. These initiatives, when completed, are expected to significantly improve our liquidity going forward.

In connection with general financing initiatives:

During 2001, we retired \$374 million of long-term debt through the exchange of 41.1 million shares of our common stock, which increased our net worth by \$349 million.

In November 2001, we sold \$1,035 million of Convertible Trust Preferred Securities, and placed \$229 million of the proceeds in escrow to fund the first three-years' distribution requirements. Total proceeds, net of escrowed funds and transaction costs, were \$775 million.

In January 2002, we sold \$600 million of 9¾ percent Senior Notes and \$225 million of 9¾ percent Senior Notes, for cash proceeds totaling \$746 million, which is net of fees and original-issue discount. These notes mature on January 15, 2009, and contain several affirmative and negative covenants which are similar to those in the New Credit Facility. Taken as a whole, the Senior Notes covenants are less restrictive than the covenants contained in the New Credit Facility. In addition, our Senior Notes do not contain any financial maintenance covenants or scheduled amortization payments. The Senior Notes covenants (1) restrict certain transactions, including new borrowings, investments and the payment of dividends, unless we meet certain financial measurements and ratios, as defined, and (2) restrict our use of proceeds from certain other transactions including asset sales. In connection with the June 21, 2002 closing of the New Credit Facility, substantially all of our U.S. subsidiaries guaranteed these notes. In order to reduce the immediate cost of this borrowing, we entered into derivative agreements to swap the cash interest obligations under the dollar portion of these notes to LIBOR plus 4.44 percent. We will be required to collateralize any out-of-the-money positions on these swaps.

In connection with vendor financing and related initiatives:

In 2001, we received \$885 million in financing from GE Capital, secured by portions of our finance receivable portfolios in the United Kingdom. At December 31, 2001, the remaining balances of these loans totaled \$521 million.

In the second quarter 2001, we sold our leasing businesses in four Nordic countries to Resonia Leasing AB for \$352 million in cash plus retained interests in certain finance receivables for total proceeds of approximately \$370 million. These sales are part of an agreement under which Resonia will provide on-going, exclusive equipment financing to our customers in those countries.

In July 2001, we transferred U.S. lease contracts to a trust, which in turn sold \$513 million of floating-rate asset-backed notes. We received cash proceeds of \$480 million, net of \$3 million of fees, plus a retained interest of \$30 million, which we will receive when the notes are repaid, which we expect to occur in August

2003. The transaction was accounted for as a secured borrowing. At December 31, 2001, the remaining debt totaled \$395 million.

In September 2001, we announced a U.S. Framework Agreement (the USFA) with GE Capital's Vendor Financial Services group, under which GE Capital will become the primary equipment-financing provider for our U.S. customers. We expect funding under the USFA to be in place in 2002 upon completion of systems and process modifications and development.

In November 2001, we entered into an agreement with GE Capital which provides for a series of loans, secured by certain of our finance receivables in the United States, up to an aggregate of \$2.6 billion, provided that certain conditions are met at the time the loans are funded. These conditions, all of which we currently meet, include maintaining a specified minimum debt rating with respect to our senior debt. In the fourth quarter of 2001, we received two secured loans from GE Capital totaling \$1,175 million. Cash proceeds of \$1,053 million were net of \$115 million of escrow requirements and \$7 million of fees. At December 31, 2001, the remaining balances of these loans totaled \$1,149 million. In March 2002, we received our third secured loan from GE Capital totaling \$266 million. Cash proceeds of \$229 million were net of \$35 million of escrow requirements and \$2 million of fees. In May 2002, we received our fourth secured loan from GE Capital, totaling \$499 million. Cash proceeds of \$496 million were net of \$3 million of fees. Through June 26, 2002 approximately \$1.9 billion of loans have been funded under this agreement.

In November 2001, we announced a Canadian Framework Agreement (the CFA) with the Canadian division of GE Capital's Vendor Financial Services group, similar to the agreement in the U.S., under which GE Capital will become the primary equipment-financing provider for our Canadian customers. We expect the CFA to be completed in 2002. In February 2002 we received a \$291 million loan from GE Capital, secured by certain of our finance receivables in Canada. Cash proceeds of \$281 million were net of \$8 million of escrow requirements and \$2 million of fees.

In December 2001, we announced that we would be forming a joint venture with De Lage Landen International BV (DLL) to manage equipment financing, billing and collections for our customers' financed equipment orders in the Netherlands. This joint venture was formed and began funding in the first quarter of 2002. DLL owns 51 percent of the venture and provides the funding to support new customer leases, and we own the remaining 49 percent of this unconsolidated venture.

In December 2001, we announced European framework agreements with GE Capital's European Equipment Finance group, under which GE Capital will become the primary equipment-financing provider for our customers in France and Germany. We expect these agreements to be completed in 2002.

In March 2002, we signed agreements with third parties in Brazil and Mexico, under which those third parties will be our primary equipment financing provider in those countries. Funding under both of these arrangements commenced in the second quarter of 2002.

In April 2002, we sold our leasing business in Italy to a third party for \$207 million in cash plus the assumption of \$20 million of debt. We can also receive retained interests up to approximately \$30 million, based on the occurrence of certain future events. This sale is part of an agreement under which the third-party will provide on-going, exclusive equipment financing to our customers in Italy.

In May 2002, we received an additional loan from GE Capital of \$106 million secured by portions of our lease receivable portfolio in the U.K.

In May 2002, we received a \$77 million loan from GE Capital, secured by certain of our finance receivables in Germany. Cash proceeds of \$65 million were net of \$12 million of escrow requirements.

*Cash and Debt Positions:*

With \$4.0 billion of cash and cash equivalents on hand at December 31, 2001, (and approximately \$1.8 billion on hand as of June 26, 2002, after giving effect to the refinancing under the New Credit Facility) we believe our liquidity is sufficient to meet current operating cash flow requirements and to satisfy all scheduled debt maturities through December 31, 2002.

As a result of the New Credit Facility discussed above, our debt maturities have changed. Significantly less debt will now mature in 2002 and 2003 than would have become due had the Old Revolver not been refinanced. In addition, a portion of our available cash has been used to retire some of the debt under the Old Revolver. The following represents our aggregate debt maturity schedules by quarter for 2002 and 2003, and reflects the New Credit Facility and related principal payments discussed above (in billions):

	2002	2003
First Quarter	\$ 0.7	\$ 0.5
Second Quarter	4.0	1.1
Third Quarter	1.0	0.3
Fourth Quarter	0.9	1.3
Full Year	\$ 6.6	\$ 3.2

Additionally, as discussed throughout this Annual Report, we have reached a settlement with the SEC as to all matters that were under investigation. It is our expectation that the resolution of these matters will restore our ability to access the public capital markets and reduce our earlier reliance on other funding sources including non-public capital markets. Our current plans include accessing the public capital markets in 2002, however, we are not dependent on such access to maintain adequate liquidity in 2002.

*Plans to Strengthen Liquidity and Financial Flexibility Beyond 2002:*

Our ability to maintain sufficient liquidity beyond 2002 is highly dependent on achieving expected operating results, including capturing the benefits from restructuring activities, and completing announced vendor financing and other initiatives. There is no assurance that these initiatives will be successful. Failure to successfully complete these initiatives could have a material adverse effect on our liquidity and our operations, and could require us to consider further measures, including deferring planned capital expenditures, modifying current restructuring plans, reducing discretionary spending, selling additional assets and, if necessary, restructuring existing debt.

We also expect that improvements in our debt ratings, and our related ability to fully access certain unsecured public debt markets, namely the commercial paper markets, will depend on (1) our ability to demonstrate sustained EBITDA growth and operating cash generation and (2) continued progress on our vendor financing initiatives, as discussed above. Until such time, we expect some bank lines to continue to be unavailable, and we intend to access other segments of the capital markets as business conditions allow, which could provide significant sources of additional funds until full access to the unsecured public debt markets is restored.

*Contractual Cash Obligations and Other Commercial Commitments and Contingencies:*

At December 31, 2001, we had the following contractual cash obligations and other commercial commitments and contingencies:

Contractual Cash Obligations:

	2002	2003	2004	2005	2006	Thereafter
	(In millions)					
Long term debt(1)	\$ 6,584	\$ 3,226	\$ 2,567	\$ 3,370	\$ 30	\$ 914
Minimum operating lease commitments	250	207	165	135	112	359
Total contractual cash obligations	\$ 6,834	\$ 3,433	\$ 2,732	\$ 3,505	\$ 142	\$ 1,273

(1) The long-term debt obligations reflect the refinancing of our New Credit Facility on June 21, 2002.



Cumulative Preferred Securities:

As of December 31, 2001, we have four series of outstanding preferred securities as summarized below. The redemption requirements and the annual cumulative dividend requirements on our outstanding preferred stock are as follows:

**Series B Convertible Preferred Stock (ESOP shares):** The balance at December 31, 2001 was \$605 million, and is redeemable in shares of common stock or cash, at our option, as employees with vested shares leave the Company. Annual cumulative dividend requirements are \$6.25 per share. In 2001, we suspended these dividends, but the unpaid dividends are cumulative and amount to approximately \$40 million at December 31, 2001.

**7½ percent Convertible Trust Preferred Securities:** The balance at December 31, 2001 was \$1,005 million, and is puttable in 2004 in cash or in shares of common stock at a redemption value of \$1,035 million. Annual cumulative distribution requirements are \$3.75 per Preferred Security on 20.7 million securities. The first three years' dividend requirements were funded at issuance and are invested in U.S. Treasury securities held by a separate trust.

**8 percent Convertible Trust Preferred Securities:** The balance at December 31, 2001 was \$639 million, and is redeemable in 2027 at a redemption value of \$650 million. Annual cumulative dividend requirements are \$80 per security on 650,000 securities.

**Canadian Deferred Preferred Stock:** The balance at December 31, 2001 was \$43 million, and is redeemable in 2006. Annual cumulative non-cash dividend requirements will increase this amount to its 2006 redemption value of approximately \$56 million.

Other Commercial Commitments and Contingencies:

**Flextronics:** As previously discussed, in 2001 we outsourced certain manufacturing activities to Flextronics under a five-year agreement. At December 31, 2001 we anticipate that we will purchase approximately \$1 billion of inventory from Flextronics during 2002 and expect to maintain this level in the future.

