XEROX CORP
Form 10-Q
October 31, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2012

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number 001-04471

XEROX CORPORATION
(Exact Name of Registrant as specified in its charter)

New York (State or other jurisdiction of incorporation or organization)	16-0468020 (IRS Employer Identification No.)
P.O. Box 4505, 45 Glover Avenue Norwalk, Connecticut	06856-4505
(Address of principal executive offices)	(Zip Code)

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

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by a check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer o Non-accelerated filer o Smaller reporting company o

Indicate by a check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

Class	Outstanding at September 30, 2012
Common Stock, $1 par value	1,272,546,910 shares

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q and any exhibits to this Report may contain "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. The words “anticipate,” “believe,” “estimate,” “expect,” “intend,” “will,” “should” and similar expressions, as they relate to us, are intended to identify forward-looking statements. These statements reflect management’s current beliefs, assumptions and expectations and are subject to a number of factors that may cause actual results to differ materially. These factors include but are not limited to: changes in economic conditions, political conditions, trade protection measures, licensing requirements, environmental regulations and tax matters in the United States and in the foreign countries in which we do business; changes in foreign currency exchange rates; actions of competitors; our ability to obtain adequate pricing for our products and services and to maintain and improve cost efficiency of operations, including savings from restructuring actions; the risk that unexpected costs will be incurred; our ability to expand equipment placements; the risk that subcontractors, software vendors and utility and network providers will not perform in a timely, quality manner; the risk that individually identifiable information of customers, clients and employees could be inadvertently disclosed or disclosed as a result of a breach of our security; our ability to recover capital investments; development of new products and services; our ability to protect our intellectual property rights; interest rates, cost of borrowing and access to credit markets; the risk that multi-year contracts with governmental entities could be terminated prior to the end of the contract term; reliance on third parties for manufacturing of products and provision of services; our ability to drive the expanded use of color in printing and copying; the outcome of litigation and regulatory proceedings to which we may be a party; and other risks that are set forth in the “Risk Factors” section, the “Legal Proceedings” section, the “Management’s Discussion and Analysis of Financial Condition and Results of Operations” section and other sections of this Quarterly Report on Form 10-Q, our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2012 and June 30, 2012 and our 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”). The Company assumes no obligation to update any forward-looking statements as a result of new information or future events or developments, except as required by law.

XEROX CORPORATION
FORM 10-Q
September 30, 2012
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For additional information about Xerox Corporation and access to our Annual Reports to Shareholders and SEC filings, free of charge, please visit our website at www.xerox.com/investor. Any information on or linked from the website is not incorporated by reference into this Form 10-Q.

PART I — FINANCIAL INFORMATION
ITEM 1 — FINANCIAL STATEMENTS

XEROX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions, except per-share data)	2012	2011	2012	2011
Revenues				
Sales	$1,537	$1,738	$4,760	$5,129
Outsourcing, service and rentals	3,727	3,689	11,257	11,052
Finance income	159	156	450	481
Total Revenues	5,423	5,583	16,467	16,662
Costs and Expenses				
Cost of sales	1,026	1,154	3,170	3,383
Cost of outsourcing, service and rentals	2,668	2,545	7,983	7,597
Equipment financing interest	49	56	153	176
Research, development and engineering expenses	161	183	495	542
Selling, administrative and general expenses	1,050	1,109	3,194	3,347
Restructuring and asset impairment charges	14	(4)	60	(28)
Amortization of intangible assets	82	87	246	259
Other expenses, net	56	86	185	268
Total Costs and Expenses	5,106	5,216	15,486	15,544
Income before Income Taxes and Equity Income	317	367	981	1,118
Income tax expense	63	81	206	284
Equity in net income of unconsolidated affiliates	34	43	105	111
Net Income	288	329	880	945
Less: Net income attributable to noncontrolling interests	6	9	20	25
Net Income Attributable to Xerox	$282	$320	$860	$920
Basic Earnings per Share	$0.21	$0.23	$0.64	$0.65
Diluted Earnings per Share	$0.21	$0.22	$0.62	$0.63

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

XEROX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2012	2011	2012	2011
Net Income	$288	$329	$880	$945
Less: Net income attributable to noncontrolling interests	6	9	20	25
Net Income Attributable to Xerox	$282	$320	$860	$920
Other Comprehensive Income (Loss)[1]:				
Translation adjustments, net	$344	$(383)	$181	$67
Unrealized (losses) gains, net	(2)	28	(11)	13
Changes in defined benefit plans, net	(10)	44	—	22
Other Comprehensive Income (Loss) Attributable to Xerox	$332	$(311)	$170	$102
Comprehensive Income, net	$620	$18	$1,050	$1,047
Less: Comprehensive income attributable to noncontrolling interests	6	9	20	25
Comprehensive Income Attributable to Xerox	$614	$9	$1,030	$1,022

(1) Refer to Note 14 - Comprehensive Income for gross components of comprehensive income, reclassification adjustments out of accumulated other comprehensive income and related tax effects.

