FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark One)

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

For the quarterly period ended: June 30, 1999

OR

[ ] 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 1-4471

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

| New York | 16-0468020 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

P.O. Box 1600
Stamford, Connecticut 06904-1600
(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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

| Class | Outstanding at July 31, 1999 |
|---|---|
| Common Stock | 663,069,923 shares |

This document consists of 35 pages

Forward-Looking Statements

From time to time Xerox Corporation (the Registrant or the Company) and its representatives may provide information, whether orally or in writing, including certain statements in this Form 10-Q under "Management's Discussion and Analysis of Results of Operations and Financial Condition," which are deemed to be "forward-looking" within the meaning of the Private Securities Litigation Reform Act of 1995 ("Litigation Reform Act"). These forward-looking statements and other information relating to the Company are based on the beliefs of management as well as assumptions made by and information currently available to management.

The words "anticipate," "believe," "estimate," "expect," "intend," "will," and similar expressions, as they relate to the Company or the Company's management, are intended to identify forward-looking statements. Such statements reflect the current views of the Registrant 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. The Registrant does not intend to update these forward-looking statements.

In accordance with the provisions of the Litigation Reform Act 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 - the Registrant operates 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 the Registrant to provide document processing products and services in each of the markets served by the Registrant, some of whom operate on a global basis. The Registrant's success in its future performance is largely dependent upon its ability to compete successfully in its currently-served markets and to expand into additional market segments.

Transition to Digital - presently black and white light-lens copiers represent approximately 31 percent of the Registrant's revenues. This segment of the general office is mature with anticipated declining industry revenues as the market transitions to digital technology. Some of the Registrant's new digital products replace or compete with the Registrant's 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.

Pricing - the Registrant's ability to succeed is dependent upon its ability to obtain adequate pricing for its products and services which provide a reasonable return to shareholders. Depending on competitive market factors, future prices the Registrant can obtain for its products and services may vary from historical levels. In addition, pricing actions to offset devaluations may not prove sufficient to offset further devaluations or may not hold in the face of customer resistance and/or competition.

Financing Business - a significant portion of the Registrant's profits arise from the financing of its customers' purchase of the Registrant's equipment. On average, 75 to 80 percent of equipment sales are financed through the Registrant. The Registrant's ability to provide such financing at competitive rates and realize profitable spreads is highly dependent upon its own costs of borrowing which, in turn, depend upon its credit ratings. Significant changes in such ratings could reduce the profitability of such financing business and/or make the Registrant's financing less attractive to customers thus reducing the volume of financing business done. The Registrant's present credit ratings permit ready access to the credit markets. There is no assurance that these credit ratings can be maintained and/or ready access to the credit markets can be assured.

Productivity - the Registrant's ability to sustain and improve its profit margins is largely dependent on its ability to maintain an efficient, cost-effective operation. Productivity improvements through process reengineering, design efficiency and supplier cost improvements are required to offset labor cost inflation and potential materials cost changes and competitive price pressures.

International Operations - the Registrant derives approximately half its revenue from operations outside of the United States. In addition, the Registrant manufactures many of its products and/or their components outside the United States. The Registrant's future revenue, cost and profit results could be adversely 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.

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. The Registrant 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 Growth - Registrant's ability to attain a consistent trend of revenue growth over the intermediate to longer term is largely dependent upon expansion of its equipment sales worldwide. The ability to achieve equipment sales growth is subject to the successful implementation of our initiatives to provide industry-oriented global solutions for major customers and expansion of its distribution channels in the face of global competition and pricing pressures. Our inability to attain a consistent trend of revenue growth could materially affect the trend of our actual results.

Restructuring - the Registrant's ability to ultimately reduce pre-tax annual expenditures by approximately $1 billion is dependent upon its ability to successfully implement the 1998 restructuring program including the elimination of 9,000 jobs, net, worldwide, the closing and consolidation of

facilities, and the successful implementation of process and systems changes.

Year 2000 - the Registrant's ability to complete its Year 2000 plan is dependent upon the availability of resources, the Registrant's ability to discover and correct the potential Year 2000 sensitive problems which could have a serious impact on the Registrant's information management systems, facilities and products, and the ability of the Registrant's suppliers and customers to bring their systems into Year 2000 compliance.

Xerox Corporation
Form 10-Q
June 30, 1999

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For additional information about The Document Company Xerox, please visit our World-Wide Web site at www.xerox.com/investor

PART I - FINANCIAL INFORMATION

Item 1

Xerox Corporation
Consolidated Statements of Income (Unaudited)

| (In millions, except per-share data) | Three months ended June 30, 1999 | Three months ended June 30, 1998 | Six months ended June 30, 1999 | Six months ended June 30, 1998 |
|---|---|---|---|---|
| Revenues | | | | |
| Sales | $ 2,561 | $ 2,567 | $ 4,677 | $ 4,771 |
| Service and rentals | 2,021 | 1,906 | 3,943 | 3,740 |
| Finance income | 280 | 269 | 542 | 535 |
| Total Revenues | 4,862 | 4,742 | 9,162 | 9,046 |
| Costs and Expenses | | | | |

| | | | | |
|---|---|---|---|---|
| Cost of sales | 1,400 | 1,411 | 2,514 | 2,639 |
| Cost of service and rentals | 1,118 | 1,028 | 2,198 | 2,029 |
| Inventory charges | - | 113 | - | 113 |
| Equipment financing interest | 140 | 137 | 273 | 279 |
| Research and development expenses | 256 | 262 | 507 | 497 |
| Selling, administrative and general expenses | 1,252 | 1,295 | 2,423 | 2,490 |
| Restructuring charge and asset impairments | - | 1,531 | - | 1,531 |
| Other, net | 63 | 64 | 120 | 122 |
| Total Costs and Expenses | 4,229 | 5,841 | 8,035 | 9,700 |
| | | | | |
| Income (Loss) before Income Taxes (Benefits), Equity Income and Minorities' Interests | 633 | (1,099) | 1,127 | (654) |
| | | | | |
| Income taxes (benefits) | 196 | (385) | 349 | (239) |
| Equity in net income of unconsolidated affiliates | (24) | (12) | (34) | (26) |
| Minorities' interests in earnings of subsidiaries | 13 | 10 | 21 | 21 |
| | | | | |
| Income (Loss) from Continuing Operations | 448 | (712) | 791 | (410) |
| | | | | |
| Discontinued Operations | - | - | - | (190) |
| | | | | |
| Net Income (Loss) | $ 448 | $ (712) | $ 791 | $ (600) |
| | | | | |
| Basic Earnings (Loss) per Share | | | | |
| Continuing Operations | $ 0.66 | $ (1.10) | $ 1.16 | $ (0.66) |
| Discontinued Operations | - | - | - | (0.29) |
| Basic Earnings per Share | $ 0.66 | $ (1.10) | $ 1.16 | $ (0.95) |
| | | | | |
| Diluted Earnings (Loss) per Share | | | | |
| Continuing Operations | $ 0.62 | $ (1.10) | $ 1.09 | $ (0.66) |
| Discontinued Operations | - | - | - | (0.29) |
| Diluted Earnings per Share | $ 0.62 | $ (1.10) | $ 1.09 | $ (0.95) |

See accompanying notes.