**Fuji Xerox:** We had product purchases from Fuji Xerox totaling \$598 million, \$812 million, and \$740 million in 2001, 2000 and 1999, respectively. Our purchase commitments with Fuji Xerox are in the normal course of business and typically have a lead time of three months.

**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 any losses when they are probable and reasonably estimable.

**EDS Contract:** We have an information management (IM) contract with Electronic Data Systems Corp (EDS). We can terminate the contract with six months notice upon the payment of termination fees, as defined in the contract. Although there are no minimum payments due under the contract, the IM function is integral to our operations and at this time, we anticipate making the following payments to EDS over the next five years (in millions): 2002 \$381; 2003 \$354; 2004 \$351; 2005 \$354; 2006 \$345.

*Other Funding Arrangements:*

**Securitizations, and Use of Special Purpose Entities:**

From time to time, we have generated liquidity by selling or securitizing portions of our finance and accounts receivable portfolios. We have typically utilized special-purpose entities (SPEs) in order to implement these transactions in a manner that isolates, for the benefit of the securitization investors, the securitized receivables from our other assets which would otherwise be available to our creditors. These transactions are typically credit-enhanced through over-collateralization. Such use of SPEs is standard industry practice, is typically required by securitization investors and makes the securitizations easier to market. None of our officers, directors or employees or those of any of our subsidiaries or affiliates hold any direct or indirect ownership interests in any of these SPEs. We typically act as service agent and collect the securitized receivables on behalf of the securitization investors. Under certain circumstances,

including the downgrading of our debt ratings by one or more rating agencies, we can be terminated as servicing agent, in which event the SPEs may engage another servicing agent and we would cease to receive a servicing fee. Although the debt rating downgrade provisions have been triggered in some of our securitization agreements, the securitization investors and/or their agents have not elected to remove us as administrative servicer as of this time. We are not liable for non-collection of securitized receivables or otherwise required to make payments to the SPEs except to the limited extent that the securitized receivables did not meet specified eligibility criteria at the time we sold the receivables to the SPEs or we fail to observe agreed-upon credit and collection policies and procedures.

Most of our SPE transactions were accounted for as borrowings, with the debt and related assets remaining on our balance sheets. Specifically, in addition to the July 2001 asset-backed notes transaction and the U.S. loans from GE Capital discussed above, which utilized SPEs as part of their structures, as of December 31, 2001, we have entered into the following similar transactions which were accounted for as debt on our balance sheets:

In the third quarter 2000, Xerox Credit Corporation (XCC) securitized certain finance receivables in the United States, generating gross proceeds of \$411 million. As of December 31, 2001, the remaining debt under this facility totaled approximately \$154 million.

In 1999, XCC securitized certain finance receivables in the United States, generating gross proceeds of \$1,150 million. At December 31, 2001, the remaining obligations in this facility totaled \$94 million, and were substantially repaid as of June 26, 2002.

We have also entered into the following SPE transactions which were accounted for as sales of receivables:

In 2000, Xerox Corporation and Xerox Canada Limited (XCL) securitized certain accounts receivable in the U.S. and Canada, generating gross proceeds of \$315 million and \$38 million, respectively. In December 2000, as a result of the senior debt downgrade by Moody's discussed above, both entities negotiated waivers with their respective counterparties to prevent the facilities from entering wind-down mode. As part of its waiver negotiation, Xerox Corporation renegotiated the \$315 million U.S. facility, reducing its size to \$290 million. The May 2002 Moody's downgrade constituted an event of termination under this agreement, which we are currently renegotiating. Failure to successfully renegotiate the facility could result in the suspension of its revolving features, whereupon we would be unable to sell new accounts receivable into the facility, and our availability would wind down. In February 2002, the size of the Canadian facility was reduced in order to make certain receivables eligible under the GE Capital Canadian transaction described above. Also in February 2002, a downgrade of our Canadian debt by Dominion Bond Rating Service caused the Canadian counterparty to withdraw its waiver, in turn causing the remaining Canadian facility at that time to enter into wind-down mode. This facility has subsequently been fully repaid.

In 1999, XCL securitized certain finance receivables, generating gross proceeds of \$345 million. At December 31, 2001, the remaining obligations in this facility totaled \$93 million, and we expect them to be fully paid in 2002. At December 31, 2001, this is the only outstanding SPE transaction with recourse provisions that could be asserted against us.

In 1999, Xerox Corporation and certain of its subsidiaries securitized accounts receivable, generating aggregate gross proceeds of \$231 million. No amounts remained outstanding as of December 31, 2001.

In summary, at December 31, 2001, amounts owed by these receivable-related SPEs to their investors totaled \$2,210 million, of which \$418 million represented transactions we treated as asset sales, and the remaining \$1,792 million is reported as Debt in our Consolidated Balance Sheet. A detailed discussion of the terms of these transactions, including descriptions of our retained interests, is included in Note 5 to the Consolidated Financial Statements. We also utilized SPEs in our Trust Preferred Securities transactions. Refer to Note 17 to the Consolidated Financial Statements for a detailed description of these transactions.

**Secured Debt Summary:**

As of March 31, 2002, after giving effect to the New Credit Facility, we have approximately \$930 million of debt which is secured by assets that are measured against the 20 percent consolidated net worth limitation described above. In addition, we have \$3,802 million of debt which is secured by assets that are not measured against that 20 percent limitation, in most cases because the applicable borrowing entities are considered financing subsidiaries under the public indenture definitions.

**Equity Put Options:**

During 2000 and 1999, we sold 7.5 million and 0.8 million equity put options, respectively, for proceeds of \$24 million and \$0.4 million. We did not sell any such options in 2001. Equity put options give the counterparty the right to sell our common shares back to us at a specified strike price. In January 2001, we paid \$28 million to settle the put options we issued in 1999, which we funded by issuing 5.9 million unregistered common shares. In the fourth quarter 2000, we were required to pay \$92 million to settle the put options that we issued in 2000. In 1999, we paid \$5 million to settle put options that we issued in 1998. There were no put options outstanding as of December 31, 2001.

**Cash Management:**

Xerox and its material subsidiaries and affiliates manage their worldwide cash, cash equivalents and liquidity resources through internal cash management systems, which include established policies and procedures. They are subject to (1) the statutes, regulations and practices of the local jurisdictions in which the companies operate, (2) the legal requirements of the agreements to which the companies are parties and (3) the policies and cooperation of the financial institutions utilized by the companies to maintain such cash management systems.

At December 31, 2001, 2000 and 1999, cash and cash equivalents on hand totaled \$3,990 million, \$1,750 million and \$132 million, respectively, and total debt was \$16,744 million, \$18,637 million, and \$16,147 million, respectively. Total debt net of cash (Net Debt) decreased by \$4,133 million in 2001, increased by \$872 million in 2000, and increased by \$769 million in 1999. The consolidated ratio of total debt to common and preferred equity was 7.0:1, 7.6:1 and 4.5:1 as of December 31, 2001, 2000 and 1999, respectively. The decrease in this ratio in 2001 reflects debt-for-equity exchanges, a curtailment of dividends, and debt repayments funded by asset sales and working capital improvements, offset partially by a net loss and the impacts of currency devaluation. The increase in 2000 reflects the 2000 net loss, an increase in debt to fund the CPID acquisition, cash payments required to settle outstanding put options on our common stock, cash dividends, and the impact of currency devaluation. The increases in both 2001 and 2000 compared to 1999 also reflect our decision, beginning in 2000, to accumulate cash to maintain financial flexibility rather than continue our historical practice of paying down debt with available cash.

The following represents the results of our cash flows for the last three years included within our Statement of Cash Flows in our consolidated financial statements (in millions):

	<u>2001</u>	<u>2000</u>	<u>1999</u>
Operating Cash Flows	\$ 1,566	\$ 207	\$ 551
Investing Cash Flows (Usage)	873	(855)	(789)
Financing Cash Flows (Usage)	(189)	2,255	300
Foreign Currency Impacts	(10)	11	(9)
	<u>2,240</u>	<u>1,618</u>	<u>53</u>
Net Change in Cash Balance			
Cash Beginning of year	1,750	132	79
	<u>\$ 3,990</u>	<u>\$ 1,750</u>	<u>\$ 132</u>

2001 operating cash flows improved significantly compared to 2000, primarily due to working capital improvements. Although our sales declined, which normally leads to a reduction in receivables and payables balances, our collections of receivables exceeded our payments on accounts payable and other current liability accounts by approximately \$500 million. We further reduced our inventory balances and spending for on-lease equipment by approximately \$480 million. We also had a short-term benefit of approximately \$350 million associated with the timing of taxes due on the

gain from our sale of half our interest of Fuji Xerox, which we did not have to pay until first quarter 2002. The overall impact of our reported net loss on our operating cash flows, after considering the impacts of non-cash items associated with restructuring charges, provisions, tax valuation allowances and gains did not vary significantly between 2001 and 2000.

Investing cash flows were higher in 2001 primarily due to \$1,768 million of cash received from the sales of businesses, including Fuji Xerox and our leasing businesses in the Nordic European countries. These cash proceeds were greater than those received from the sale of businesses in 2000, which resulted in proceeds of \$640 million. In 2001 we also reduced capital spending and internal-use software spending significantly. Other factors contributing to the 2001 improvement were the acquisition of CPID in 2000, which utilized cash of \$856 million, while in 2001 we were required to fund \$628 million of certain escrow and insurance trusts based on contractual requirements.

Our 2001 financing activities largely consisted of a net repayment of approximately \$1.1 billion of debt, offset by a private placement of \$1.0 billion of trust preferred securities. Our suspension of dividends on our common and preferred stock also had a positive impact on our cash flows in 2001.

Refer to our EBITDA-based cash flows discussion below to understand the way we look at cash flows from a treasury and cash management perspective, and for explanations of cash flows for 2000 and 1999.

Historically, we separately managed the capital structures of our non-financing operations and our captive financing operations. Consistent with our continuing efforts to exit the customer equipment financing business, we now use EBITDA and operating cash flow to measure our liquidity, and we no longer distinguish between financing and non-financing operations in our liquidity management processes. We define EBITDA as earnings before interest expense, income taxes, depreciation, amortization, minorities' interests, equity in income of unconsolidated affiliates, and non-recurring and non-operating items. We believe that EBITDA provides investors and analysts with a useful measure of liquidity generated from recurring operations. EBITDA is not intended to represent an alternative to either operating income or cash flows from operating activities (as those terms are defined in GAAP). While EBITDA is frequently used to analyze companies, the definition of EBITDA we employ, as presented herein, may differ from definitions of EBITDA employed by other companies.