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

XEROX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(in millions, except share data in thousands)	September 30, 2012	December 31, 2011
Assets		
Cash and cash equivalents	$882	$902
Accounts receivable, net	3,190	2,600
Billed portion of finance receivables, net	187	166
Finance receivables, net	1,877	2,165
Inventories	1,128	1,021
Other current assets	1,122	1,058
Total current assets	8,386	7,912
Finance receivables due after one year, net	3,591	4,031
Equipment on operating leases, net	526	533
Land, buildings and equipment, net	1,566	1,612
Investments in affiliates, at equity	1,442	1,395
Intangible assets, net	2,857	3,042
Goodwill	9,042	8,803
Deferred tax assets, long-term	454	672
Other long-term assets	2,375	2,116
Total Assets	$30,239	$30,116
Liabilities and Equity		
Short-term debt and current portion of long-term debt	$1,893	$1,545
Accounts payable	1,591	2,016
Accrued compensation and benefits costs	795	757
Unearned income	446	432
Other current liabilities	1,488	1,631
Total current liabilities	6,213	6,381
Long-term debt	7,458	7,088
Pension and other benefit liabilities	2,206	2,487
Post-retirement medical benefits	879	925
Other long-term liabilities	768	861
Total Liabilities	17,524	17,742
Series A Convertible Preferred Stock	349	349
Common stock	1,322	1,353
Additional paid-in capital	6,095	6,317
Treasury stock, at cost	(361)	(124)
Retained earnings	7,716	7,046
Accumulated other comprehensive loss	(2,546)	(2,716)
Xerox shareholders’ equity	12,226	11,876
Noncontrolling interests	140	149
Total Equity	12,366	12,025
Total Liabilities and Equity	$30,239	$30,116
Shares of common stock issued	1,322,428	1,352,849
Treasury stock	(49,881)	(15,508)
Shares of common stock outstanding	1,272,547	1,337,341

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

XEROX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in millions)	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Cash Flows from Operating Activities:				
Net income	$288	$329	$880	$945
Adjustments required to reconcile net income to cash flows from operating activities:				
Depreciation and amortization	339	301	965	890
Provision for receivables	23	45	83	99
Provision for inventory	9	13	26	32
Net loss (gain) on sales of businesses and assets	5	—	2	(8)
Undistributed equity in net income of unconsolidated affiliates	(32)	(43)	(67)	(83)
Stock-based compensation	30	29	92	92
Restructuring and asset impairment charges	14	(4)	60	(28)
Payments for restructurings	(30)	(42)	(113)	(162)
Contributions to defined benefit pension plans	(73)	(225)	(310)	(348)
Increase in accounts receivable and billed portion of finance receivables	(413)	(262)	(1,021)	(548)
Collections of deferred proceeds from sales of receivables	94	105	350	287
Increase in inventories	(44)	(141)	(128)	(278)
Increase in equipment on operating leases	(65)	(76)	(200)	(205)
Decrease in finance receivables	412	74	687	234
Increase in other current and long-term assets	(34)	(61)	(196)	(184)
Increase (decrease) in accounts payable and accrued compensation	7	181	(230)	(197)
Increase (decrease) in other current and long-term liabilities	36	78	(126)	(97)
Net change in income tax assets and liabilities	32	52	93	220
Net change in derivative assets and liabilities	7	19	(2)	43
Other operating, net	(11)	(6)	(38)	(21)
Net cash provided by operating activities	594	366	807	683
Cash Flows from Investing Activities:				
Cost of additions to land, buildings and equipment	(110)	(80)	(283)	(245)
Proceeds from sales of land, buildings and equipment	1	5	8	9
Cost of additions to internal use software	(30)	(41)	(100)	(122)
Acquisitions, net of cash acquired	(156)	(51)	(243)	(188)
Net change in escrow and other restricted investments	6	(1)	14	(9)
Other investing, net	—	1	3	20
Net cash used in investing activities	(289)	(167)	(601)	(535)
Cash Flows from Financing Activities:				
Net proceeds (payments) on debt	199	(101)	742	602

Payment of liability to subsidiary trust issuing preferred securities	—	—	—	(670)
Common stock dividends	(63)	(63)	(177)	(182)
Preferred stock dividends	(6)	(6)	(18)	(18)
Proceeds from issuances of common stock	33	10	43	41
Excess tax benefits from stock-based compensation	10	1	10	5
Payments to acquire treasury stock, including fees	(361)	(309)	(718)	(309)
Repurchases related to stock-based compensation	(40)	(21)	(41)	(27)
Distributions to noncontrolling interests	(2)	(3)	(63)	(15)
Net cash used in financing activities	(230)	(492)	(222)	(573)
Effect of exchange rate changes on cash and cash equivalents	(7)	(20)	(4)	(1)
Increase (decrease) in cash and cash equivalents	68	(313)	(20)	(426)
Cash and cash equivalents at beginning of period	814	1,098	902	1,211
Cash and Cash Equivalents at End of Period	$882	$785	$882	$785

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

XEROX CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in millions, except per-share data and where otherwise noted)

Note 1 – Basis of Presentation
References herein to “we,” “us,” “our,” the “Company” and “Xerox” refer to Xerox Corporation and its consolidated subsidiari unless the context specifically requires otherwise.
We have prepared the accompanying unaudited Condensed Consolidated Financial Statements in accordance with the accounting policies described in our 2011 Annual Report to Shareholders, which is incorporated by reference in our 2011 Annual Report on Form 10-K (“2011 Annual Report”), and the interim reporting requirements of Form 10-Q. Accordingly, certain information and note disclosures normally included in our annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. You should read these Condensed Consolidated Financial Statements in conjunction with the Consolidated Financial Statements included in our 2011 Annual Report.
In our opinion, all adjustments which are necessary for a fair statement of financial position, operating results and cash flows for the interim periods presented have been made. These adjustments consist of normal recurring items. Interim results of operations are not necessarily indicative of the results of the full year.
For convenience and ease of reference, we refer to the financial statement caption “Income before Income Taxes and Equity Income” as “pre-tax income.”