## Xerox Corporation
## Consolidated Balance Sheets

| (In millions, except share data in thousands) Assets | June 30, 1999 (Unaudited) | December 31, 1998 |
|---|---|---|
| Cash | $ 103 | $ 79 |
| Accounts receivable, net | 2,897 | 2,671 |
| Finance receivables, net | 4,945 | 5,220 |
| Inventories | 3,091 | 3,269 |
| Deferred taxes and other current assets | 1,446 | 1,236 |
| | | |
| Total Current Assets | 12,482 | 12,475 |
| | | |
| Finance receivables due after one year, net | 8,065 | 9,093 |
| Land, buildings and equipment, net | 2,367 | 2,366 |
| Investments in affiliates, at equity | 1,400 | 1,456 |
| Goodwill, net | 1,688 | 1,731 |
| Other assets | 1,182 | 1,233 |
| Investment in discontinued operations | 1,447 | 1,670 |
| | | |
| Total Assets | $ 28,631 | $ 30,024 |
| | | |
| Liabilities and Equity | | |
| | | |
| Short-term debt and current portion of long-term debt | $ 3,857 | $ 4,104 |
| Accounts payable | 759 | 948 |
| Accrued compensation and benefit costs | 582 | 722 |
| Unearned income | 205 | 210 |
| Other current liabilities | 1,815 | 2,523 |
| | | |
| Total Current Liabilities | 7,218 | 8,507 |
| | | |
| Long-term debt | 11,567 | 10,867 |
| Postretirement medical benefits | 1,114 | 1,092 |

| | | |
|---|---|---|
| Deferred taxes and other liabilities | 2,395 | 2,711 |
| Discontinued operations liabilities - policyholders' deposits and other | 694 | 911 |
| Deferred ESOP benefits | (370) | (370) |
| Minorities' interests in equity of subsidiaries | 118 | 124 |
| Company-obligated, mandatorily redeemable preferred securities of subsidiary trust holding solely subordinated debentures of the Company | 638 | 638 |
| Preferred stock | 678 | 687 |
| Common shareholders' equity | 4,579 | 4,857 |
| Total Liabilities and Equity | $ 28,631 | $ 30,024 |
| Shares of common stock issued | 662,661 | 657,196 |
| Shares of common stock outstanding | 662,661 | 656,787 |

See accompanying notes.

Xerox Corporation
Consolidated Statements of Cash Flows (Unaudited)

| Six months ended June 30 (In millions) | 1999 | 1998 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Income (Loss)from Continuing Operations | $ 791 | $ (410) |
| Adjustments required to reconcile income to cash flows from operating activities: | | |
| Depreciation and amortization | 457 | 393 |
| Provisions for doubtful accounts | 123 | 111 |
| Restructuring and other charges | - | 1,644 |
| Provision for postretirement medical benefits, net of payments | 22 | 21 |
| Charges against 1998 restructuring reserve | (221) | (133) |
| Minorities' interests in earnings of subsidiaries | 21 | 21 |
| Undistributed equity in income of affiliated companies | (33) | (21) |
| Increase in inventories | (100) | (577) |
| Increase in on-lease equipment | (125) | (149) |
| Decrease (Increase) in finance receivables | 101 | (476) |
| Increase in accounts receivable | (281) | (224) |
| Decrease in accounts payable and accrued compensation and benefit costs | (319) | (224) |
| Net change in current and deferred income taxes | 124 | (561) |
| Change in other current and noncurrent liabilities | (414) | (246) |
| Other, net | (217) | (295) |
| Total | (71) | (1,126) |
| **Cash Flows from Investing Activities** | | |
| Cost of additions to land, buildings and equipment | (310) | (169) |
| Proceeds from sales of land, buildings and equipment | 26 | 25 |
| Acquisition of XLConnect, net of cash acquired | - | (380) |
| Other, net | (26) | 4 |
| Total | (310) | (520) |
| **Cash Flows from Financing Activities** | | |
| Net change in debt | 609 | 1,904 |
| Dividends on common and preferred stock | (293) | (265) |
| Proceeds from sale of common stock | 117 | 82 |
| Repurchase of common and preferred stock | - | (47) |
| Dividends to minority shareholders | (28) | (4) |
| Total | 405 | 1,670 |
| Effect of Exchange Rate Changes on Cash | (6) | 15 |
| Cash Provided by Continuing Operations | 18 | 39 |
| Cash Provided by Discontinued Operations | 6 | 28 |
| Increase in Cash | 24 | 67 |
| Cash at Beginning of Period | 79 | 75 |
| Cash at End of Period | $ 103 | $ 142 |

See accompanying notes.

1. The unaudited consolidated interim financial statements

presented herein have been prepared by Xerox Corporation ("the Company") in accordance with the accounting policies described in its 1998 Annual Report to Shareholders and should be read in conjunction with the notes thereto.

In the opinion of management, all adjustments (consisting only of normal recurring adjustments) which are necessary for a fair statement of operating results for the interim periods presented have been made.

Certain historical amounts have been restated to reflect reclassifications to conform to the current presentation. The impact of these changes is not material and did not affect net income.

References herein to we or our refer to Xerox and consolidated subsidiaries unless the context specifically requires otherwise.

2. Inventories consist of (in millions):

| | June 30, 1999 | December 31, 1998 |
|---|---|---|
| Finished goods | $ 1,901 | $ 1,923 |
| Work in process | 133 | 111 |
| Raw materials | 433 | 464 |
| Equipment on operating leases, net | 624 | 771 |
| Total | $ 3,091 | $ 3,269 |

3. On January 25, 1999, the Board of Directors approved a two-for-one split of the Company's common stock. The effective date of the stock split was February 23 for shareholders of record as of February 4. Shareholders' equity has been restated to give retroactive recognition to the stock split in prior periods by reclassifying from additional paid-in capital to common stock the par value of the additional shares arising from the split. In addition, all references in the financial statements to number of shares and per-share amounts have been restated.

4. On April 7, 1998, we announced a worldwide restructuring program associated with enhancing our competitive position and lowering our overall cost structure. In connection with this program, in the second quarter of 1998 we recorded a pre-tax provision of $1,644 million ($1,107 million after taxes and including our $18 million share of a restructuring charge recorded by Fuji Xerox). The program includes the elimination of approximately 9,000 jobs, net, worldwide, the closing and consolidation of facilities, and the write-down of certain assets. The charges associated with this restructuring program include $113 million of inventory charges recorded as cost of revenues and $316 million of asset impairments. Included in the asset impairment charge are facility fixed assets write-downs of $156 million and other asset write-downs of $160 million. For facility fixed assets classified as assets to be disposed of, the impairment loss recognized is based on fair value less cost to sell, with fair value based on third-party valuations as well as our internal estimates of existing market prices for similar assets. The effect of suspending depreciation on assets no longer in use for the second quarter of 1999 is not material. The remaining $160 million of asset impairments includes the write-down of certain technology assets and other items impacted by the consolidation activities.

The headcount reductions are occurring primarily in administrative functions, but also impact service, research and manufacturing.

The following table summarizes the status of the restructuring reserve (in millions):

| | Total Reserve | Charges Against Reserve | June 30, 1999 Balance |
|---|---|---|---|
| Severance and related costs | $1,017 | $486 | $531 |
| Asset impairment | 316 | 316 | - |
| Lease cancellation and other costs | 198 | 67 | 131 |
| Inventory charges | 113 | 113 | - |
| Total | $1,644 | $982 | $662 |

As of June 30 1999, approximately 8,200 employees have left the Company under the restructuring program.

There have been no material changes to the program since its announcement in April 1998, and the majority of the remaining reserve will be utilized throughout the remainder of 1999 and 2000.