The following is a summary of EBITDA, operating and other cash flows for the years ended December 31, 2001, 2000 and 1999:

	2001	2000	1999
		Restated	Restated
Non-financing revenues	\$ 15,879	\$ 17,589	\$ 17,820
Non-financing cost of sales	10,050	11,233	10,529
Non-financing gross profit	5,829	6,356	7,291
Research and development expense	(997)	(1,064)	(1,020)
Selling, administrative and general expenses	(4,728)	(5,518)	(5,204)
Depreciation and amortization expense, excluding goodwill and intangibles	1,238	1,158	1,040
Adjusted EBITDA	1,342	932	2,107
Working capital and other changes	794	694	(319)
On-Lease equipment spending	(271)	(506)	(387)
Capital spending	(219)	(452)	(594)
Restructuring payments	(484)	(387)	(441)
Operating Cash Flow*	1,162	281	366
Interest payments	(1,074)	(1,050)	(848)
Financing cash flow	1,374	494	292
Debt borrowings (repayments), net	(1,242)	2,917	793
Net proceeds from Trust Preferred Securities	775		
Dividends and other non-operating items	(541)	(808)	(508)
Proceeds from sales of businesses	1,768	640	65
Acquisitions	18	(856)	(107)
Net Increase in Cash	\$ 2,240	\$ 1,618	\$ 53

\* The primary difference between this amount and the Cash Flows from Operations reported in our GAAP Statements of Cash Flows, is the inclusion of Capital Spending in, and the exclusion of Financing Cash Flow and Interest Payments from, the amount shown above.

2001 EBITDA operating cash flow of \$1,162 million increased by \$881 million, from \$281 million in the prior year. The improvement was driven by cost reductions, lower on-lease equipment spending, lower capital spending, and modest working capital improvements, and was partially offset by higher restructuring payments and lower revenues. The decline in capital spending was due primarily to significant spending constraints as well as completion in 2000 of our remaining Ireland projects described below. The decline in on-lease equipment spending reflected declining rental placement activity and populations, particularly in our older-generation light lens products.

The increase in EBITDA financing cash flow in 2001 reflected lower finance receivable originations resulting from lower equipment sales in 2001 compared to 2000. Dividends and other non-operating items used \$541 million of cash in 2001, compared to usage of \$808 million in 2000. This improvement was largely due to cash savings of approximately \$500 million resulting from our elimination and suspension of our common and Series B Preferred dividends, respectively, which we announced in July 2001, and lower payments required to terminate derivative contracts, partially offset by a \$255 million payment related to our funding of trusts to replace Ridge Reinsurance letters of credit.

In 2001, we generated \$1,768 million of cash from the sales of businesses, including the sale of half our interest in Fuji Xerox, our leasing businesses in four European countries, and certain of our manufacturing-related assets to Flextronics, as discussed below. These asset sales, together with net proceeds of \$775 million from the sale of trust preferred securities and the significant improvements in operating and financing cash flows, funded net repayments of debt totaling \$1,242 million in 2001, compared to incremental borrowings of \$2,917 million in 2000 which included funding for the CPID acquisition.

EBITDA operating cash flow was \$281 million in 2000, including \$328 million of accounts receivable securitizations, compared to \$366 million in 1999. Significant improvements in working capital and lower capital spending essentially offset lower EBITDA, which reflected lower revenues and higher costs compared to 1999. Capital spending in 2000 included production tooling and our investments in Ireland, where we consolidated European customer support centers



and invested in inkjet supplies manufacturing. The significant decline in 2000 spending versus 1999 is due primarily to substantial completion of several aspects of the Ireland projects as well as significant spending constraints. Investments in on-lease equipment reflected growth in our document outsourcing business.

The significant increase in interest payments in 2000 largely reflects higher debt levels.

In 2000, we generated \$640 million of cash from the sales of businesses, including the sale of our China operations to Fuji Xerox for \$550 million, and we used \$856 million of cash for the acquisition of the CPID division of Tektronix. The increased spending in Dividends and other non operating items reflected cash payments of \$68 million to settle put options on our common stock, plus payments of \$108 million to settle out-of-the-money currency and interest rate derivatives which were cancelled upon one of our debt downgrades discussed below. Together with increased interest costs, only partially offset by modest increases in operating and financing cash flows, these cash decreases required us to borrow an incremental \$2,917 million in 2000.

Cash restructuring payments were \$484 million, \$387 million, and \$441 million in 2001, 2000 and 1999, respectively. We expect that substantially all of the remaining restructuring reserves as of December 31, 2001 of \$282 million will be paid in 2002. The status of the restructuring reserves is discussed in Note 3 to the Consolidated Financial Statements.

**Item 7a. Quantitative and Qualitative Disclosures about Market Risk**

*Financial Risk Management:*

We are typical of multinational corporations because we are exposed to market risk from changes in foreign currency exchange rates and interest rates that could affect our results of operations and financial condition. Accordingly, we have historically entered into derivative contracts, including interest rate swap agreements, forward exchange contracts and foreign currency swap agreements, to manage such interest rate and foreign currency exposures. The fair market values of all of our derivative contracts change with fluctuations in interest rates and/or currency rates, and are designed so that any change in their values is offset by changes in the values of the underlying exposures. Our derivative instruments are held solely to hedge economic exposures; we do not enter into such transactions for trading purposes, and we employ long-standing policies prescribing that derivative instruments are only to be used to achieve a set of very limited objectives. As described above, our ability to currently enter into new derivative contracts is severely constrained. Therefore, while the following paragraphs describe our overall risk management strategy, our current ability to employ that strategy effectively has been severely limited.

Currency derivatives are primarily arranged to manage the risk of exchange rate fluctuations associated with assets and liabilities that are denominated in foreign currencies. Our primary foreign currency market exposures include the Japanese Yen, Euro, Brazilian Real, British Pound Sterling and Canadian Dollar. For each of our legal entities, we have historically hedged a significant portion of all foreign-currency-denominated cash transactions. From time to time (when cost-effective) foreign-currency-denominated debt and foreign-currency derivatives have been used to hedge international equity investments.

Virtually all customer-financing assets earn fixed rates of interest. Therefore, we have historically sought to lock in an interest rate spread by arranging fixed-rate liabilities with maturities similar to those of the underlying assets, and we have funded the assets with liabilities in the same currency. As part of this overall strategy, pay-fixed-rate/receive-variable-rate interest rate swaps are often used in place of more expensive fixed-rate debt. Additionally, pay-variable-rate/receive-fixed-rate interest rate swaps are used from time to time to transform longer-term fixed-rate debt into variable-rate obligations. The transactions performed within each of these categories enable more cost-effective management of interest rate exposures by eliminating the risk of a major change in interest rates. We refer to the effect of these practices as match funding customer financing assets.

Consistent with the nature of economic hedges, unrealized gains or losses from interest rate and foreign currency derivative contracts are designed to offset any corresponding changes in the value of the underlying assets, liabilities or debt.

Assuming a 10 percent appreciation or depreciation in foreign currency exchange rates from the quoted foreign currency exchange rates at December 31, 2001, the potential change in the fair value of foreign currency-denominated assets and liabilities in each entity would aggregate approximately \$31 million, and a 10 percent appreciation or depreciation of the U.S. Dollar against all currencies from the quoted foreign currency exchange rates at December 31, 2001, would have a \$335 million impact on our Cumulative Translation Adjustment portion of equity. The amount permanently invested in foreign subsidiaries and affiliates primarily Xerox Limited, Fuji Xerox and Xerox do Brasil and translated into dollars using the year-end exchange rates, was \$3.3 billion at December 31, 2001, net of foreign currency-denominated liabilities designated as a hedge of our net investment.

Pay fixed-rate and receive variable-rate swaps are often used in place of more expensive fixed-rate debt. Additionally, pay variable-rate and receive fixed-rate swaps are used from time to time to transform longer-term fixed-rate debt into variable-rate obligations. The transactions performed within each of these categories enable more cost-effective management of interest rate exposures. The potential risk attendant to this strategy is the non-performance of the swap counterparty. We address this risk by arranging swaps with a diverse group of strong-credit counterparties, regularly monitoring their credit ratings and determining the replacement cost, if any, of existing transactions. On a consolidated basis, including the impact of our hedging activities, weighted-average interest rates for 2001, 2000 and 1999 approximated 5.5 percent, 6.2 percent and 5.7 percent, respectively.



Many of the financial instruments we use are sensitive to changes in interest rates. Interest rate changes result in fair value gains or losses on our term debt and interest rate swaps, due to differences between current market interest rates and the stated interest rates within the instrument. The loss in fair value at December 31, 2001, from a 10 percent change in market interest rates would be approximately \$161 million for our interest rate sensitive financial instruments. Our currency and interest rate hedging are typically unaffected by changes in market conditions as forward contracts, options and swaps are normally held to maturity consistent with our objective to lock in currency rates and interest rate spreads on the underlying transactions.

As described above, the downgrades of our debt during 2000, 2001 and 2002, together with the recently-concluded SEC investigation, significantly reduced our access to capital markets. Furthermore, several of the debt downgrades triggered various contractual provisions which required us to collateralize or repurchase a number of derivative contracts which were then outstanding. While we have been able to replace some derivatives on a limited basis, our current debt ratings restrict our ability to utilize derivative agreements to manage the risks associated with interest rate and some foreign currency fluctuations, including our ability to continue effectively employing our match funding strategy. For this reason, we anticipate increased volatility in our results of operations due to market changes in interest rates and foreign currency rates.