Note 2 – Recent Accounting Pronouncements
Fair Value Accounting: In May 2011, the FASB issued ASU 2011-04, which amended Fair Value Measurements and Disclosures - Overall (ASC Topic 820-10) to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are consistent between U.S. GAAP and International Financial Reporting Standards. This update changed certain fair value measurement principles and enhanced the disclosure requirements, particularly for level 3 fair value measurements. We adopted this update prospectively effective for our fiscal year beginning January 1, 2012. This update did not have a material effect on our financial condition, results of operations or disclosures.
Balance Sheet Offsetting: In December 2011, the FASB issued ASU 2011-11, Balance Sheet (Topic 210), Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the Balance Sheet and instruments and transactions subject to an agreement similar to a master netting arrangement to enable users of their financial statements to understand the effects of offsetting and related arrangements on their financial position. This update is effective for our fiscal year beginning January 1, 2013 and must be applied retrospectively. The principal impact from this update will be to expand disclosures regarding our financial instruments. We currently report our derivative assets and liabilities on a gross basis in the Balance Sheet even in those instances where offsetting may be allowed under a master netting agreement.

Note 3 – Segment Reporting
Our reportable segments are aligned with how we manage the business and view the markets we serve. We report our financial performance based on the following two primary reportable segments – Services and Technology. Our Services segment operations involve delivery of a broad range of services including business process, document and IT outsourcing. Our Technology segment includes the sale and support of a broad range of document systems from entry level to high-end.
The Services segment is comprised of three outsourcing service offerings:

- Business Process Outsourcing ("BPO")
- Document Outsourcing (which includes Managed Print Services) ("DO")
- Information Technology Outsourcing ("ITO")

Business process outsourcing services include service arrangements where we manage a customer's business activity or process. Document outsourcing services include service arrangements that allow customers to streamline, simplify and digitize document-intensive business processes through automation and deployment of software applications and tools and the management of their printing needs. Document outsourcing services also include revenues from our partner print services offerings. Information technology outsourcing services include service arrangements where we manage a customer's IT-related activities, such as application management and application development, data center operations or testing and quality assurance.

Our Technology segment is centered on strategic product groups, which share common technology, manufacturing and product platforms. This segment includes the sale of document systems and supplies, technical services and product financing. Our products range from:

- "Entry," which includes A4 devices and desktop printers; to
- "Mid-range," which includes A3 devices that generally serve workgroup environments in midsize to large enterprises and includes products that fall into the following market categories: Color 41+ ppm priced at less than $100K and Light Production 91+ ppm priced at less than $100K; to
- "High-end," which includes production printing and publishing systems that generally serve the graphic communications marketplace and large enterprises.

The segment classified as Other includes several units, none of which meet the thresholds for separate segment reporting. This group primarily includes Global Paper and Supplies Distribution Group (predominantly paper sales), licensing revenues, GIS network integration solutions and electronic presentation systems and non-allocated Corporate items including non-financing interest, as well as other items included in Other expenses, net.

Operating segment revenues and profitability were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	Segment Revenue	Segment Profit (Loss)	Segment Revenue	Segment Profit (Loss)
2012				
Services	$2,847	$ 269	$8,474	$ 830
Technology	2,259	245	6,967	758
Other	317	(62)	1,026	(182)
Total	$5,423	$ 452	$16,467	$ 1,406
2011				
Services	$2,717	$ 323	$7,973	$ 911
Technology	2,500	258	7,547	824
Other	366	(86)	1,142	(225)
Total	$5,583	$ 495	$16,662	$ 1,510

	Three Months Ended September 30,		Nine Months Ended September 30,	
Reconciliation to Pre-tax Income	2012	2011	2012	2011
Segment Profit	$452	$495	$1,406	$1,510
Reconciling items:				
Restructuring and asset impairment charges	(14)	4	(60)	28
Restructuring charges of Fuji Xerox	(5)	(1)	(15)	(16)
Amortization of intangible assets	(82)	(87)	(246)	(259)
	(34)	(43)	(105)	(111)

Equity in net income of unconsolidated affiliates				
Loss on early extinguishment of liability	—	—	—	(33)
Other	—	(1)	1	(1)
Pre-tax Income	$317	$367	$981	$1,118

Note 4 – Acquisitions

In July 2012, we acquired the following companies:

- Wireless Data Services, Ltd. ("WDS"), a provider of technical support, knowledge management and related consulting services to the world's largest wireless telecommunication brands, for approximately $95 (£60 million). Based in the U.K., WDS's expertise in the telecommunications industry strengthens our broad portfolio of customer care solutions.
- Lateral Data, LP., a leading e-discovery technology provider, for approximately $30. Lateral Data's flagship software, Viewpoint™, brings simplicity and affordability to e-discovery and complements the offerings of Xerox Litigation Services.
- Martin Whalen Office Solutions, Inc., a leading provider of office technology and software solutions, for approximately $31. This acquisition further expands our distribution in Illinois and supports our strategy to create a nationwide network of locally based companies focused on customer needs.