5. Common shareholders' equity consists of (in millions):

| | June 30, 1998 | December 31, 1998 |
|---|---|---|
| Common stock | $ 665 | $ 660 |
| Additional paid-in-capital | 1,475 | 1,265 |
| Retained earnings | 4,175 | 3,712 |
| Translation adjustments | (1,736) | (761) |
| Treasury stock | - | (19) |
| Total | $ 4,579 | $ 4,857 |

Comprehensive income is as follows (in millions):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 1999 | 1998 | 1999 | 1998 |
| Net income (loss) | $ 448 | $ (712) | $ 791 | $ (600) |
| Fuji Xerox stub period income(loss) | - | - | - | (6) |
| Translation adjustments | (121) | (159) | (975) | (230) |
| Comprehensive income (loss) | $ 327 | $ (871) | $ (184) | $ (836) |

6. Interest expense totaled $405 million and $334 million for the six months ended June 30, 1999 and 1998, respectively.

7. Operating segment profit or loss information for the three months ended June 30, 1999 and 1998 is as follows (in millions):

| | Core Business | Paper and Media | Other | Total |
|---|---|---|---|---|
| 1999 | | | | |
| Revenue from external customers | $3,992 | $280 | $ 310 | $ 4,582 |
| Finance income | 279 | - | 1 | 280 |
| Intercompany revenues | (41) | - | 41 | - |
| Total segment revenues | $4,230 | $280 | $ 352 | $ 4,862 |
| Segment profit | $ 599 | $ 16 | $ 18 | $ 633 |
| 1998 | | | | |
| Revenue from external customers | $3,888 | $289 | $ 296 | $ 4,473 |
| Finance income | 268 | - | 1 | 269 |
| Intercompany revenues | (100) | - | 100 | - |
| Total segment Revenues | $4,056 | $289 | $ 397 | $ 4,742 |
| Segment profit (loss) before restructuring | $ 541 | $ 14 | $ (10) | $ 545 |
| Segment profit (loss) after restructuring | $ (964) | $ 11 | $(146) | $(1,099) |

Operating segment profit or loss information for the six months ended June 30, 1999 and 1998 is as follows (in millions):

| | Core Business | Paper and Media | Other | Total |
|---|---|---|---|---|
| 1999 | | | | |
| Revenue from external customers | $7,470 | $563 | $ 587 | $ 8,620 |
| Finance income | 541 | - | 1 | 542 |
| Intercompany revenues | (76) | - | 76 | - |
| Total segment revenues | $7,935 | $563 | $ 664 | $ 9,162 |
| Segment profit | $1,083 | $ 34 | $ 10 | $ 1,127 |
| 1998 | | | | |

| | | | | |
|---|---|---|---|---|
| Revenue from external customers | $7,346 | $588 | $ 577 | $ 8,511 |
| Finance income | 534 | - | 1 | 535 |
| Intercompany revenues | (158) | - | 158 | - |
| Total segment Revenues | $7,722 | $588 | $ 736 | $ 9,046 |
| Segment profit (loss) before restructuring | $ 995 | $ 30 | $ (35) | $ 990 |
| Segment profit (loss) after restructuring | $ (510) | $ 27 | $(171) | $ (654) |

## 8. Securitization of Receivables

In the second quarter of 1999, Xerox Credit Corporation, a wholly owned subsidiary, securitized approximately $750 million of finance receivables. The gain from this transaction was not material.

## 9. Litigation

### Continuing Operations

On March 10, 1994, a lawsuit was filed in the United States District Court for the District of Kansas by two independent service organizations (ISOs) in Kansas City and St. Louis and their parent company. Subsequently, a single corporate entity, CSU, L.L.C.("CSU") was substituted for the three affiliated companies. CSU claimed damages predominately resulting from the Company's alleged refusal to sell parts for high volume copiers and printers to CSU prior to 1994. The Company's policies and practices with respect to the sale of parts to ISOs were at issue in an antitrust class action in Texas, which was settled by the Company during 1994. Claims for individual lost profits of ISOs who were not named parties, such as CSU, were not included in that class action. The Company asserted counterclaims against CSU alleging patent and copyright infringement relating to the copying of diagnostic software and service manuals. On April 8, 1997, the District Court granted partial summary judgment in favor of the Company on CSU's antitrust claims, ruling that the Company's unilateral refusal to sell or license its patented parts cannot give rise to antitrust liability. On January 8, 1999, the Court dismissed with prejudice all of CSU's antitrust claims. CSU has preserved for appeal only its claims that Xerox unlawfully refused to sell critical parts (including patented parts), to sell manuals and to license patented and copyrighted software and its claim that the Company's refusal to sell non-critical parts was unlawful because it was in conjunction with an allegedly unlawful refusal to sell critical parts. The District Court also granted summary judgment in favor of the Company on its patent infringement claim, leaving open with respect to patent infringement only the issues of willfulness and the amount of damages, and granted partial summary judgment in favor of the Company with respect to some of its claims of copyright infringement. A judgment in the amount of $1,039,282 was entered in favor of the Company and against CSU on the copyright infringement counterclaim. CSU has appealed to the United States Court of Appeals for the Federal Circuit.

On April 11, 1996, an action was commenced by Accuscan Corp. (Accuscan), in the United States District Court for the Southern District of New York, against the Company seeking unspecified damages for infringement of a patent of Accuscan which expired in 1993. The suit, as amended, was directed to facsimile and certain other products containing scanning functions and sought damages for sales between 1990 and 1993. On April 1, 1998, the jury entered a verdict in favor of Accuscan for $40 million. However, on September 14, 1998, the Court granted the Company's motion for a new trial on damages. The Company is also seeking to appeal the issue of liability and believes that the liability verdict should be set aside. A new trial on damages is set for August, 1999.

On December 18, 1998, three former employees of Crum & Forster Holdings, Inc. (a former subsidiary of ours) ("C&F") filed a lawsuit in the United States District Court for the District of New Jersey claiming wrongful termination of their participation in the Xerox Corporation Employee Stock Ownership Plan ("ESOP"). Xerox, the ESOP, C&F and the company that acquired C&F are named

defendants.  Plaintiffs purport to bring this action on behalf of themselves and a class of approximately 10,000 persons who were employed by C&F (or one of its insurance subsidiaries which also participated in the ESOP) from July 1, 1989 through December 31, 1993.  Plaintiffs assert violations of the Employee Retirement Income Security Act, breach of contract, conversion, unjust enrichment and fraudulent misrepresentation.  They are seeking approximately $250 million in damages.

The foregoing action is related to an action previously filed in the United States District Court for the Western District of Texas. The Texas plaintiffs did not specify their damages, but they sought certification of a similar class of former ESOP participants. Plaintiffs' motion for class certification was denied by the Court on March 26, 1999.  The plaintiffs have asked the Court to reconsider its decision.

On May 26, 1999, the District Court of New Jersey granted Xerox' motion to transfer the New Jersey case to the Western District of Texas, where it has been consolidated with the previously filed action.

We deny any wrongdoing and we intend to vigorously defend the consolidated action.

On June 24, 1999 Xerox Corporation was served with a summons and complaint filed in the Superior Court of the State of California for the County of Los Angeles.  The complaint was filed on behalf of 681 individual plaintiffs claiming damages as a result of Xerox' alleged disposal and/or release of hazardous substances into the soil, air and groundwater. On July 22, 1999 a complaint was filed in the same Court, which has not yet been served on Xerox, in a separate action on behalf of an additional 80 plaintiffs with the same claims for damages as the earlier action. Plaintiffs in both cases further allege that they have been exposed to such hazardous substances by inhalation, ingestion and dermal contact, including but  not limited to, hazardous substances contained within the municipal drinking water supplied by the City of Pomona and the Southern California Water Company.  Plaintiffs' claims against Xerox include personal injury, wrongful death, property damage, negligence, trespass, nuisance, fraudulent concealment, absolute liability for ultra-hazardous activities, civil conspiracy, battery, and violation of California Unfair Trade Practices Act.  Damages are unspecified.

We deny any liability for the plaintiffs' alleged damages and intend to vigorously defend these actions.