**Item 8. Financial Statements and Supplementary Data**

**AUDITED FINANCIAL STATEMENTS**

Report of Independent Accountants  
Consolidated Statements of Operations  
Consolidated Balance Sheets  
Consolidated Statements of Cash Flows  
Consolidated Statements of Common Shareholders' Equity

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Summary of Significant Accounting Policies
2. Restatement of 2000 and 1999 Financial Statements
3. Restructuring Programs
4. Acquisitions
5. Divestitures
6. Receivables, Net
7. Inventories and Equipment on Operating Leases, Net
8. Land, Buildings and Equipment, Net
9. Investments in Affiliates, at Equity
10. Segment Reporting
11. Discontinued Operations
12. Debt
13. Financial Instruments
14. Employee Benefit Plans
15. Income and Other Taxes
16. Litigation and Regulatory Matters
17. Preferred Securities
18. Common Stock
19. Earnings Per Share
20. Subsequent Events
21. Restatement for Correction of Interest Expense in 2001 Financial Statements
22. Accounting Changes and Adoption of New Accounting Standards

**REPORT OF INDEPENDENT ACCOUNTANTS**

To the Board of Directors and Shareholders of Xerox Corporation:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, cash flows and common shareholders' equity present fairly, in all material respects, the financial position of Xerox Corporation and its subsidiaries at December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, the Company restated its consolidated financial statements for the years ended December 31, 2000 and 1999, previously audited by other independent accountants. Further, as discussed in Note 21, the Company restated its consolidated financial statements for the year ended December 31, 2001.

/s/ PRICEWATERHOUSE COOPERS LLP

PricewaterhouseCoopers LLP

Stamford, Connecticut

June 26, 2002, except for Notes 21 and 22, which are as of December 20, 2002

## CONSOLIDATED STATEMENTS OF OPERATIONS

	Year ended December 31		
	2001	2000	1999
	Restated Note 21 (in millions, except per-share data)	Restated Note 2	Restated Note 2
<b>Revenues</b>			
Sales	\$ 7,443	\$ 8,839	\$ 8,967
Service, outsourcing and rentals	8,436	8,750	8,853
Finance income	1,129	1,162	1,175
<b>Total Revenues</b>	<b>17,008</b>	<b>18,751</b>	<b>18,995</b>
<b>Costs and Expenses</b>			
Cost of sales	5,170	6,080	5,631
Cost of service, outsourcing and rentals	4,880	5,153	4,898
Equipment financing interest	457	498	435
Research and development expenses	997	1,064	1,020
Selling, administrative and general expenses	4,728	5,518	5,204
Restructuring and asset impairment charges	715	475	12
Gain on sale of half of interest in Fuji Xerox	(773)		
Gain on affiliate's sale of stock	(4)	(21)	
Purchased in-process research and development		27	
Gain on sale of China operations		(200)	
Other expenses, net	444	524	507
<b>Total Costs and Expenses</b>	<b>16,614</b>	<b>19,118</b>	<b>17,707</b>
<b>Income (Loss) before Income Taxes (Benefits), Equity Income, Minorities Interests and Cumulative Effect of Change in Accounting Principle</b>			
	394	(367)	1,288
Income taxes (benefits)	497	(70)	446
<b>(Loss) Income before Equity Income, Minorities Interests, Cumulative Effect of Change in Accounting Principle</b>	<b>(103)</b>	<b>(297)</b>	<b>842</b>
Equity in net income of unconsolidated affiliates	53	66	48
Minorities' interests in earnings of subsidiaries	(42)	(42)	(46)
<b>(Loss) Income before Cumulative Effect of Change in Accounting Principle</b>	<b>(92)</b>	<b>(273)</b>	<b>844</b>
Cumulative effect of change in accounting principle	(2)		
<b>Net (Loss) Income</b>	<b>\$ (94)</b>	<b>\$ (273)</b>	<b>\$ 844</b>
<b>Basic (Loss) Earnings per Share(1)</b>			
(Loss) Income before Cumulative Effect of Change in Accounting Principle	\$ (0.15)	\$ (0.48)	\$ 1.20
<b>Net (Loss) Earnings per Share</b>	<b>\$ (0.15)</b>	<b>\$ (0.48)</b>	<b>\$ 1.20</b>
<b>Diluted (Loss) Earnings per Share(1)</b>			
(Loss) Income before Cumulative Effect of Change in Accounting Principle	\$ (0.15)	\$ (0.48)	\$ 1.17
<b>Net (Loss) Earnings per Share</b>	<b>\$ (0.15)</b>	<b>\$ (0.48)</b>	<b>\$ 1.17</b>

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

- (1) Basic and diluted (loss) earnings per share is determined using income or loss available to common shareholders, which is calculated as net (loss) income less accrued preferred dividends. See Note 19.

## CONSOLIDATED BALANCE SHEETS

	December 31	
	2001	2000
	Restated Note 21 (in millions)	Restated Note 2
<b>Assets</b>		
Cash and cash equivalents	\$ 3,990	\$ 1,750
Accounts receivable, net	1,896	2,269
Finance receivables, net	3,922	4,392
Inventories	1,364	1,983
Deferred taxes and other current assets	1,428	1,078
<b>Total Current Assets</b>	<b>12,600</b>	11,472
Finance receivables due after one year, net	5,756	6,406
Equipment on operating leases, net	804	1,266
Land, buildings and equipment, net	1,999	2,527
Investments in affiliates, at equity	632	1,270
Intangible and other assets, net	4,409	3,763
Goodwill, net	1,445	1,549
<b>Total Assets</b>	<b>\$ 27,645</b>	<b>\$ 28,253</b>
<b>Liabilities and Equity</b>		
Short-term debt and current portion of long-term debt	\$ 6,637	\$ 3,080
Accounts payable	704	1,050
Accrued compensation and benefits costs	724	645
Unearned income	244	233
Other current liabilities	1,951	1,536
<b>Total Current Liabilities</b>	<b>10,260</b>	6,544
Long-term debt	10,107	15,557
Postretirement medical benefits	1,233	1,197
Deferred taxes and other liabilities	2,018	1,925
<b>Total Liabilities</b>	<b>23,618</b>	25,223
Deferred ESOP benefits	(135)	(221)
Minorities' interests in equity of subsidiaries	73	87
Obligation for equity put options		32
Company-obligated, mandatorily redeemable preferred securities of subsidiary trusts holding solely subordinated debentures of the Company	1,687	684
Preferred stock	605	647
Common stock, including additional paid in capital	2,622	2,231
Retained earnings	1,008	1,150
Accumulated other comprehensive loss	(1,833)	(1,580)
<b>Total Liabilities and Equity</b>	<b>\$ 27,645</b>	<b>\$ 28,253</b>

Shares of common stock issued and outstanding were (in thousands) 722,314 and 668,576 at December 31, 2001 and December 31, 2000, respectively.

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31		
	2001	2000	1999
	Restated Note 21	Restated Note 2 (in millions)	Restated Note 2
<b>Cash Flows from Operating Activities</b>			
Net (loss) income	\$ (94)	\$ (273)	\$ 844
Adjustments required to reconcile net (loss) income to cash flows from operating activities:			
Depreciation and amortization	1,332	1,244	1,090
Provisions for receivables and inventory	748	848	594
Restructuring and other charges	715	502	12
Cash payments for restructurings	(484)	(387)	(441)
Gains on sales of businesses and assets	(765)	(288)	(78)
Gain on early extinguishment of debt	(63)		
Minorities' interests in earnings of subsidiaries	42	42	46
Undistributed equity in income of affiliated companies	(20)	(25)	(10)
Decrease (increase) in inventories	319	74	(165)
Increase in on-lease equipment	(271)	(506)	(387)
Decrease (increase) in finance receivables	162	(701)	(1,246)
Proceeds from sale of finance receivables			345
Decrease (increase) in accounts receivable	115	(385)	(484)
Proceeds from sale of accounts receivable		328	231
(Decrease) increase in accounts payable and accrued compensation and benefits costs	(270)	59	21
Net change in current and deferred income taxes	442	(421)	210
(Decrease) increase in other current and non-current liabilities	(160)	55	218
Early termination of derivative contracts	(148)	(108)	
Other, net	(34)	149	(249)
<b>Net cash provided by operating activities</b>	<b>1,566</b>	<b>207</b>	<b>551</b>
<b>Cash Flows from Investing Activities</b>			
Cost of additions to land, buildings and equipment	(219)	(452)	(594)
Proceeds from sales of land, buildings and equipment	69	44	99
Cost of additions to internal use software	(124)	(211)	(241)
Proceeds from divestitures	1,768	640	65
Acquisitions, net of cash acquired	18	(856)	(107)
Funds placed in escrow and other restricted cash	(628)		
Other, net	(11)	(20)	(11)
<b>Net cash provided by (used in) investing activities</b>	<b>873</b>	<b>(855)</b>	<b>(789)</b>
<b>Cash Flows from Financing Activities</b>			
Net (decrease) increase in debt	(1,098)	2,917	793
Proceeds from issuance of mandatorily redeemable preferred	1,004		
Dividends on common and preferred stock	(93)	(587)	(586)
Proceeds from issuances of common stock	28		128
Settlements of equity put options, net	(28)	(68)	(5)
Dividends to minority shareholders	(2)	(7)	(30)
<b>Net cash (used in) provided by financing activities</b>	<b>(189)</b>	<b>2,255</b>	<b>300</b>
Effect of exchange rate changes on cash and cash equivalents	(10)	11	(9)
<b>Increase in cash and cash equivalents</b>	<b>2,240</b>	<b>1,618</b>	<b>53</b>

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Cash and cash equivalents at beginning of year	<u>1,750</u>	<u>132</u>	<u>79</u>
<b>Cash and cash equivalents at end of year</b>	<b><u>\$ 3,990</u></b>	<b><u>\$ 1,750</u></b>	<b><u>\$ 132</u></b>