In February 2012, we acquired R.K. Dixon, a leading provider of IT services, copiers, printers and managed print services, for approximately $58. The acquisition furthers our coverage of central Illinois and eastern Iowa.

WDS and Lateral Data are included in our Services segment while the acquisitions of Martin Whalen Office Solutions and R.K. Dixon are included within our Technology segment. Our Services segment acquired two additional businesses during the nine months ended September 30, 2012 for a total of $29 in cash.

The operating results of the 2012 acquisitions are not material to our financial statements and are included within our results from the respective acquisition dates. The purchase prices were primarily allocated to intangible assets and goodwill based on third-party valuations and management's estimates.

Note 5 – Receivables, Net

Accounts Receivable Sales Arrangements

Accounts receivable sales arrangements are utilized in the normal course of business as part of our cash and liquidity management. We have facilities in the U.S., Canada and several countries in Europe that enable us to sell certain accounts receivable without recourse to third-parties on a periodic basis. The accounts receivables sold are generally short-term trade receivables with payment due dates of less than 60 days.

During 2012, we entered into an additional facility in the U.S. that enabled us to sell a designated pool of receivables on a revolving basis to a wholly-owned consolidated bankruptcy-remote limited purpose subsidiary, which in turn sold such receivables to third-party commercial paper conduit purchasers (collectively, the "Purchasers") for cash and a deferred purchase price receivable. The Purchasers' maximum cash investment in the receivables at any time was $265 and new receivables were purchased from cash collections on previously sold receivables. In September 2012, we negotiated a termination agreement with the Purchasers to repurchase the then outstanding receivables for cash and the satisfaction of the deferred purchase price. During the third quarter 2012, we had total cash outflows to the Purchasers of approximately $215, which reflects interim settlements as well as the repurchase of the remaining outstanding receivables upon termination. There were no outstanding balances associated with this facility as of September 30, 2012.

All of our arrangements involve the sale of our entire interest in groups of accounts receivables for cash. In most instances a portion of the sales proceeds are held back by the purchaser and payment is deferred until collection of the related receivables sold. Such holdbacks are not considered legal securities nor are they certificated. We report collections on such receivables as operating cash flows in the Condensed Consolidated Statements of Cash Flows because such receivables are the result of an operating activity and the associated interest rate risk is de minimis due

to its short-term nature. Our risk of loss following the sales of accounts receivable is limited to the outstanding deferred purchase price receivable. These receivables are included in the caption “Other current assets” in the accompanying Condensed Consolidated Balance Sheets and were $124 and $97 at September 30, 2012 and December 31, 2011, respectively.
Under most of the arrangements, we continue to service the sold accounts receivable. When applicable, a servicing liability is recorded for the estimated fair value of the servicing. The amounts associated with the servicing liability were not material.

Of the accounts receivable sold and derecognized from our balance sheet, $678 and $815 remained uncollected as of September 30, 2012 and December 31, 2011, respectively. Accounts receivables sales were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Accounts receivable sales	$725	$754	$2,816	$2,303
Deferred proceeds	122	93	525	290
Fees associated with sales	4	5	16	14
Estimated decrease to operating cash flows(1)	(266)	(35)	(168)	(29)

(1) Represents the difference between current and prior period receivable sales adjusted for the effects of: (i) the deferred proceeds, (ii) collections prior to the end of the quarter and (iii) currency. The three months ended September 30, 2012 includes cash outflows related to our U.S. revolving facility of $215.

Sale of Finance Receivables

In September 2012, we sold our entire interest in a group of U.S. lease finance receivables from our Technology segment with a net carrying value of $341 to a third-party financial institution for cash proceeds of $314 and a beneficial interest from the purchaser of $52. The lease contracts, including associated service and supply elements, were initially sold to a wholly-owned consolidated bankruptcy-remote limited purpose subsidiary, which in turn sold the principal and interest portions of such contracts to the third-party financial institution (the "ultimate purchaser"). As of September 30, 2012, the principal value of the receivables sold and derecognized from our balance sheet was $350. A pre-tax gain of $23 was recognized on this sale and is net of fees and expenses of approximately $2. The gain on the sale is reported in Finance Income within our Technology segment. We will continue to service the sold receivables for which we will receive a 1% servicing fee. We have concluded that the 1% servicing fee (approximately $6 over the expected life of the associated receivables) is adequate compensation and, accordingly, no servicing asset or liability was recorded.

The beneficial interest represents our right to receive future cash flows from the sold receivables, which exceed the servicing fee as well as the ultimate purchaser's initial investment and associated return on that investment. The beneficial interest was initially recognized at an estimate of fair value based on the present value of the expected future cash flows. The present value of the expected future cash flows was calculated using management's best estimate of key assumptions including credit losses, prepayment rate and an appropriate risk adjusted discount rate (all unobservable Level 3 inputs) for which we utilized annualized rates of 2.1%, 9.3% and 10.0%, respectively. These assumptions are supported by both our historical experience and anticipated trends relative to the particular portfolio of receivables sold. However, to assess the sensitivity on the fair value of the beneficial interest, we adjusted the credit loss rate, prepayment rate and discount rate assumptions individually by 10% and 20% while holding the other assumptions constant. Although the effect of multiple assumption changes was not considered in this analysis, a 10% or 20% adverse variation in any one of these three individual assumptions would each decrease the recorded beneficial interest by approximately $2 or less.