10.  In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities.  SFAS No. 133 requires companies to recognize all derivatives as assets or liabilities measured at their fair value.  Gains or losses resulting from changes in the values of those derivatives would be accounted for depending on the use of the derivative and whether it qualifies for hedge accounting. We do not expect this Statement to have a material impact on our consolidated financial statements. In July 1999, the FASB issued SFAS 137 which defers the effective date of SFAS 133 until the start of fiscal years beginning after June 15, 2000.  We will adopt SFAS 133 beginning January 1, 2001.

Item 2

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

### Document Processing

Summary

Income increased 13 percent to $448 million in the 1999 second quarter from $395 million in the 1998 second quarter, before the 1998 worldwide restructuring program charge of $1,107 million.  The increase reflects improved revenue growth, particularly in the United States and Europe, and ongoing benefits from the company's worldwide restructuring program and the continuing focus on productivity and expense controls.

Pre-currency revenues, excluding Brazil, grew 7 percent, reflecting revenue growth of 9 percent in the United States and 6 percent in Europe. Including Brazil where revenues declined substantially due to the January currency devaluation and economic weakness, pre-currency revenues grew 4 percent. Total 1999 second quarter revenues, including the effect of adverse European currency translation, grew 3 percent to $4.9 billion compared with $4.7 billion in the 1998 second quarter. Revenues in the 1999 first half were $9.2 billion compared with $9.0 billion a year ago.

Diluted earnings per share increased 15 percent to $0.62 in the 1999 second quarter from $0.54 in the 1998 second quarter, before the 1998 restructuring charge.

For the first six months of the year, diluted earnings per share from continuing operations, before the 1998 restructuring charge, increased 14 percent to $1.09 and income from continuing operations increased 13 percent to $791 million.

Pre-Currency Growth

To understand the trends in the business, we believe that it is helpful to adjust revenue and expense growth (except for ratios) to exclude the impact of changes in the translation of foreign currencies into U.S. dollars. We refer to this adjusted growth as pre-currency growth. 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, and our operations in these countries traditionally implement pricing actions to recover the impact of inflation and devaluation.

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. When compared with the average of the major European currencies on a revenue-weighted basis, the U.S. dollar was approximately 3 percent stronger in the 1999 second quarter than in the 1998 second quarter. As a result, European currency translation had an unfavorable impact of one percentage point on revenue growth in both the second quarter and first half of 1999.

The unfavorable impact of our Brazilian operation on our total revenue growth was approximately 3 percentage points. This included the continued impact of the very significant January currency devaluation and a weaker economic environment. The average Real exchange rate declined 33 percent to 1.71 in the 1999 second quarter from 1.15 in the 1998 second quarter.

Revenues denominated in currencies where the local currency is the functional currency, including the Brazilian Real, are not hedged for purposes of translation into U.S. dollars.

Revenues

Total pre-currency revenues grew 4 percent in the 1999 second quarter and grew 7 percent excluding Brazil. For the major product categories, the pre-currency revenue growth rates are as follows:

| | 1998 | | | | | 1999 | | 1999 (Excluding Brazil) | |
|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | FY | Q1 | Q2 | Q1 | Q2 |
| Total Revenues | 10% | 10% | 6% | 7% | 8% | (1)% | 4% | 3% | 7% |
| Digital Products | 34 | 41 | 38 | 33 | 36 | 28 | 26 | 33 | 32 |
| Light Lens Copiers | (4) | (8) | (15) | (16) | (11) | (24) | (20) | (20) | (18) |

Digital product revenues grew 26 percent in the 1999 second quarter and reached 52 percent of revenues compared with 42 percent of total revenues in the 1998 second quarter. This growth was driven by the continued outstanding revenue growth from our expanding family of black-and-white Document Centre digital multi-function products, particularly the 55 and 65 page-per-minute products. Production publishing revenues grew 8 percent in the 1999 second quarter and production printing revenues grew 5 percent. Color copying and printing revenue growth improved to 11 percent in the

1999 second quarter, compared with 8 percent in the 1999 first quarter, reflecting initial placements of the DocuColor 30 and DocuColor 100 product lines and excellent growth in DocuColor 40 and indirect channels color laser revenues. Office color copier revenues declined as unit volumes declined, and pricing pressure and some shift to less-featured models was partially offset by growth in recurring revenues. Our DocuPrint N series of monochrome laser printers and new and expanding line of monochrome digital copiers sold through indirect sales channels continued their excellent growth. For the 1999 first half, digital product revenues grew 27 percent, driven by outstanding growth from the Document Centre digital copier family, the DocuPrint N series and digital copiers sold through indirect sales channels as well as 10 percent growth in production publishing revenues and 10 percent growth in color copying and printing revenues. Black-and-white light-lens copier revenues declined 20 percent in the 1999 second quarter and 22 percent in the 1999 first half as a result of the weakness in Brazil, increased pricing pressures and customer transition to digital copiers.

Geographically, the pre-currency revenue growth rates are as follows:

| | 1998 | | | | | 1999 | |
|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | FY | Q1 | Q2 |
| Total Revenues | 10% | 10% | 6% | 7% | 8% | (1)% | 4% |
| United States | 7 | 13 | 10 | 11 | 10 | 4 | 9 |
| Europe | 13 | 10 | 5 | 8 | 9 | 2 | 6 |
| Other Areas | 11 | 6 | (4) | (4) | 1 | (16) | (12) |
| Memo: Fuji Xerox | 2 | (4) | (6) | (4) | (3) | (1) | (3) |

U.S. revenue growth in the 1999 second quarter was driven by a rebound in equipment sales through both direct and indirect channels, as well as continued excellent growth in document outsourcing. U.S. revenue growth in the 1999 first half of 6 percent was driven by strong growth in equipment sales through both direct and indirect channels, as well as continued excellent growth in document outsourcing.

European revenue growth rebounded to 6 percent in the 1999 second quarter, reflecting strong equipment sales growth and outstanding document outsourcing growth. Spain, Italy and Eastern Europe had strong revenue growth in the 1999 second quarter, France and the U.K. had good growth, while revenues declined in Germany and Holland. European revenue growth of 4 percent in the 1999 first half reflected good equipment sales growth and outstanding document outsourcing growth.

Other Areas include operations principally in Latin America, Canada, China, Russia, India, the Middle East and Africa. Revenue in Brazil declined by 32 percent in the 1999 second quarter and 38 percent in the 1999 first half reflecting primarily the very significant currency devaluation as well as the Brazilian recession. Brazilian revenues represented approximately 6 percent of Xerox revenues in the 1999 second quarter compared with 9 percent in the 1998 second quarter. Excluding Brazil, revenue growth in Other Areas was modest, including strong growth in Mexico and flat revenues in Canada.

Fuji Xerox Co., Ltd., an unconsolidated entity jointly owned by Xerox Limited and Fuji Photo Film Company Limited, develops, manufactures and distributes document processing products in Japan, Australia, New Zealand, and other areas of the Pacific Rim. Fuji Xerox revenue declined by 3 percent in the 1999 second quarter and 2 percent in the 1999 first half reflecting a modest revenue decline in Japan partially offset by modest revenue growth in Fuji Xerox' other Asia Pacific territories.

The pre-currency growth rates by type of revenue are as follows:

| | 1998 | | | | | | | 1999 (Excluding Brazil) | |
|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | FY | Q1 | Q2 | Q1 | Q2 |
| Equipment Sales | 17% | 19% | 7% | 10% | 12% | (3)% | 2% | 4% | 12% |
| Recurring Revenues | 6 | 6 | 5 | 4 | 5 | 1 | 4 | 3 | 4 |

| Total Revenues | 10% | 10% | 6% | 7% | 8% | (1)% | 4% | 3% | 7% |
|---|---|---|---|---|---|---|---|---|---|

Memo:

| Document Outsourcing* | 29 | 39 | 36 | 44 | 38 | 31 | 34 | 34 | 35 |
|---|---|---|---|---|---|---|---|---|---|

*Includes equipment accounted for as equipment sales.