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



## CONSOLIDATED STATEMENTS OF COMMON SHAREHOLDERS EQUITY

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss(1)	Treasury Stock Shares	Treasury Stock Amount	Total
(In millions, except share data)								
Balance at December 31, 1998, as reported	657,196	\$ 660	\$ 1,265	\$ 3,482	\$ (755)	(409)	\$ (19)	\$ 4,633
Effect of restatement (Note 2)			63	(1,781)	111			(1,607)
Balance at December 31, 1998, as restated*	657,196	\$ 660	\$ 1,328	\$ 1,701	\$ (644)	(409)	\$ (19)	\$ 3,026
Net income				844				844
Translation adjustments					(547)			(547)
Minimum pension liability					(33)			(33)
<b>Comprehensive income</b>								264
Stock option and incentive plans	5,331	6	134	(5)		270	12	147
Xerox Canada exchangeable stock	1,362							
Convertible securities	1,267	1	63	(52)		139	7	19
Cash dividends declared								
Common stock (\$0.80 per share)				(532)				(532)
Preferred stock (\$6.25 per share)				(54)				(54)
Settlement of put options			(5)					(5)
Tax benefits on benefit plans			80	8				88
Balance at December 31, 1999, as restated*	665,156	667	1,600	1,910	(1,224)			2,953
Net loss				(273)				(273)
Translation adjustments					(356)			(356)
Minimum pension liability					5			5
Unrealized loss on securities					(5)			(5)
<b>Comprehensive loss</b>								(629)
Stock option and incentive plans	940	1	32					33
Xerox Canada exchangeable stock	29							
Convertible securities	2,451	2	28	(8)				22
Cash dividends declared								
Common stock (\$0.65 per share)				(434)				(434)
Preferred stock (\$6.25 per share)				(52)				(52)
Put options, net			(100)					(100)
Tax benefits on benefit plans			1	7				8
Balance at December 31, 2000, as restated*	668,576	670	1,561	1,150	(1,580)			1,801
Net loss				(94)				(94)
Translation adjustments					(210)			(210)
Minimum pension liability					(40)			(40)
Unrealized gain on securities					4			4
FAS 133 transition adjustment					(19)			(19)
Net changes on cash flow hedges					12			12
<b>Comprehensive loss</b>								(347)
Stock option and incentive plans	546	1	5					6
Xerox Canada exchangeable stock	312							
Convertible securities	5,865	6	36					42
Cash dividends declared								
Common stock (\$0.05 per share)				(34)				(34)
Preferred stock (\$1.56 per share)				(14)				(14)

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Put options, net			4					4
Equity for debt exchanges	41,154	41	270					311
Issuance of unregistered shares	5,861	6	22					28
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Balance at December 31, 2001, as restated**	722,314	\$ 724	\$ 1,898	\$ 1,008	\$ (1,833)		\$	\$ 1,797
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

(1) As of December 31, 2001, Accumulated Other Comprehensive Loss is composed of cumulative translation adjustments of \$(1,758), minimum pension liability of \$(67), unrealized loss on securities of \$(1) and net SFAS No. 133 related items of \$(7).

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

\* See Note 2.

\*\* See Note 21.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**Note 1 Summary of Significant Accounting Policies**

**Description of Business and Basis of Presentation.** Xerox Corporation is The Document Company and a leader in the global document market, selling equipment and providing document solutions including hardware and services that enhance our customers' work processes and business results. Our activities encompass developing, manufacturing, marketing, servicing, and financing a complete range of document processing products, solutions and services designed to make organizations around the world more productive.

**Liquidity.** Historically, our primary sources of funding have been cash flows from operations, borrowings under our commercial paper and term funding programs, and securitizations of accounts and finance receivables. Funds were used to finance customers' purchases of our equipment, and to fund working capital requirements, capital expenditures and business acquisitions. Our specific business challenges, including revenue declines over the past few years, coupled with significant competitive and industry changes and adverse economic conditions, began to negatively affect our operations and liquidity in 2000. These challenges, which were exacerbated by significant technology and acquisition spending, impacted our cash availability and created marketplace concerns regarding our liquidity, which led to credit rating downgrades and restricted access to capital markets.

Our access to many of the aforementioned sources is currently limited due to our below investment grade rating on our debt. Our debt rating has been reduced several times since October 2000. These rating downgrades have had a number of significant negative impacts on us, including the unavailability of uncommitted bank lines, very limited ability to utilize derivative instruments to hedge foreign and interest currency exposures, thereby increasing volatility to changes in exchange rates, and higher interest rates on borrowings. Additionally, as more fully disclosed below, we are required to maintain minimum cash balances in escrow on certain borrowings, securitizations, swaps and letters of credit. These restricted cash balances are not considered cash or cash equivalents on our balance sheet.

On June 21, 2002, we permanently repaid \$2.8 billion on our then outstanding revolving credit facility. An amended \$4.2 billion facility replaced the previous \$7 billion facility. However, we currently have no incremental borrowing capacity under the facility as the entire \$4.2 billion is outstanding as of such date.

The new facility is disclosed in more detail in. The new facility contains more stringent financial covenants than the prior facility, including the following:

Minimum EBITDA (based on rolling quarters, as defined)

Maximum leverage (total adjusted debt divided by EBITDA, as defined)

Maximum capital expenditures (annual test)

Minimum consolidated net worth (quarterly test, as defined)

We expect to be in full compliance with the covenants and other provisions of the new credit facility through December 31, 2002 and beyond. Failure to be in compliance with any material provision of the new facility could have a material adverse effect on our financial position, results of operations and cash flows.

In addition, as part of our Turnaround Plan (see Note 3), we have taken significant steps to improve our liquidity, including asset sales, monetizations of portions of our receivables portfolios, and general financings including issuance of high yield debt and preferred securities. Since early 2000, we have been restructuring our cost base. We have implemented a series of plans to resize our workforce and reduce our cost structure through such restructuring initiatives. Key factors influencing our liquidity include our ability to generate cash flow from an appropriate combination of operating improvements anticipated in our Turnaround Plan and continued execution of the initiatives described above. We believe our projected liquidity is sufficient to meet our current operating cash flow requirements and satisfy our 2002 scheduled debt maturities and other cash flow requirements. However, our ability to meet our obligations beyond 2002 is dependent on our ability to generate positive cash flow from a combination of operating

improvements, capital markets transactions, third party vendor financing programs and receivable monetizations. Failure to implement these initiatives could have a material adverse effect on our liquidity and our operations and we would need to implement alternative plans that could include additional asset sales, additional reductions in operating costs, deferral of capital expenditures, further reductions in working capital and further debt restructurings. While we believe we could successfully complete the alternative plans, if necessary, there can be no assurance that such alternatives would be available or that we would be successful in their implementation.

**Basis of Consolidation.** The consolidated financial statements include the accounts of Xerox Corporation and all of its controlled subsidiary companies (collectively the Company). All significant intercompany accounts and transactions have been eliminated. References herein to we or our refer to Xerox and consolidated subsidiaries unless the context specifically requires otherwise.

Investments in business entities in which the Company does not have control, but has the ability to exercise significant influence over operating and financial policies (generally 20 to 50 percent ownership), are accounted for by the equity method.

Upon the sale of stock by a subsidiary, we recognize a gain or loss in our Consolidated Statements of Operations equal to our proportionate share of the increase or decrease in the subsidiary's equity.

Operating results of acquired businesses are included in the Consolidated Statements of Operations from the date of acquisition. See Note 4.

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

**Use of Estimates.** The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions are used for, but not limited to: allocation of revenues and fair values in multiple element arrangements; accounting for residual values; economic lives of leased assets; allowance for doubtful accounts; retained interests associated with the sales of accounts or finance receivables; inventory valuation; merger, restructuring and other related charges; asset impairments; depreciable lives of assets; useful lives of intangible assets and goodwill; pension and postretirement benefit plans; discontinued operations reinsurance obligations; and tax valuation allowances. Future events and their effects cannot be predicted with certainty; accordingly, our accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of our consolidated financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as the Company's operating environment changes. Actual results could differ from those estimates.

The following table summarizes the more significant charges which require management estimates:

(in millions)	Year ended December 31		
	2001	2000	1999
		Restated Note 2	Restated Note 2
Restructuring provisions and asset impairments	\$ 715	\$ 475	\$ 12
Amortization of goodwill and intangible assets	94	86	50
Provisions for receivables	506	613	450
Provisions for obsolete and excess inventory	242	235	144
Depreciation of equipment on operating leases	657	626	560
Depreciation of land, buildings and equipment	402	417	416
Amortization of capitalized software	179	115	64
Pension benefits net periodic benefit cost	99	44	102
Other benefits net periodic benefit cost	130	109	107
Deferred tax asset valuation allowance provisions	247	12	92

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

**Accounting Changes.** Effective January 1, 2001, we adopted Statement of Financial Accounting Standards, No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), which requires companies to recognize all derivatives as assets or liabilities measured at their fair value, regardless of the purpose or intent of holding them. Gains or losses resulting from changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, depending on the type of hedge transaction. Changes in fair value for derivatives not designated as hedging instruments and the ineffective portions of hedges are recognized in earnings in the current period. The adoption of SFAS No. 133 resulted in a net cumulative after-tax loss of \$2 in the Statement of Operations and a net cumulative after-tax loss of \$19 in Accumulated Other Comprehensive Income. Further, as a result of recognizing all derivatives at fair value, including the differences between the carrying values and fair values of related hedged assets, liabilities and firm commitments, we recognized a \$361 increase in assets and a \$382 increase in liabilities (amounts have been restated to reflect the effects of the correction of fair value assigned to certain derivative instruments upon adoption of SFAS No. 133 of \$42 million. See Note 21 to the Consolidated Financial Statements for additional information). See Note 13.

#### New Accounting Standards

**Business Combinations:** In 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, Business Combinations (SFAS No. 141). SFAS No. 141 requires the use of the purchase method of accounting for business combinations and prohibits the use of the pooling of interests method. We have not historically engaged in transactions that qualify for the use of the pooling of interests method and therefore, this aspect of the new standard will not have an impact on our financial results. SFAS No. 141 also changes the definition of intangible assets acquired in a purchase business combination, providing specific criteria for the initial recognition and measurement of intangible assets apart from goodwill. As a result, the purchase price allocation of future business combinations may be different than the allocation that would have resulted under the previous rules. SFAS No. 141 also requires that upon adoption of Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets (SFAS No. 142), we reclassify the carrying amounts of certain intangible assets into or out of goodwill, based on certain criteria as discussed below. All business acquisitions initiated after June 30, 2001 must apply provisions of this standard.

**Goodwill and Intangible Assets:** SFAS No. 142, also issued in 2001, addresses financial accounting and reporting for acquired goodwill and other intangible assets subsequent to their initial recognition. The provisions of SFAS No. 142 were adopted January 1, 2002. See Note 22 for further discussion.

**Asset Retirement Obligations:** In 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations. The Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and associated asset

retirement costs. We are required to implement this standard on January 1, 2003. We do not expect this Statement will have a material effect on our financial position or results of operations.

*Impairment or Disposal of Long-Lived Assets:* In 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The Statement primarily supercedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. The Statement retains the previously existing accounting requirements related to the recognition and measurement of the impairment of long-lived assets to be held and used, while expanding the measurement requirements of long-lived assets to be disposed of by sale to include discontinued operations. It also expands on the previously existing reporting requirements for discontinued operations to include a component of an entity that either has been disposed of or is classified as held for sale. We implemented this standard on January 1, 2002, and do not expect this Statement will have a material effect on our financial position or results of operations.