The ultimate purchaser has no recourse to our other assets for the failure of customers to pay principal and interest when due beyond our beneficial interest of which $19 and $33 is included in "Other current assets" and "Other long-term assets", respectively, in the accompanying Condensed Consolidated Balance Sheets at September 30, 2012. The beneficial interest is held by the bankruptcy-remote subsidiary and therefore is not available to satisfy any of our creditor obligations. We will report collections on the beneficial interest as operating cash flows in the Condensed Consolidated Statements of Cash Flows because such beneficial interests are the result of an operating activity and the associated interest rate risk is de minimis considering it has a weighted average life of less than two years.

Finance Receivables – Allowance for Credit Losses and Credit Quality

Finance receivables include sales-type leases, direct financing leases and installment loans. Our finance receivable portfolios are primarily in the U.S., Canada and Europe. We generally establish customer credit limits and estimate the allowance for credit losses on a country or geographic basis. Our policy and methodology used to establish our allowance for doubtful accounts has been consistently applied over all periods presented.

The following table is a rollforward of the allowance for doubtful finance receivables as well as the related investment in finance receivables:

	United States	Canada	Europe	Other[3]	Total
Allowance for Credit Losses:					
Balance at December 31, 2011	$75	$33	$91	$2	$201
Provision	2	1	12	—	15
Charge-offs	(4)	(3)	(12)	—	(19)
Recoveries and other[1]	1	2	2	1	6
Balance at March 31, 2012	74	33	93	3	203
Provision	3	2	11	1	17
Charge-offs	(5)	(4)	(15)	—	(24)
Recoveries and other[1]	1	—	(6)	(1)	(6)
Balance at June 30, 2012	$73	$31	$83	$3	$190
Provision	3	3	9	—	15
Charge-offs	(8)	(5)	(11)	—	(24)
Recoveries and other[1]	—	2	3	—	5
Sale of finance receivables	(9)	—	—	—	(9)
Balance at September 30, 2012	$59	$31	$84	$3	$177
Finance receivables as of September 30, 2012 collectively evaluated for impairment[2]	$2,384	$811	$2,466	$168	$5,829
Allowance for Credit Losses:					
Balance at December 31, 2010	$91	$37	$81	$3	$212
Provision	7	4	11	—	22
Charge-offs	(10)	(5)	(8)	—	(23)
Recoveries and other[1]	(1)	2	3	—	4
Balance at March 31, 2011	87	38	87	3	215
Provision	1	3	14	—	18
Charge-offs	(6)	(5)	(11)	—	(22)
Recoveries and other[1]	(1)	—	(1)	—	(2)
Balance at June 30, 2011	$81	$36	$89	$3	$209
Provision	4	1	18	—	23
Charge-offs	(7)	(3)	(19)	—	(29)
Recoveries and other[1]	1	(1)	(5)	—	(5)
Balance at September 30, 2011	$79	$33	$83	$3	$198
Finance receivables as of September 30, 2011 collectively evaluated for impairment[2]	$2,943	$793	$2,714	$95	$6,545

(1) Includes the impacts of foreign currency translation and adjustments to reserves necessary to reflect events of non-payment such as customer accommodations and contract terminations.

(2) Total Finance receivables exclude residual values of $3 and $8, and the allowance for credit losses of $177 and $198 at September 30, 2012 and 2011, respectively.

(3) Includes developing market countries and smaller units.

We evaluate our customers based on the following credit quality indicators:

- Investment grade: This rating includes accounts with excellent to good business credit, asset quality and the capacity to meet financial obligations. These customers are less susceptible to adverse effects due to shifts in economic conditions or changes in circumstance. The rating generally equates to a Standard & Poors (S&P) rating of BBB- or better. Loss rates in this category are normally minimal at less than 1%.

- Non-investment grade: This rating includes accounts with average credit risk that are more susceptible to loss in the event of adverse business or economic conditions. This rating generally equates to a BB S&P rating. Although we experience higher loss rates associated with this customer class, we believe the risk is somewhat mitigated by the fact that our leases are fairly well dispersed across a large and diverse customer base. In addition, the higher loss rates are largely offset by the higher rates of return we obtain on such leases. Loss rates in this category are generally in the range of 2% to 4%.

- Substandard: This rating includes accounts that have marginal credit risk such that the customer's ability to make repayment is impaired or may likely become impaired. We use numerous strategies to mitigate risk including higher rates of interest, prepayments, personal guarantees, etc. Accounts in this category include customers who were downgraded during the term of the lease from investment and non-investment grade status when the lease was originated. Accordingly, there is a distinct possibility for a loss of principal and interest or customer default. The loss rates in this category are around 10%.