Equipment sales, which grew 2 percent in the 1999 second quarter and were flat for the 1999 first half, were impacted significantly by the currency devaluation and recession in Brazil. Excluding Brazil, equipment sales grew 12 percent in the second quarter and 8 percent in the first half as U.S. and European sales productivity and indirect channels equipment sales rebounded. Approximately 50 percent of 1999 second quarter equipment sales was derived from products introduced since 1997, including the company's expanding line of black-and-white Document Centre digital multi-function equipment, the DocuColor 30, the DocuColor 70, the DocuColor 100, the DocuTech 65, 96 and 180 page-per-minute Production Publishers, and the expanding monochrome and color laser and inkjet product families sold through indirect channels.

Recurring revenues, including revenues from service, document outsourcing, rentals, supplies, paper and finance income, represent the revenue stream that follows equipment placement. Growth in these revenues is primarily a function of the growth in our installed population of equipment, usage levels, pricing and interest rates. The recurring revenue growth of 4 percent in the 1999 second quarter and 1999 first half is consistent with the trend throughout 1998, reflecting continued excellent growth in Document Outsourcing as customers focus on their core business and outsource their document processing requirements to Xerox, and the favorable revenue impact of higher machine populations resulting from higher equipment sales last year. This was partially offset by some diversion from service, rentals, supplies, paper and finance income to document outsourcing as well as competitive price pressures.

Key Ratios and Expenses

The trend in key ratios was as follows:

| | 1998 | | | | | 1999 | |
|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | FY | Q1 | Q2 |
| Gross Margin | 44.9% | 45.6% | 46.3% | 48.0% | 46.3% | 45.9% | 45.3% |
| SAG % Revenue | 27.8 | 27.3 | 27.7 | 26.8 | 27.3 | 27.2 | 25.8 |

The gross margin declined by 0.3 percentage points in the 1999 second quarter from the 1998 second quarter before the 1998 restructuring charge as continuing competitive price pressures and changing business mix due primarily to higher revenue growth in both the document outsourcing and the indirect channels businesses were partially offset by manufacturing and other productivity improvements. The gross margin increased 0.3 percentage points in the 1999 first half from the 1998 first half before the 1998 restructuring charge as manufacturing and other productivity improvements were partially offset by continuing competitive price pressures and changing business mix due primarily to higher revenue growth in both the document outsourcing and the indirect channels businesses.

Selling, administrative and general expenses (SAG) declined 2 percent in the 1999 second quarter from the 1998 second quarter and 2 percent in the 1999 first half from the 1998 first half driven by a substantial decline in general and administrative expenses reflecting the benefits of our 1998 restructuring program, our continued focus on productivity and expense controls to mitigate the impact of the economic turmoil in Brazil, and significant cost reductions in Brazil as well as the beneficial currency translation impact of the devaluation of the Brazilian currency. In the 1999 second quarter and 1999 first half, SAG represented 25.8 percent and 26.5 percent of revenue, an improvement of 1.5 and 1.1 percentage points, respectively from the corresponding 1998 periods.

Research and development (R&D) expense in the 1999 second quarter declined 2 percent from the 1998 second quarter, as increased R&D product program spending was more than offset by lower overhead expenses. R&D expense for the first half of 1999 increased 2 percent. We continue to invest in technological development to maintain our premier position in the rapidly changing document

processing market with an added focus on increasing the effectiveness of that investment and time to market. Xerox R&D is strategically coordinated with that of Fuji Xerox which invested $636 million in R&D in the 1998 full year, for a combined total of $1.7 billion.

Worldwide employment declined by 300 in the 1999 second quarter to 92,500 as a result of 1,800 employees leaving the company under the worldwide restructuring program, partially offset by the net hiring of 1,500 employees for the company's fast-growing document outsourcing business, direct sales representatives, staffing for the centralized European customer care and shared services operations in Ireland and research and development skills enhancement.

The small decreases in other expenses, net, from the 1998 second quarter and 1998 first half were primarily due to planned lower year 2000 remediation spending and several small one-time gains which were essentially offset by increased non-financing interest expense. The increased non-financing interest expense was the result of higher debt balances partially offset by lower interest rates.

Income Taxes (Benefits), Equity in Net Income of Unconsolidated Affiliates and Minorities' Interests in Earnings of Subsidiaries

Income before income taxes increased 16 percent to $633 million in the 1999 second quarter from $545 million in the 1998 second quarter before the 1998 worldwide restructuring program charge.

The effective tax rate was 31.0 percent in the 1999 second quarter, which is consistent with the 1999 first quarter and the full year expectation.

Equity in net income of unconsolidated affiliates is principally our 50 percent share of Fuji Xerox income. Excluding our $18 million share of a 1998 second quarter Fuji Xerox restructuring charge, total equity in net income decreased in the 1999 second quarter and the 1999 first half. Difficult economic conditions in Japan and other Asia Pacific countries impacted Fuji Xerox income again in the 1999 second quarter. We expect the difficult economic conditions in Japan and the Pacific Rim to continue to adversely affect Fuji Xerox' operations and it is unlikely that their earnings, before currency translation, will contribute to Xerox earnings growth in 1999.

On April 7, 1998, we announced a worldwide restructuring program associated with enhancing our competitive position and lowering our overall cost structure. In connection with this program, we recorded a second quarter 1998 pre-tax provision of $1,644 million ($1,107 million after taxes and including our $18 million share of a restructuring charge recorded by Fuji Xerox). The program includes employment reductions, the closing and consolidation of facilities, and the write-down of certain assets.

As of June 30, 1999, approximately 8,200 employees had left the company under the restructuring program. The reserve balance of $662 million at June 30, 1999 relates to cash expenditures to be incurred primarily during the remainder of 1999 and 2000.

The Year 2000 (Y2K) problem is the result of computer programs written in two digits, rather than four, to define the applicable year. As a result, many information systems are unable to properly recognize and process date-sensitive information beyond December 31, 1999. As with all major companies, certain of our information systems and products require remediation or replacement in order to render these systems Year 2000 compliant. Though a majority of our remediation and replacement work has been completed, 1999 will be used to finish any remaining mission-critical areas and develop and deploy business contingency plans.

We have divided the Year 2000 project into five major sections: Information Technology; and the non-Information Technology areas of Facilities, Vendor Compliance, Product Compliance and Facilities Management products and services. The general phases common to all sections are: 1) Awareness - a strategic approach was developed to address the Year 2000 problem. 2) Assessment - detailed plans and target dates were developed. 3) Programming - includes hardware and software upgrades, systems replacements, vendor certification and other associated changes. 4) Testing - includes testing and conversion of system applications. 5) Implementation - includes

compliance achievement and user acceptance.

The Information Technology section includes applications (software), compute (mainframe/smaller computer environments), infrastructure (networks, servers, and workstations), and telecommunications. The status of each section as of June 30, 1999 is as follows:

Applications - 99 percent of the mission-critical applications are Y2K Compliant and tested. The remaining work is planned for completion by the third quarter of 1999.

Compute - 94 percent of our mainframe/smaller computer environments have been upgraded to be Y2K compliant with the remainder scheduled to be completed by September 1999.

Infrastructure - 96 percent of networks, servers, and workstations have been upgraded to be Y2K compliant with the remainder to be completed by the third quarter of 1999.

Telecommunications - 79 percent of internal mission-critical components requiring upgrades are Y2K compliant with the remainder planned for compliance by October 1999. We continue to assess external public utility provider readiness and pursue status on those providers who do not respond.