In 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. The Statement rescinds Statement 4 which required all gains and losses from extinguishment of debt to be aggregated and, when material, classified as an extraordinary item net of related income tax effect. Statement 145 also amends Statement 13 to require that certain lease modifications having economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. We implemented this standard in the second quarter of 2002. See Note 22 for further discussion of the applicable reclassification effects on our consolidated financial statements.

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

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

*Service:* Service revenues are derived primarily from maintenance contracts on our equipment sold to customers and are recognized over the term of the contracts. A substantial portion of our products are sold with full service maintenance agreements for which the customer typically pays a base service fee plus a variable amount based on usage. As a consequence we do not have any significant product warranty obligations including for any obligations under customer satisfaction programs.

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

*Revenue Recognition for Sales-Type Leases Under Bundled Arrangements:* We sell most of our products and services under bundled contract arrangements, which contain multiple deliverable elements. These arrangements typically include equipment, service and supplies, and financing components for which the customer pays a single negotiated price for all elements. These arrangements typically also include a variable service component for page volumes in excess of stated minimums. When separate prices are listed in multiple element customer contracts, they may not be representative of the fair values of those elements because the prices of the different components of the arrangement may be modified in customer negotiations, although the aggregate consideration may remain the same. Therefore, revenues under these arrangements are allocated based upon estimated fair values of each element. Our revenue allocation methodology first begins by determining the fair value of the service component as well as other executory costs and any profit thereon and second, by determining the fair value of the equipment based on comparison of the equipment values in our accounting systems to a range of cash selling prices. The resultant implicit interest rate is compared to fair market value rates to assess reasonableness of the overall allocations to the multiple elements. Finance income is earned on an accrual basis under an effective annual yield method over the lease term.

*Determination of Appropriate Revenue Recognition for Sales-Type Leases:* Our accounting for leases involves specific determination under SFAS No. 13 which often involves complex judgements. The general criteria for SFAS No. 13, at least one of which is required to be met in order to account for a lease as a sale versus as a rental, are (a) whether ownership transfers by the end of the lease term, (b) whether there is a bargain purchase option at the end of the lease term which is exercisable by the lessee, (c) whether the lease term is equal to or greater than at least 75 percent of the economic life of the equipment and (d) whether the present value of the minimum lease payments, as defined, are equal to or greater than 90 percent of the fair market value of the equipment. In addition to these criteria, there are also important criteria that are required to be assessed including whether collectibility of the lease payments is reasonably predictable and that there are important uncertainties related to costs that we have yet to incur with respect to the lease.

The critical elements of SFAS No. 13 that we analyze with respect to our lease accounting are the determination of economic life and the fair market value of equipment, including our estimates of residual values. Accounting for sales-type lease transactions requires management to make estimates with respect to economic lives and expected residual value of the equipment in accordance with specific criteria as set forth in generally accepted accounting principles. Those estimates are based upon historical experience with economic lives of all of our equipment products. We consider the most objective measure of historical experience, for purposes of estimating the economic life, to be the original contract term since most equipment is returned by lessees at or near the end of the contracted term. The most frequent contractual lease term for our principal products is five years, and only a small percentage of our leases are for original terms longer than five years. Accordingly, we have estimated the economic life of most of our products to be five years. We believe that this is representative of the period during which the equipment is expected to be economically usable, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease. Residual values are established at lease inception using estimates of fair value at the end of the lease term. Our residual values are established with due consideration to forecasted supply and demand for our various products, product retirement and future product launch plans, end of lease customer behavior, remanufacturing strategies, used equipment markets (to the extent they exist for the particular product), competition and technological changes. Unguaranteed residual values are assigned primarily to our high volume copying, printing and production publishing products. We review residual values regularly and, when appropriate, adjust them based on estimates of forecasted demand including the impacts of future product launches. Impairment charges are recorded when available information indicates that the decline is other than temporary and it is probable that we will not be able to fully recover the recorded values. See Note 6.

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

**Restricted Cash and Investments.** At December 31, 2001, we had the following amounts of restricted cash: \$115 of cash held in escrow as security for our performance of services related to the lease contracts transferred under the secured borrowings with General Electric Capital Corporation; \$229 of cash held in escrow related to the scheduled distribution payments for trust preferred securities sold in November 2001; \$111 of cash held as collateral related to our swaps and letters of credit; and \$30 of cash held in escrow related to our asset-backed security transaction entered in July 2001. As discussed in Note 11, we also have \$684 of cash and investments in trust as support for our discontinued operations reinsurance obligations. These restricted amounts are included in either Deferred taxes and other current assets or Intangible and other assets, net, as appropriate, in the Consolidated Balance Sheets.

**Securitizations and Transfers of Receivables.** Sales, transfers and securitizations of recognized financial assets are accounted for under Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS No. 140). From time to time, in the normal course of business, we may securitize or sell finance receivables and accounts receivable with or without recourse and/or discounts. The receivables are removed from the Consolidated Balance Sheet at the time they are sold and the risk of loss has transferred to the purchaser. However, we maintain risk of loss on our retained interest in such receivables. Sales and transfers that do not meet the criteria for surrender of control or were sold to a consolidated special purpose entity (non-qualified special purpose entity) under SFAS No. 140 are accounted for as secured borrowings.

When we sell receivables in securitizations of finance receivables or accounts receivable, we retain servicing rights, beneficial interests, and, in some cases, a cash reserve account, all of which are retained interests in the securitized receivables. The value assigned to the retained interests in securitized trade receivables is based on the relative fair values of the interest retained and sold in the securitization. We estimate fair value based on the present value of future

expected cash flows using management's best estimates of the key assumptions, consisting of receivable amounts, anticipated credit losses and discount rates commensurate with the risks involved.

Gains or losses on the sale of the receivables depend in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair value at the date of transfer.

**Provisions for Losses on Uncollectible Receivables.** The provisions for losses on uncollectible trade and finance receivables are determined principally on the basis of past collection experience applied to ongoing evaluations of our receivables and evaluations of the risks of repayment. Allowances for doubtful accounts on our accounts receivable balances at December 31, 2001 and 2000 amounted to \$306 and \$289, respectively.

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

**Land, Buildings and Equipment and Equipment on Operating Leases.** Land, buildings and equipment are recorded at cost. Buildings and equipment are depreciated over their estimated useful lives. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful life. Equipment on operating leases is depreciated to its estimated residual value over the term of the lease. Depreciation is computed using principally the straight-line method. Significant improvements are capitalized; maintenance and repairs are expensed. See Notes 7 and 8.

**Internal Use Software.** We capitalize direct costs incurred during the application development stage and the implementation stage for developing, purchasing or otherwise acquiring software for internal use. These costs are included in Intangible and other assets and are amortized over the estimated useful lives of the software, generally three to five years. All costs incurred during the preliminary project stage, including project scoping, identification and testing of alternatives, are expensed as incurred. See Note 8.

**Goodwill and Other Intangible Assets.** Goodwill represents the cost of acquired businesses in excess of the fair value of identifiable tangible and intangible net assets purchased, and is amortized on a straight-line basis over periods ranging from 5 to 40 years. Other intangible assets represent the fair value of identifiable intangible assets acquired in purchase business combinations and include an acquired customer base, distribution network, assembled workforce, technology and trademarks. Goodwill and other intangible assets are reported net of accumulated amortization. Total accumulated amortization at December 31, 2001 and 2000 was \$334 and \$253, respectively.

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

**Foreign Currency Translation.** The functional currency for most foreign operations is the local currency. Net assets are translated at current rates of exchange, and income, expense and cash flow items are translated at the average exchange rate for the year. The translation adjustments are recorded in Accumulated Other Comprehensive Income. The U.S. dollar is used as the functional currency for certain subsidiaries that conduct their business in U.S. dollars or operate in hyperinflationary economies. A combination of current and historical exchange rates is used in remeasuring the local currency transactions of these subsidiaries, and the resulting exchange adjustments are included in income. Aggregate foreign currency gains were \$29, \$103 and \$7 in 2001, 2000 and 1999, respectively, and are included in Other expenses, net in the Consolidated Statements of Operations. Effective January 1, 2002, we changed the functional currency of our Argentina operation from the U.S. dollar to the Peso as a result of operational changes made subsequent to the government's new economic plan.

## **Note 2 Restatement of 2000 and 1999 Financial Statements**

On April 11, 2002, we reached a settlement with the Securities and Exchange Commission (SEC) relating to matters that had been under investigation by the SEC since June 2000. In connection with the settlement, we agreed to restate



our financial statements as of and for the years ended December 31, 1997 through 2000 as well as undertake a review of our material internal controls and accounting policies. In addition, as a result of the re-audit of our 2000 and 1999 consolidated financial statements, additional adjustments were recorded. The restatement reflects adjustments which are corrections of errors made in the application of U.S. generally accepted accounting principles (GAAP) and includes (i) adjustments related to the application of the provisions of Statement of Financial Accounting Standards No. 13 Accounting for Leases (SFAS No. 13) and (ii) adjustments that arose as a result of other errors in the application of GAAP. The principal adjustments are discussed below.

#### **Application of SFAS No. 13**

*Revenue allocations in bundled arrangements:* We sell most of our products and services under bundled lease arrangements which contain multiple deliverable elements. These multiple element arrangements typically include separate equipment, service, supplies and financing components for which a customer pays a single fixed negotiated price on a monthly basis, as well as a variable amount for page volumes in excess of stated minimums. The restatement primarily reflects adjustments related to the allocation of revenue and the resultant timing of revenue recognition for sales-type leases under these bundled lease arrangements.

The methodology we used in prior years for allocating revenue to our sales-type leases involved first, estimating the fair market value of the service and financing components of the leases. Specifically, with respect to the financing component, we estimated the overall interest rate to be applied to transactions to be the rate we targeted to achieve a fair return on equity for our financing operations. This is effectively a discounted cash flow valuation methodology. In estimating this interest rate we considered a number of factors including our cost of funds, debt levels, return on equity, debt to equity ratios, income generated subsequent to the initial lease term, tax rates, and the financing business overhead costs. We made service revenue allocations based, primarily, on an analysis of our service gross margins. After deducting service and finance values from the minimum payments due under the lease, the equipment value was derived. These allocation procedures resulted in adjustments to values initially reflected in our accounting systems, such that values attributed to the service and financing components were generally decreased and the values assigned to the equipment components were generally increased.