Credit quality indicators are updated at least annually and the credit quality of any given customer can change during the life of the portfolio. Details about our finance receivables portfolio based on industry and credit quality indicators are as follows:

	September 30, 2012			
	Investment Grade	Non-investment Grade	Substandard	Total Finance Receivables
Finance and Other Services	$301	$235	$96	$632
Government and Education	762	17	2	781
Graphic Arts	94	117	175	386
Industrial	134	65	20	219
Healthcare	108	38	23	169
Other	86	66	45	197
Total United States	1,485	538	361	2,384
Finance and Other Services	152	115	43	310
Government and Education	118	9	3	130
Graphic Arts	38	35	36	109
Industrial	64	40	29	133
Other	77	41	11	129
Total Canada	449	240	122	811
France	271	275	134	680
U.K./Ireland	218	155	53	426
Central(1)	274	453	75	802
Southern(2)	163	228	73	464
Nordics(3)	52	38	4	94
Total Europe	978	1,149	339	2,466

Other	125	38	5	168
Total	$3,037	$1,965	$827	$5,829

	December 31, 2011			
	Investment Grade	Non-investment Grade	Substandard	Total Finance Receivables
Finance and Other Services	$349	$380	$160	$889
Government and Education	821	20	4	845
Graphic Arts	126	200	172	498
Industrial	180	83	32	295
Healthcare	130	42	28	200
Other	97	93	76	266
Total United States	1,703	818	472	2,993
Finance and Other Services	153	118	51	322
Government and Education	121	9	4	134
Graphic Arts	36	39	35	110
Industrial	56	41	34	131
Other	74	42	12	128
Total Canada	440	249	136	825
France	246	354	92	692
U.K./Ireland	201	162	54	417
Central(1)	330	494	57	881
Southern(2)	219	256	63	538
Nordics(3)	60	39	3	102
Total Europe	1,056	1,305	269	2,630
Other	75	26	7	108
Total	$3,274	$2,398	$884	$6,556

(1) Switzerland, Germany, Austria, Belgium and Holland.
(2) Italy, Greece, Spain and Portugal.
(3) Sweden, Norway, Denmark and Finland.

The aging of our billed finance receivables is based upon the number of days an invoice is past due and is as follows:

September 30, 2012

	Current	31-90 Days Past Due	>90 Days Past Due	Total Billed Finance Receivables	Unbilled Finance Receivables	Total Finance Receivables	Finance Receivables >90 Days and Accruing
Finance and Other Services	$20	$4	$2	$26	$606	$632	$18
Government and Education	24	4	3	31	750	781	35
Graphic Arts	21	2	1	24	362	386	11
Industrial	9	2	1	12	207	219	9
Healthcare	7	2	—	9	160	169	6
Other	8	1	1	10	187	197	7
Total United States	89	15	8	112	2,272	2,384	86
Canada	5	3	1	9	802	811	29
France	4	—	—	4	676	680	32
U.K./Ireland	4	1	3	8	418	426	5
Central(1)	6	2	3	11	791	802	40
Southern(2)	25	11	12	48	416	464	68
Nordics(3)	2	—	—	2	92	94	—
Total Europe	41	14	18	73	2,393	2,466	145
Other	3	1	—	4	164	168	—
Total	$138	$33	$27	$198	$5,631	$5,829	$260

December 31, 2011

	Current	31-90 Days Past Due	>90 Days Past Due	Total Billed Finance Receivables	Unbilled Finance Receivables	Total Finance Receivables	Finance Receivables >90 Days and Accruing
Finance and Other Services	$18	$4	$1	$23	$866	$889	$15
Government and Education	21	5	2	28	817	845	29
Graphic Arts	16	2	1	19	479	498	7
Industrial	7	2	1	10	285	295	6
Healthcare	5	2	—	7	193	200	5
Other	8	1	—	9	257	266	4
Total United States	75	16	5	96	2,897	2,993	66
Canada	3	2	1	6	819	825	27
France	1	1	1	3	689	692	16
U.K./Ireland	3	2	3	8	409	417	4
Central(1)	7	2	3	12	869	881	46
Southern(2)	31	4	13	48	490	538	82
Nordics(3)	1	—	—	1	101	102	—
Total Europe	43	9	20	72	2,558	2,630	148
Other	2	1	—	3	105	108	—
Total	$123	$28	$26	$177	$6,379	$6,556	$241

(1) Switzerland, Germany, Austria, Belgium and Holland.
(2) Italy, Greece, Spain and Portugal.
(3) Sweden, Norway, Denmark and Finland.

Note 6 – Inventories

The following is a summary of Inventories by major category:

	September 30, 2012	December 31, 2011
Finished goods	$944	$866
Work-in-process	74	58
Raw materials	110	97
Total Inventories	$1,128	$1,021

Note 7 – Investment in Affiliates, at Equity

Our equity in net income of our unconsolidated affiliates was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Fuji Xerox	$32	$42	$97	$104
Other investments	2	1	8	7
Total Equity in Net Income of Unconsolidated Affiliates	$34	$43	$105	$111

Fuji Xerox

Equity in net income of Fuji Xerox is affected by certain adjustments required to reflect the deferral of profit associated with intercompany sales. These adjustments may result in recorded equity income that is different from that implied by our 25% ownership interest. Equity income for the nine months ended September 30, 2012 and 2011 includes after-tax restructuring charges of $15 and $16, respectively, primarily reflecting Fuji Xerox's continued cost-reduction initiatives.