The Facilities section, which includes building electrical systems, elevators, access control, security systems, etc., is primarily in the remediation phase. We are on track for achieving compliance of critical owned sites by October 31, 1999. Leased sites are on track and planned for compliance by December 31, 1999.

We began our efforts in the Vendor Compliance area in 1997. A general awareness letter was sent to all external suppliers, and an assessment survey was sent to all business critical suppliers. Follow-up was then initiated to validate survey responses and provide a risk profile for each supplier.

To date, 93 percent of mission critical suppliers have been assessed. New suppliers have been added to the list and assessments are underway. Of the suppliers assessed, 87 percent are rated high confidence as of July 1999. We will continue to work with the 13 percent of suppliers rated low confidence to ensure supply continuity through 2000. Assessments for the remaining 7 percent of mission critical suppliers should be completed by August 1999.

The Y2K vendor compliance process as it relates to our manufacturing operations has primarily focused on our first tier suppliers, and concerns about the adequacy of a single strategy approach. In response to these concerns, we will to the extent necessary, build an inventory hedge on selected key products and critical sole source parts. This inventory coupled with our normal inventory levels will provide us with a resolution window to resolve any Y2K issues. We expect the additional inventory to be less than the $100 million originally anticipated. In summary, we believe the resolution period incorporated in the Y2K vendor strategy is adequate to provide supplier continuity coverage. This procedure is intended to provide a means of managing risk; however, no assurance can be given that it will eliminate the potential disruption caused by third party failure.

Our 1999 efforts include on-site inspection of 20 key suppliers to be completed by the end of the third quarter of 1999 and contingency planning.

Regarding Product Compliance, 99 percent of our products, excluding end-of-life products, are Y2K compliant, or we have developed a software/hardware patch or have another solution available. We are implementing these Y2K solutions for all in-field Xerox products worldwide, with expected completion during the third quarter of 1999.

In Facilities Management, we have completed inventory, compliance assessment, and action plans. Remediation activities are underway for all customers; 97 percent of required remediation of third party components has been accomplished. Completion of remediation, on-site integrated testing of components and full deployment is planned for the third quarter of 1999. Remediation of Xerox products at these sites is being coordinated with the product compliance area.

Contingency Planning--Certain of our processes have in place business resumption plans. In addition, we have established a contingency program which requires our critical business process managers to develop alternative plans should our, or third party remediation efforts experience unforeseen difficulty.

We are also dependent upon our customers for sales and cash flows. Y2K interruptions in our customers' operations could result in reduced sales, increased inventory or receivable levels and cash flow reductions. While these events are possible, our customer base is sufficiently broad to minimize those risks.

In 1993, Xerox began a project to replace the majority of its legacy systems, which in many cases date back to the 1960s. These efforts continue today. As to remediation, we currently estimate that costs, exclusive of software and systems that are being replaced or upgraded in the normal course of business, and including our products and facilities, as well as legacy systems, will be $183 million, of which $28 million was spent in 1997, $92 million in 1998 and $30 million in the first half of 1999. We estimate $33 million will be spent in the remainder of 1999.

We believe that the remediation of our information systems and products will occur in a timely fashion so that the Y2K problem will not result in significant operating problems with our operating systems, facilities and products. However, if such remediations are not completed in a timely manner or if third party suppliers of products or services have not completed their remediation efforts, the Y2K problem could potentially have a material adverse impact on our operations. Possible worst case consequences could include an interruption in our ability to: bill and apply collections from our customers; manufacture and deliver products to our customers; or meet our cash requirement needs.

New Accounting Standards. In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133 requires companies to recognize all derivatives as assets or liabilities measured at their fair value. Gains or losses resulting from changes in the values of those derivatives would be accounted for depending on the use of the derivative and whether it qualifies for hedge accounting. We do not expect this Statement to have a material impact on our consolidated financial statements. In July 1999, the FASB issued SFAS 137 which defers the effective date of SFAS 133 until the start of fiscal years beginning after June 15, 2000. We will adopt SFAS 133 beginning January 1, 2001.

Discontinued Operations - Insurance and Other Financial Services

The net investment in the discontinued financial services businesses which includes Insurance, Other Financial Services and Third Party Financing and Real Estate totaled $753 million at June 30, 1999 compared with $759 million at December 31, 1998. The change in 1999 was primarily caused by the funding of reinsurance coverage for the former Talegen Holdings, Inc. (Talegen) companies to Ridge Reinsurance Limited (Ridge Re) and interest for the period on the assigned debt, both of which were more than offset by the sale of six of our remaining eight financing leases, the sale of other Real Estate investments and other run-off activity. A discussion of the discontinued businesses follows.

Status of Insurance

In 1995, we recorded a $1,546 million after tax charge in connection with the disengagement activities for our five then remaining Talegen insurance companies and three related service companies.

In 1997 and 1998, all of the insurance companies and service companies were sold. As part of the consideration for one of the companies, The Resolution Group, Inc. (TRG), which closed in the fourth quarter of 1997, we received a $462 million performance-based instrument. We will participate in the future cash flows of TRG via the performance-based instrument. The recovery of this

instrument is dependent upon the sufficiency of TRG's available cash flows. Based on current forecasts at June 30, 1999, we expect to realize $462 million for this instrument. However, the ultimate realization may be greater or less than this amount.

Xerox Financial Services, Inc. (XFSI) continues to provide aggregate excess of loss reinsurance coverage to certain of the former Talegen units and TRG through Ridge Re, a wholly owned subsidiary. The coverage limits remaining at June 30, 1999 total $620 million, which is net of 15 percent coinsurance and exclusive of $234 million in coverage which was reinsured under a retrocessional arrangement during the fourth quarter of 1998 for a total cost to Ridge Re of $158 million. At June 30, 1999, Ridge Re had recognized the discounted value of approximately $327 million of the available coverage and it is possible that some additional reserves could ultimately be needed, although this is not currently anticipated. In April 1999, Ridge Re entered into a novation agreement with another insurer to eliminate its obligations for the reinsurance coverage for Westchester Specialty Group (WSG), a former Talegen unit. The coverage limit under WSG's policy was $128 million. In connection with the agreement, Ridge Re paid the insurer $95 million.

XFSI has guaranteed to certain of the former Talegen units and TRG that Ridge Re will meet all of its financial obligations under the Reinsurance Agreements. Related premium payments to Ridge Re are made by XFSI and guaranteed by us. As of June 30, 1999, there were three remaining annual premium installments of $38 million, plus finance charges. We have also guaranteed that Ridge Re will meet its financial obligations on $578 million of the Reinsurance Agreements and have provided a $400 million partial guaranty of Ridge Re's $600 million letter of credit facility. This facility is required to provide security with respect to aggregate excess of loss reinsurance obligations under contracts with certain of the former Talegen units and TRG.

XFSI may also be required, under certain circumstances, to purchase over time additional redeemable preferred shares of Ridge Re, up to a maximum of $301 million.

### Net Investment in Insurance

The net investment in Insurance at June 30, 1999 totaled $602 million compared with a balance of $513 million at December 31, 1998. The increase in 1999 is due to contractual payments to Ridge Re for annual premium installments and associated finance charges, an anticipated settlement payment related to the sale of one of the former Talegen units and interest on the assigned insurance debt.

### Other Financial Services

The net investment in Other Financial Services at June 30, 1999 was $138 million compared with $132 million at December 31, 1998. Debt associated with these assets totaled $50 million at June 30, 1999 and December 31, 1998. The increase in the investment is primarily due to interest on the assigned debt and settlement of litigation, partially offset by the disposition of other investments.