We have determined that the allocation methodology used in prior years did not comply with SFAS No. 13, therefore, we have utilized a different methodology to account for our sales-type leases involving multiple element arrangements. This methodology begins by determining the fair value of the service component, as well as other executory costs and any profit thereon, and second, by determining the fair value of the equipment based on a comparison of the equipment values in our accounting system to a range of cash selling prices. The resultant implicit interest rate is then compared to fair market value rates to assess the reasonableness of the overall allocations to the multiple elements.

We conducted an extensive analysis of available verifiable objective evidence of fair value (VOE) based on cash sales prices and compared these prices to the range of equipment values recorded in our lease accounting systems. With the exception of Latin America, where operating lease accounting is applied as discussed below, the range of cash selling prices supports the reasonableness of the range of equipment lease prices as originally recorded, at the inception of the lease, in our accounting systems. In applying our new methodology described above, we have therefore concluded that the revenue amounts allocated by our accounting systems to the equipment component of a multiple element arrangement represents a reasonable estimate of the fair value of the equipment. As a consequence, \$541 and \$650 of previously recorded equipment sale revenue during the years ended December 31, 2000 and 1999, respectively, have been reversed and we have recognized additional service and finance income of \$463 and \$393, which represents the impact of reversing amounts previously recorded as equipment sales-type leases and recognizing such amounts over the lease term. The net cumulative reduction in revenue, as a result of this change, was \$335 for the two-year period ended December 31, 2000.

*Transactions not qualifying as sales-type leases:* We re-evaluated the application of SFAS No. 13 for leases originally accounted for as sales-type leases in our Latin American operations, and we determined that these leases should have been recorded as operating leases. This determination was made after we conducted an in-depth review of the historical effective lease terms compared to the contractual terms of our lease agreements. Since historically, and during all periods presented, a majority of leases were terminated significantly prior to the expiration of the contractual lease term, we concluded that such leases did not qualify as sales-type leases under certain provisions of SFAS No. 13. Specifically, because we generally do not collect the receivable from the initial transaction, upon termination of the

contract or during the subsequent lease term, the recoverability of the lease investment was not predictable at the inception of the original lease term. As a consequence, \$459 and \$300 of previously recorded equipment sale revenue during the years ended December 31, 2000 and 1999, respectively, have been reversed and we have recognized additional rental revenue of \$401 and \$357, which represents the impact of changing the classification of previously recorded sales-type leases to operating leases. The net cumulative reduction in revenue, as a result of this change, was \$1 for the two-year period ended December 31, 2000.

During the course of the restatement process, we concluded that the estimated economic life used for classifying leases for the majority of our products should have been five years versus the three to four years we previously utilized. This resulted from an in-depth review of our lease portfolios, for all periods presented, which indicated that the most frequent term of our lease contracts was 60 months. We believe that this has been and is representative of the period during which the equipment is expected to be economically usable, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease. As a consequence, many shorter duration leases did not meet the criteria of SFAS No. 13 to be accounted for as sales-type leases. Additionally, other lease arrangements were found to not meet other requirements of SFAS No. 13 for treatment as sales-type leases. As a consequence \$74 and \$160 of equipment revenue recorded during the two years ended December 31, 2000 and 1999, respectively, have been reversed and we have recognized additional rental revenue of \$131 and \$100, which represents the impact of changing the classification of previously recorded sales-type leases to operating leases. The net cumulative reduction in revenue, as a result of this change was \$3 for the two-year period ended December 31, 2000.

*Accounting for the sale of equipment subject to operating leases:* We have historically sold pools of equipment subject to operating leases to third party finance companies (the counterparty) or through structured financings with third parties and recorded the transaction as a sale at the time the equipment is accepted by the counterparty. These transactions increased equipment sale revenue, primarily in Latin America, in 2000 and 1999 by \$148 and \$400, respectively. Upon additional review of the terms and conditions of these contracts, it was determined that the form of the transactions at inception included retained ownership risk provisions or other contingencies that precluded these transactions from meeting the criteria for sale treatment under the provisions of SFAS No. 13. The form of these transactions notwithstanding, these risk of loss or contingency provisions have resulted in only minor impacts on our operating results. These transactions have however been restated and recorded as operating leases in our consolidated financial statements. As a consequence \$111 and \$342 of equipment revenue recorded during the years ended December 31, 2000 and 1999, respectively, have been reversed and we have recognized additional rental revenue of \$235 and \$99, which represents the impact of changing the classification of previously recorded sales-type leases to operating leases. The net cumulative reduction in revenue, as a result of this change was \$119 for the two-year period ended December 31, 2000. Additionally, for transactions in which cash proceeds were received up-front we have recorded these proceeds as secured borrowings. The remaining balance of these borrowings aggregated \$55 and \$123 at December 31, 2001 and 2000, respectively.

#### **Other adjustments**

In addition to the aforementioned revenue related adjustments, other errors in the application of GAAP were identified. These include the following:

*Sales of receivables transactions:* During 1999, we sold \$1,395 of U.S. finance receivables originating from sales-type leases. These transactions were accounted for as sales of receivables. These sales were made to special purpose entities (SPEs), which qualified for non-consolidation in accordance with then existing accounting requirements. As a result of the changes in the estimated economic life of our equipment to five years, certain leases transferred in these transactions did not meet the sales-type lease requirements and were accounted for as operating leases. This change in lease classification affected a number of the leases that were sold into the aforementioned SPEs resulting in these entities now holding operating leases as assets. This change disqualified the SPEs from non-consolidation and effectively required us to record the proceeds received on these sales as secured borrowings. This increased our net finance receivables by \$367 and debt by \$418 as of December 31, 2000. The debt balance remaining was \$94 at December 31, 2001. These transactions are also discussed in Note 6 to the Consolidated Financial Statements.

During 1999, we sold \$288 of accounts receivables, to financial institutions. Upon additional review of the terms and conditions of these transactions, we determined that \$57 (including \$14 which was restated in connection with the prior restatement of our financial statements) did not qualify for sale treatment as a result of our agreeing to reacquire the

receivables in 2000. Accordingly, we have restated our previously reported results for these transactions and they are now reported in our Consolidated Financial Statements as short-term borrowings. This change increased Accounts receivable, net and debt by \$57 as of December 31, 1999; the transaction was settled in early 2000. No similar transactions have occurred since 1999.

*South Africa deconsolidation:* We determined that we inappropriately consolidated our South African affiliate since 1998 as the minority joint venture partner has substantive participating rights. Accordingly, we have deconsolidated all assets, liabilities, revenues and expenses. We now account for this investment on the equity method of accounting. The reduction in revenues was \$72 and \$71 for the years ended December 31, 2000 and 1999, respectively, and there was no impact on net income or common shareholders equity.

*Purchase accounting reserves:* In connection with the 1998 acquisition of XL Connect Solutions, Inc. (XLConnect), we recorded liabilities aggregating \$65 for contingencies identified at the date of the acquisition. During 2000 and 1999, we determined that certain of these contingent liabilities were no longer required, and \$29 of the liabilities were either reversed into income or we charged certain costs related to ongoing activities of the acquired business against these liabilities. Upon additional review it was subsequently determined that approximately \$51 of these contingent liabilities did not meet the criteria to initially be recorded as acquisition liabilities. Accordingly, we have adjusted the goodwill and liabilities at the date of acquisition and corrected the 2000 and 1999 income statement impacts.

*Restructuring reserves:* During 2000 and 1998, we recorded restructuring charges associated with our decisions to exit certain activities of the business. Upon additional review we determined that certain adjustments made to the original charges were not in accordance with GAAP. The adjustments to decrease pre-tax loss in 2000 of \$65 consist primarily of corrections to the timing of the release of reserves originally recorded under the March 2000 restructuring program. We should have reversed the applicable reserves in late 2000 when the information was available that our original plan had changed indicating that such reserves were no longer necessary. Previously, the reversal was recorded in early 2001. Similarly, the adjustment of \$12 to decrease 1999 pre-tax income relates primarily to the inappropriate release of restructuring reserves which should have been recorded in 1998 based on information available at the time.

*Tax refunds:* In 1995, we received a final favorable court decision that entitled us to refunds of certain tax amounts paid in the U.S., plus accrued interest on the tax. The court established the legal precedent upon which the refunds were to be based. We recorded the income associated with the tax refund and the related interest from 1995 through 1999. We determined that the benefit should have been recorded in periods prior to 1997. These adjustments decreased pre-tax income by \$14 for the year ended December 31, 1999.

*Other adjustments:* In addition to the above items and in connection with our review of prior year's financial records we determined that other accounting errors were made with respect to the accounting for certain non-recurring transactions, the timing of recording and reversing certain liabilities and the timing of recording certain asset write-offs. We have restated our 2000 and 1999 Consolidated Financial Statements for such items. These adjustments increased pre-tax loss by \$89 for the year ended December 31, 2000 and decreased pre-tax income by \$131 for the year ended December 31, 1999.