Condensed financial data of Fuji Xerox was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Summary of Operations:				
Revenues	$3,192	$3,330	$9,586	$9,274
Costs and expenses	2,988	3,042	8,928	8,584
Income before income taxes	204	288	658	690
Income tax expense	68	107	246	231
Net Income	136	181	412	459
Less: Net income – noncontrolling interests	2	1	4	3
Net Income – Fuji Xerox	$134	$180	$408	$456
Weighted Average Rate[(1)]	78.61	77.69	79.47	80.37

(1) Represents Yen/U.S. Dollar exchange rate used to translate.

Note 8 – Restructuring Programs

During the nine months ended September 30, 2012, we recorded net restructuring and asset impairment charges of $60, which included approximately $64 of severance costs related to headcount reductions of approximately 2,000 employees primarily in North America and $7 of lease cancellation and asset impairment charges. These costs were partially offset by $11 of net reversals for changes in estimated reserves from prior period initiatives.

Information related to restructuring program activity during the nine months ended September 30, 2012 is outlined below:

	Severance and Related Costs	Lease Cancellation and Other Costs	Asset Impairments[2]	Total
Balance December 31, 2011	$116	$ 7	$—	$123
Restructuring provision	64	5	2	71
Reversals of prior accruals	(11)	—	—	(11)
Net current period charges[1]	53	5	2	60
Charges against reserve and currency	(108)	(4)	(2)	(114)
Balance September 30, 2012	$61	$ 8	$—	$69

(1) Represents net amount recognized within the Condensed Consolidated Statements of Income for the period shown.

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

Reconciliation to the Condensed Consolidated Statements of Cash Flows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Charges against reserve	$(29)	$(49)	$(114)	$(169)
Asset impairment	—	—	2	—
Effects of foreign currency and other non-cash items	(1)	7	(1)	7
Cash Payments for Restructurings	$(30)	$(42)	$(113)	$(162)

The following table summarizes the total amount of costs incurred in connection with these restructuring programs by segment:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Services	$6	$(2)	$25	$(2)
Technology	8	(4)	37	(23)
Other	—	2	(2)	(3)
Total Net Restructuring Charges	$14	$(4)	$60	$(28)

We expect to incur additional restructuring charges of approximately $50 to $100 in the fourth quarter of 2012 for actions and initiatives which have not yet been finalized. The additional restructuring is expected to be more focused on the Services segment.

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Note 9 – Debt

Debt Exchange

In February 2012, we completed an exchange of our 5.71% Zero Coupon Notes due 2023 with an accreted book value at the date of the exchange of $303, for $362 of our 4.50% Senior Notes due 2021. Accordingly, this increased the principal amount for our 4.50% Senior Notes due 2021 from $700 to $1,062. The exchange was conducted to retire high-interest, long-dated debt in a favorable interest rate environment. The debt exchange was accounted for as a non-revolving debt modification and, therefore, it did not result in any gain or loss. The difference between the book value of our Zero Coupon Notes and the principal value of the Senior Notes issued in exchange will be accreted over the remaining term of the Senior Notes. Upfront fees paid to third parties in connection with the exchange were not material and were expensed as incurred.

Senior Notes

In March 2012, we issued $600 of Floating Rate Senior Notes due 2013 (the "2013 Floating Rate Notes") and $500 of 2.95% Senior Notes due 2017 (the "2017 Senior Notes"). The 2013 Floating Rate Notes were issued at par and the 2017 Senior Notes were issued at 99.875% of par, resulting in aggregate net proceeds for both notes of approximately $1,093. The 2013 Floating Rate Notes accrue interest at a rate per annum, reset quarterly, equal to the three-month LIBOR plus 1.400% and are payable quarterly. The 2017 Senior Notes accrue interest at a rate of 2.95% per annum and are payable semi-annually. As a result of the discount, they have a weighted average effective interest rate of 2.977%. In connection with the issuance of these Senior Notes, debt issuance costs of $6 were deferred. This debt issuance partially pre-funded the May 2012 maturity of our $1,100 of 5.59% Senior Notes.

Interest Expense and Income

Interest expense and interest income were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest expense[1]	$106	$116	$324	$367
Interest income[2]	162	161	460	498

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

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

Net Proceeds (Payments) on Debt

Net proceeds on debt as shown on the Condensed Consolidated Statements of Cash Flows was as follows:

	Nine Months Ended September 30,	
	2012	2011
Net proceeds from short-term debt	$742	$351
Net proceeds from issuance of long-term debt	1,112	1,030
Net payments on long-term debt	(1,112)	(779)
Net Proceeds on Debt	$742	$602

Note 10 – Financial Instruments
Interest Rate Risk Management
We may use interest rate swap agreements to manage our interest rate exposure and to achieve a desired proportion of variable and fixed rate debt. These derivatives may be designated as fair value hedges or cash flow hedges depending on the nature of the risk being hedged.

At September 30, 2012 and December 31, 2011, we did not have any interest rate swaps outstanding.
Foreign Exchange Risk Management
We are a global company that is exposed to foreign currency exchange rate fluctuations in the normal course of our business. As a part of our foreign exchange risk management strategy, we use derivative instruments, primarily forward contracts and purchase option contracts, to hedge the following foreign currency exposures, thereby reducing volatility of earnings or protecting fair values of assets and liabilities:

- Foreign currency-denominated assets and liabilities
- Forecasted purchases and sales in foreign currency

Summary of Foreign Exchange Hedging Positions
At September 30, 2012, we had outstanding forward exchange and purchased option contracts with gross notional values of $2,980, which is reflective of the amounts that are normally outstanding at any point during the year. Approximately 83% of these contracts mature within three months, 9% in three to six months and 8% in six to twelve months.