### Third Party Financing and Real Estate

Third Party Financing and Real Estate assets at June 30, 1999 and December 31, 1998 totaled $101 million and $250 million, respectively. The reduction primarily relates to the sale of six of our remaining eight financing leases as well as other asset sales and runoff activity that were consistent with the amounts contemplated in the formal disposal plan. Debt associated with these assets totaled $38 million and $86 million at June 30, 1999 and December 31, 1998, respectively.

## Capital Resources and Liquidity

Total debt, including ESOP and Discontinued Operations debt not shown separately in our consolidated balance sheets, increased to $15,513 million at June 30, 1999 or $406 million more than at December 31, 1998. The changes in consolidated indebtedness during

the first six months of 1999 and 1998 are summarized as follows (in millions):

| | 1999 | 1998 |
|---|---|---|
| Total debt* as of January 1 | $15,107 | $12,903 |
| Non-Financing Businesses: | | |
| Document Processing operations cash usage | 889 | 899 |
| Brazil dollar debt reallocation | 446 | - |
| Discontinued businesses | (6) | (28) |
| Non-Financing Businesses | 1,329 | 871 |
| Financing Businesses | (1,050) | 220 |
| Shareholder dividends | 293 | 265 |
| Purchase of XLConnect, net of cash acquired | - | 380 |
| Common stock and cash balance changes | (166) | 32 |
| Total Debt as of June 30 | $15,513 | $14,671 |

* Includes discontinued operations.

For analytical purposes, total equity includes common equity, ESOP preferred stock, mandatorily redeemable preferred securities and minorities' interests.

The following table summarizes the changes in total equity during the first six months of 1999 and 1998 (in millions):

| | 1999 | 1998 |
|---|---|---|
| Total equity as of January 1 | $6,306 | $6,454 |
| Income from Continuing Operations | 791 | (410) |
| Loss from Discontinued Operations | - | (190) |
| Shareholder dividends | (293) | (265) |
| Exercise of stock options | 117 | 82 |
| Repurchase of common stock | - | (47) |
| Change in minorities' interests | (6) | (3) |
| Translation adjustments | (976) | (230) |
| All other, net | 74 | 39 |
| Total equity as of June 30 | $6,013 | $5,430 |

Non-Financing Operations

The following table summarizes document processing non-financing operations cash generation and usage for the six months ended June 30, 1999 and 1998 (in millions):

| | 1999 | 1998 |
|---|---|---|
| Document Processing Non-Financing: | | |
| Income from continuing operations | $ 624 | $ 537* |
| Depreciation** and amortization | 457 | 393 |
| Subtotal | 1,081 | 930 |
| Additions to land, buildings and equipment | (310) | (169) |
| Increase in inventories | (100) | (764) |
| (Increase) decrease in on-lease equipment | (125) | 38 |
| Increase in accounts receivable | (281) | (224) |
| Net change in other assets and liabilities | (933) | (577) |
| Subtotal | (1,749) | (1,696) |
| Cash charges against 1998 restructuring reserve | (221) | (133) |
| Net Cash Usage | $ (889) | $ (899) |

*  Before restructuring charge
** Includes rental equipment depreciation of $216 million and $200 million in six months ended June 30, 1999 and 1998, respectively

Non-financing operations' cash usage during the first six months of 1999 totaled $889 million or $10 million less than in the first six months of 1998.  The positive effects of higher net income and non-cash charges and improved inventory turnover were largely offset by capital spending related to our pan European initiatives, net changes in other assets and liabilities such as prepaid expenses, accounts payable and accrued compensation, and higher payments related to the 1998 restructuring reserve.

## Financing Businesses

Customer financing-related debt declined by $1,050 million and increased by $220 million during the first six months of 1999 and 1998, respectively. This significant period-over-period reduction reflects: i. an allocation to non financing operations, based on our 8:1 debt to equity guideline, of a portion of Xerox do Brasil's U.S. dollar denominated debt used to fund local currency denominated customer finance receivables and, ii. The securitization in second quarter 1999 of $750 million of Xerox Credit Corporation financing contracts.

Debt related to discontinued third party financing and real estate activities, which is included in financing business debt, totaled $38 million at June 30, 1999 or $52 million less than at year end 1998. Asset sales and portfolio run-off account for the year to date reduction. Third party financing and real estate debt was $108 at June 30, 1998 or $11 million less than at year-end 1997.

## Risk Management

Xerox is typical of multinational corporations in that it is exposed to market risk from changes in foreign currency exchange rates and interest rates that could affect our results of operations and financial condition.

We have entered into certain financial instruments to manage interest rate and foreign currency exposures. These instruments are held solely for hedging purposes and include interest rate swap agreements, forward exchange contracts and foreign currency swap agreements. We do not enter into derivative instrument transactions for trading purposes and employ long-standing policies prescribing that derivative instruments are only to be used to achieve a set of very limited objectives.

Currency derivatives are primarily arranged in conjunction with underlying transactions that give rise to foreign currency-denominated payables and receivables. For example, an option to buy foreign currency to settle the importation of goods from foreign suppliers, or a forward exchange contract to fix the dollar value of a foreign currency-denominated loan.

With regard to interest rate hedging, virtually all customer-financing assets earn fixed rates of interest. Therefore, we "lock in" an interest rate spread by arranging fixed-rate liabilities with similar maturities as the underlying assets, and fund the assets with liabilities in the same currency, except in developing economies where capital market access to these financial instruments is impracticable. We refer to the effect of these conservative practices as "match funding" customer financing assets. This practice effectively eliminates the risk of a major decline in interest margins during a period of rising interest rates. Conversely, this practice effectively eliminates the opportunity to materially increase margins when interest rates are declining.

Pay fixed-rate and receive variable-rate swaps are typically 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.

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.

# PART II - OTHER INFORMATION

## Item 1. Legal Proceedings

The information set forth under Note 9 contained in the "Notes to Consolidated Financial Statements" on pages 11-13 of this Quarterly Report on Form 10-Q is incorporated by reference in answer to this item.

## Item 2. Changes in Securities

During the quarter ended June 30, 1999, Registrant issued the following securities in transactions which were not registered under the Securities Act of 1933, as amended (the Act):

(a) Securities Sold: On April 1, 1999, Registrant issued 1943 shares of Common stock, par value $1 per share.

(b) No underwriters participated. The shares were issued to each of the non-employee Directors of Registrant: B.R. Inman, A.A.Johnson, V.E. Jordan, Jr., Y. Kobayashi, H. Kopper, R.S. Larsen, G.J. Mitchell, N.J. Nicholas, Jr., J.E. Pepper, P. F. Russo, M.R. Seger and T.C.Theobald.

(c) The shares were issued at a deemed purchase price of $52.125 per share (aggregate price $101,125), based upon the market value on the date of issuance, in payment of the quarterly Directors' fees pursuant to Registrant's Restricted Stock Plan for Directors.

(d) Exemption from registration under the Act was claimed based upon Section 4(2) as a sale by an issuer not involving a public offering.

## Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Shareholders of Xerox Corporation was duly called and held on May 20, 1999 at The Ritz-Carlton San Francisco, 600 Stockton at California Street, San Francisco, California.

Proxies for the meeting were solicited on behalf of the Board of Directors of the Registrant pursuant to Regulation 14A of the General Rules and Regulations of the Commission. There was no solicitation in opposition to the Board of Directors' nominees for election as directors as listed in the Proxy Statement, and all nominees were elected.