**The following table presents the effects of the aforementioned adjustments on total revenue:**

**Increase (decrease) to total revenue:**

	<u>Year ended December 31,</u>	
	<u>2000</u>	<u>1999</u>
Revenue, previously reported	\$ 18,701	\$ 19,567
Application of SFAS No. 13:		
Revenue allocations in bundled arrangements	(78)	(257)
Latin America operating lease accounting	(58)	57
Other transactions not qualifying as sales-type leases	57	(60)
Sales of equipment subject to operating leases	124	(243)
Subtotal	45	(503)
Other revenue restatement adjustments:		
Sales of receivables transactions	61	(6)

South Africa deconsolidation	(72)	(71)
Other revenue items, net	16	8
	<u>          </u>	<u>          </u>
Subtotal	5	(69)
Increase (decrease) in total revenue	50	(572)
	<u>          </u>	<u>          </u>
Revenue, restated	\$ 18,751	\$ 18,995
	<u>          </u>	<u>          </u>

The following table presents the effects of the aforementioned adjustments on pre-tax income (loss):

**Increase (decrease) to pre-tax (loss) income:**

	<b>Year ended December 31,</b>	
	<b>2000</b>	<b>1999</b>
Pre-tax (loss) income, previously reported	\$ (384)	\$ 1,908
Revenue restatement adjustments:		
Revenue allocations in bundled arrangements	(74)	(252)
Latin America operating lease accounting	80	39
Other transactions not qualifying as sales-type leases	12	(50)
Sales of equipment subject to operating leases	11	(162)
Sales of receivables transactions	18	(32)
South Africa deconsolidation	(11)	(8)
Other revenue items, net	12	22
<b>Subtotal</b>	<b>48</b>	<b>(443)</b>
Other restatement adjustments:		
Purchase accounting reserves	(7)	(20)
Restructuring reserves	65	(12)
Tax refunds		(14)
Other, net	(89)	(131)
<b>Subtotal</b>	<b>(31)</b>	<b>(177)</b>
Increase (decrease) in pre-tax (loss) income	17	(620)
<b>Pre-tax (loss) income, restated</b>	<b>\$ (367)</b>	<b>\$ 1,288</b>

These adjustments resulted in a cumulative net reduction of Common Shareholders' Equity of \$1,692 as of December 31, 2000. The following table presents the impact of the restatement adjustments on Common Shareholders' Equity as of January 1, 1999:

Increase (decrease) in Common Shareholders' Equity:	
Common Shareholders' Equity balance, January 1, 1999, previously reported	\$ 4,633
Revenue allocations in bundled arrangements	(589)
Latin America operating lease accounting	(1,836)
Other transactions not qualifying as sales-type leases	(166)
Sales of equipment subject to operating leases	(66)
Other items, net	216
Income tax impacts of above adjustments	834
<b>Decrease in Common Shareholders' Equity</b>	<b>(1,607)</b>
<b>Common Shareholders' Equity balance, January 1, 1999, restated</b>	<b>\$ 3,026</b>

The following tables present the impact of the restatements on a condensed basis:

	<u>As Previously Reported</u>	<u>As Restated</u>
Year ended December 31, 2000		
<b>Statement of operations:</b>		
Total Revenues	\$ 18,701	\$ 18,751
Sales	10,059	8,839
Service, outsourcing and rentals	7,718	8,750
Finance income	924	1,162
Total Costs and Expenses	19,085	19,118
Net loss	(257)	(273)
Basic loss per share	\$ (0.44)	\$ (0.48)
Diluted loss per share	\$ (0.44)	\$ (0.48)
<b>Balance Sheet:</b>		
Accounts receivable, net	\$ 2,281	\$ 2,269
Current finance receivables, net	5,097	4,392
Inventories	1,932	1,983
Deferred taxes and other current assets	1,247	1,078
Total Current Assets	12,298	11,472
Finance receivables due after one year, net	7,957	6,406
Equipment on operating leases, net	724	1,266
Land, buildings and equipment, net	2,495	2,527
Investments in affiliates, at equity	1,362	1,270
Intangible and other assets, net	3,061	3,763
Goodwill, net	1,578	1,549
Total Assets	29,475	28,253
Short-term debt and current portion of long-term debt	2,693	3,080
Accounts payable	1,033	1,050
Accrued compensation and benefit costs	662	645
Unearned income	250	233
Other current liabilities	1,630	1,536
Total Current Liabilities	6,268	6,544
Long-term debt	15,404	15,557
Deferred taxes and other liabilities	1,876	1,925
Total Liabilities	24,745	25,223
Common Shareholders' Equity	3,493	1,801
Total Liabilities and Equity	\$ 29,475	\$ 28,253

	As Previously Reported	As Restated
Year ended December 31, 1999		
<b>Statement of operations:</b>		
Total Revenues	\$ 19,567	\$ 18,995
Sales	10,441	8,967
Service, outsourcing and rentals	8,045	8,853
Finance income	1,081	1,175
Total Costs and Expenses	17,659	17,707
Net income	1,339	844
Basic earnings per share	\$ 1.96	\$ 1.20
Diluted earnings per share	\$ 1.85	\$ 1.17

**Note 3 Restructuring Programs**

Since early 2000, we have engaged in several restructuring programs, as we have responded to economic weakness, as well as company-specific challenges, including the poor execution of a major sales force realignment, the disruptive consolidation of our U.S. customer administrative centers and increased competition. We engaged in a series of plans related to resizing our employee base, exiting certain businesses, outsourcing some internal functions and engaging in other actions designed to reduce our cost structure.

We accomplished these objectives through the undertaking of three separate restructuring initiatives as follows:

**RESTRUCTURING ACTION**

Turnaround Program  
SOHO Disengagement  
March 2000 Restructuring

**INITIATION OF PLAN**

October 2000  
June 2001  
March 2000

These actions were in addition to a worldwide restructuring program we initiated in 1998. The execution of the actions and payments of obligations continued through December 31, 2001, with each plan initiative in various stages of completion. As management continues to evaluate the business, there may be supplemental charges for new plan initiatives as well as changes in estimates to amounts previously recorded as payments are made or actions are completed. Asset impairment charges were incurred in connection with these restructuring actions for those assets made obsolete or redundant as a result of the plans. The details of the restructuring actions are explained below.

**Turnaround Program.** As noted above, beginning in October 2000, we engaged in a series of actions to reduce costs, improve operations, transition customer equipment financing to third-party vendors and sell certain assets that we believe will positively affect our capital resources and liquidity position when completed.

As an initial step in this program, in the fourth quarter 2000, we provided \$105, consisting of \$71 for severance and related costs and \$34 for asset impairments associated with the disposition of a non-core business. Over half of these charges related to our Production segment, with the remainder relating to our Office, DMO and Other segments. During 2001, we provided \$403 of restructuring costs, net of reversals of \$26. The reversals related to the change of certain initiatives. Of the amounts provided, \$339 was for severance and other employee separation costs (including \$21 for pension curtailment charges), \$28 was for asset impairments and \$36 was for lease cancellation and other exit costs. The majority of these charges relate to our Production and Office segments. The aggregate 2001 and 2000 severance and other employee separation costs are related to the elimination of approximately 7,800 positions worldwide reflecting continued streamlining of existing work processes, elimination of redundant resources and the consolidation of activities into other existing operations. By December 31, 2001, approximately 5,900 employees had left the Company under the Turnaround Program. The lease cancellation and other exit costs and asset impairments related primarily to manufacturing operations. Included in 2001 restructuring charges are \$24, primarily for severance and other employee separation costs, related to the outsourcing of certain Office segment manufacturing to Flextronics, as discussed further in Note 5. The Turnaround Program reserve balance at December 31, 2001 was \$223. The remaining balance primarily relates to severance costs and is expected to be substantially utilized in 2002.

As discussed in Note 5, we have completed several divestitures and the outsourcing of some of our manufacturing operations in 2001. In addition, we have actively engaged in our plan to transition customer financing to third parties, as described in Note 6.

**SOHO Disengagement.** In 2001, we began a separate restructuring program associated with the disengagement from our worldwide small office/home office (SOHO) business. In connection with exiting this business, we recorded a pretax charge of \$239, net of reversals. Reversals of \$26 were primarily related to a higher than anticipated number of employees redeployed and better than expected experience on certain contract terminations. The charge included provisions for the elimination of approximately 1,200 jobs worldwide by the end of 2001, the closing of facilities and the write-down of certain assets to net realizable value. The restructuring provision associated with this action included \$164 for asset impairments, \$49 for lease cancellation, purchase decommitments and other exit costs, and \$26 for severance and employee separation costs. An additional provision of \$34 related to excess inventory was recorded as a charge to Cost of sales. As of December 31, 2001, approximately 800 employees had left the Company under the SOHO disengagement program. The SOHO disengagement reserve balance at December 31, 2001 was \$23. The remaining balance primarily relates to severance costs and is expected to be substantially utilized in 2002.

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

**March 2000 Restructuring.** In March 2000, we announced details of a worldwide restructuring program and recorded pre-tax provisions and charges of \$489 which included severance and employee separation costs of \$424, asset impairments of \$30 and other exit costs of \$35. An additional provision of \$84 related to excess inventory primarily resulting from the planned consolidation of certain warehousing operations was recorded as a charge to Cost of sales. The severance related to the elimination of 5,200 positions worldwide. Approximately 65 percent, 20 percent and 15 percent of the positions related to the U.S., Europe, and Latin America, respectively. In late 2000, as a result of weakening business conditions and poor operating results, we reevaluated the remaining plan. After considering the delays in the consolidation and outsourcing of certain of our warehousing and logistics operations and the cancellation of certain European initiatives no longer necessary as a result of higher than expected attrition, we determined that adjustments to the remaining reserve were necessary. As such, and in connection with the Turnaround Program discussed above, \$71 of the original \$489 provision was reversed in the fourth quarter 2000. The amount reversed consisted of \$59 related to severance costs associated with 1,000 positions and \$12 related to other exit costs. During 2001, we recorded additional provisions of \$70 for instances when the actual cost of certain initiatives exceeded the amount estimated at the time of the original charge. We also recorded reversals of \$17 associated with the delay or the cancellation of certain initiatives, primarily in service and manufacturing. As of December 31, 2001, the March 2000 restructuring program has been substantially completed.

**1998 Restructuring.** In 1998, we announced a worldwide restructuring program and recorded a pre-tax provision of \$1,393. During 2001, we recorded additional provisions for changes in estimates of \$15 and reversals of \$8, primarily as a result of changes in certain manufacturing initiatives. Cash charges against the reserve during 1999 were \$366 for severance and related costs and \$54 for lease cancellation and other costs. Also, during 1999 we provided an additional provision of \$12, net of reversals, related to changes in estimates. As of December 31, 2001, the 1998 Restructuring program has been substantially completed.



The following table summarizes the activity in the restructuring reserves for the two years ended December 31, 2001:

	1999 Balance	Provision	Reversal	Charges	2000 Balance	Provision	Reversals	Charges	2001 Balance
<b>Turnaround Program:</b>									
Severance and related costs	\$	\$ 71	\$	\$	\$ 71	\$ 364	\$ (25)	\$ (211)	\$ 199
Lease cancellation and other costs						37	(1)	(4)	32
Subtotal		71			71	401	(26)	(215)	231
Currency changes								(8)	(8)
Total		71			71	401	(26)	(223)	223
<b>SOHO Disengagement:</b>									
Severance and related costs						37	(11)	(12)	14
Lease cancellation and other costs						64	(15)	(39)	10
Subtotal						101	(26)	(51)	24
Currency changes									