The following is a summary of the primary hedging positions and corresponding fair values as of September 30, 2012:

Currency Hedged (Buy/Sell)	Gross Notional Value	Fair Value Asset (Liability)[1]
Euro/U.K. Pound Sterling	$627	$(5)
Japanese Yen/U.S. Dollar	474	9
Japanese Yen/Euro	456	5
U.S. Dollar/Euro	440	2
Canadian Dollar/Euro	177	1
U.K. Pound Sterling/Euro	168	—
Mexican Peso/U.S. Dollar	69	2
Indian Rupee/U.S. Dollar	62	2
Euro/Japanese Yen	51	—
Euro/Swiss Franc	48	—
Philippine Peso/U.S. Dollar	47	1
U.K. Pound Sterling/U.S. Dollar	43	—
U.S. Dollar/Japanese Yen	41	—
Euro/U.S. Dollar	37	—
All Other	240	—
Total Foreign Exchange Hedging	$2,980	$17

(1) Represents the net receivable (payable) amount included in the Condensed Consolidated Balance Sheet at September 30, 2012.

Foreign Currency Cash Flow Hedges

We designate a portion of our foreign currency derivative contracts as cash flow hedges of our foreign currency-denominated inventory purchases, sales and expenses. No amount of ineffectiveness was recorded in the Condensed Consolidated Statements of Income for these designated cash flow hedges and all components of each derivative’s gain or loss was included in the assessment of hedge effectiveness. The net (liability) asset fair value of these contracts was $19 and $26 as of September 30, 2012 and December 31, 2011, respectively.

Summary of Derivative Instruments Fair Value

The following table provides a summary of the fair value amounts of our derivative instruments:

Designation of Derivatives	Balance Sheet Location	September 30, 2012	December 31, 2011
Derivatives Designated as Hedging Instruments			
Foreign exchange contracts – forwards	Other current assets	$21	$37
	Other current liabilities	(2)	(11)
	Net Designated Asset	$19	$26
Derivatives NOT Designated as Hedging Instruments			
Foreign exchange contracts – forwards	Other current assets	$7	$21
	Other current liabilities	(9)	(20)
	Net Undesignated Liability	$(2)	$1
Summary of Derivatives	Total Derivative Assets	$28	$58
	Total Derivative Liabilities	(11)	(31)
	Net Derivative Asset	$17	$27

Summary of Derivative Instruments Gains (Losses)

Derivative gains and (losses) affect the income statement based on whether such derivatives are designated as hedges of underlying exposures. The following is a summary of derivative gains and (losses).

Designated Derivative Instruments Gains (Losses)

The following tables provide a summary of gains (losses) on derivative instruments:

Derivatives in Fair Value Relationships	Location of Gain (Loss) Recognized in Income	Derivative Gain (Loss) Recognized in Income Nine Months Ended September 30,		Hedged Item Gain (Loss) Recognized in Income Nine Months Ended September 30,	
		2012	2011	2012	2011
Interest rate contracts	Interest expense	$—	$16	$—	$(16)

Derivatives in Cash Flow Hedging Relationships	Derivative Gain (Loss) Recognized in OCI (Effective Portion) Three Months Ended September 30,		Location of Derivative Gain (Loss) Reclassified from AOCI into Income (Effective Portion)	Gain (Loss) Reclassified from AOCI to Income (Effective Portion) Three Months Ended September 30,	
	2012	2011		2012	2011
Foreign exchange contracts – forwards	$8	$43	Cost of sales	$8	$4

Derivatives in Cash Flow Hedging Relationships	Derivative Gain (Loss) Recognized in OCI (Effective Portion) Nine Months Ended September 30,		Location of Derivative Gain (Loss) Reclassified from AOCI into Income (Effective Portion)	Gain (Loss) Reclassified from AOCI to Income (Effective Portion) Nine Months Ended September 30,	
	2012	2011		2012	2011
	$16	19	Cost of sales	$29	—

Foreign exchange
contracts – forwards

No amount of ineffectiveness was recorded in the Condensed Consolidated Statements of Income for these designated cash flow hedges and all components of each derivative's gain or (loss) was included in the assessment of hedge effectiveness. In addition, no amount was recorded for an underlying exposure that did not occur or was not expected to occur.

For the nine months ended September 30, 2012, net gains of $14 were recorded in accumulated other comprehensive loss associated with our cash flow hedging activity. The entire balance is expected to be reclassified into net income within the next 12 months, providing an offsetting economic impact against the underlying anticipated transactions.

Non-Designated Derivative Instruments Gains (Losses)

Non-designated derivative instruments are primarily instruments used to hedge foreign currency-denominated assets and liabilities. They are not designated as hedges since there is a natural offset for the re-measurement of the underlying foreign currency-denominated asset or liability.

The following table provides a summary of gains (losses) on non-designated derivative instruments:

Derivatives NOT Designated as Hedging Instruments	Three Months Ended September 30,	N