At the meeting, votes were cast upon the Proposals described in the Proxy Statement for the meeting (filed with the Commission pursuant to Regulation 14A and incorporated herein by reference) as follows:

Proposal 1 - Election of directors for the ensuing year.

| Name | For | Withheld Vote |
|---|---|---|
| Paul A. Allaire | 566,878,320 | 11,359,049 |
| W. F. Buehler | 566,805,213 | 11,432,156 |
| B. R. Inman | 571,677,147 | 6,560,222 |
| Antonia Ax:son Johnson | 566,740,492 | 11,496,877 |
| Vernon E. Jordan, Jr. | 565,902,128 | 12,335,241 |
| Yotaro Kobayashi | 566,719,405 | 11,517,964 |
| Hilmar Kopper | 550,928,031 | 27,309,338 |
| Ralph S. Larsen | 566,809,883 | 11,427,486 |
| George J. Mitchell | 566,470,850 | 11,766,519 |
| N. J. Nicholas, Jr. | 566,795,655 | 11,441,714 |
| John E. Pepper | 566,831,918 | 11,405,451 |
| Barry D. Romeril | 566,817,435 | 11,419,934 |
| Patricia F. Russo | 566,725,607 | 11,511,762 |
| Martha R. Seger | 566,692,084 | 11,545,285 |
| Thomas C. Theobald | 566,749,780 | 11,487,589 |
| G. Richard Thoman | 566,845,853 | 11,391,516 |

Proposal 2 - To elect KPMG LLP as independent auditors for the year 1999.

| | |
|---|---|
| For - | 575,956,548 |
| Against - | 633,843 |
| Abstain - | 1,646,978 |

Proposal 3 - To approve the amendments to the 1991 Long-Term Incentive Plan

| | |
|---|---|
| For - | 442,602,711 |
| Against - | 64,831,939 |
| Abstain - | 3,314,621 |
| Broker Non-vote | 66,794,198 |

Proposal 4 - To approve amendments to the 1996 Non-Employee Director Stock Option Plan

| | |
|---|---|
| For - | 519,355,487 |
| Against - | 55,334,579 |
| Abstain - | 3,547,303 |

Proposal 5 - To approve an amendment to the Certificate of Incorporation regarding Preferred Stock voting rights

| | |
|---|---|
| For - | 557,693,685 |
| Against - | 17,060,661 |
| Abstain - | 3,483,023 |

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibit 3 (a) (1) Restated Certificate of Incorporation of Registrant filed by the Department of State of the State of New York on October 29, 1996. Incorporated by reference to Exhibit 3 (a) (1) to Registrant's Quarterly Report on Form 10-Q for the Quarter Ended September 30, 1996.

Exhibit 3 (b) By-Laws of Registrant, as amended through April 6, 1999. Incorporated by reference to Exhibit 3 (b)to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 1999.

Exhibit 11 Computation of Net Income per Common Share.

Exhibit 12 Computation of Ratio of Earnings to Fixed Charges.

Exhibit 27 Financial Data Schedule (in electronic form only).

(b) Current reports on Form 8-K dated March 26, 1999 reporting Item 5 Other Events and filing exhibits under Item 7 and on May 13, 1999 filing exhibits under Item 7 were filed during the quarter for which this Quarterly Report is filed.

SIGNATURES

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

XEROX CORPORATION
(Registrant)

/s/ Philip D. Fishbach
______________________________

Date: August 11, 1999

By Philip D. Fishbach
Vice President and Controller
(Principal Accounting Officer)

Exhibit 11

# Xerox Corporation

## Computation of Net Income Per Common Share

(Dollars in millions, except per-share data; shares in thousands)

| | Three months ended June 30, 1999 | Three months ended June 30, 1998 | Six Months ended June 30, 1999 | Six Months ended June 30, 1998 |
|---|---|---|---|---|
| **I. Basic Net Income (Loss) Per Common Share** | | | | |
| Income (loss) from continuing operations | $ 448 | $ (712) | $ 791 | $ (410) |
| Accrued dividends on ESOP preferred stock, net | (10) | (11) | (20) | (23) |
| Adjusted income (loss)from continuing operations | 438 | (723) | 771 | (433) |
| Discontinued operations | - | - | - | (190) |
| Adjusted net income (loss) | $ 438 | $ (723) | $ 771 | $ (623) |
| Average common shares outstanding during the period | 659,234 | 656,418 | 659,994 | 655,006 |
| Common shares issuable with respect to exchangeable shares | 2,206 | 3,330 | 2,012 | 3,330 |
| Adjusted average shares outstanding for the period | 661,440 | 659,748 | 662,006 | 658,336 |
| Basic earnings (loss) per share: | | | | |
| Continuing operations | $ 0.66 | $ (1.10) | $ 1.16 | $ (0.66) |
| Discontinued operations | - | - | - | (0.29) |
| Basic earnings per share | $ 0.66 | $ (1.10) | $ 1.16 | $ (0.95) |
| **II. Diluted Net Income (Loss) Per Common Share** | | | | |
| Income (loss) from continuing operations | $ 448 | $ (712) | $ 791 | $ (410) |
| ESOP expense adjustment, net of tax | 2 | - | 4 | - |
| Accrued dividends on ESOP preferred stock, net | - | (11) | - | (23) |
| Interest on convertible debt, net of tax | 4 | - | 8 | - |
| Adjusted income (loss) from continuing operations | 454 | (723) | 803 | (433) |
| Discontinued operations | - | - | - | (190) |
| Adjusted net income (loss) | $ 454 | $ (723) | $ 803 | $ (623) |
| Average common shares outstanding during the period | 659,234 | 656,418 | 659,994 | 655,006 |
| Stock options, incentive and exchangeable shares | 11,837 | 3,330 | 11,202 | 3,330 |
| Convertible debt | 13,190 | - | 13,190 | - |
| ESOP preferred stock | 52,433 | - | 52,337 | - |
| Adjusted average shares outstanding for the period | 736,694 | 659,748 | 736,723 | 658,336 |
| Diluted earnings (loss) per share: | | | | |
| Continuing operations | $ 0.62 | $ (1.10) | $ 1.09 | $ (0.66) |
| Discontinued operations | - | - | - | (0.29) |
| Diluted earnings per share | $ 0.62 | $ (1.10) | $ 1.09 | $ (0.95) |

Exhibit 12

Xerox Corporation
Computation of Ratio of Earnings to Fixed Charges

| (In millions) | Six months ended June 30, 1999 | 1998 | Year ended December 31, 1998* | 1997 | 1996 | 1995 | 1994 |
|---|---|---|---|---|---|---|---|
| Fixed charges: | | | | | | | |
| Interest expense | $ 405 | $ 334 | $ 748 | $ 617 | $ 592 | $ 603 | $ 520 |
| Rental expense | 61 | 69 | 145 | 140 | 140 | 142 | 170 |
| Total fixed charges before capitalized interest and preferred stock dividends of subsidiaries | 466 | 403 | 893 | 757 | 732 | 745 | 690 |
| Preferred stock dividends of subsidiaries | 27 | 27 | 55 | 50 | - | - | - |
| Capitalized interest | 2 | - | - | - | - | - | 2 |
| Total fixed charges | $ 495 | $ 430 | $ 948 | $ 807 | $ 732 | $ 745 | $ 692 |
| Earnings available for fixed charges: | | | | | | | |
| Earnings** | $1,161 | $ (628) | $ 837 | $2,268 | $2,067 | $1,980 | $1,602 |
| Less undistributed income in minority owned companies | (33) | (21) | (27) | (84) | (84) | (90) | (54) |
| Add fixed charges before capitalized interest and preferred stock dividends of subsidiaries | 466 | 403 | 893 | 757 | 732 | 745 | 690 |
| Total earnings available for fixed charges | $1,594 | $ (246) | $1,703 | $2,941 | $2,715 | $2,635 | $2,238 |
| Ratio of earnings to fixed charges (1)(2) | 3.22 | * | 1.80 | 3.64 | 3.71 | 3.54 | 3.23 |

(1) The ratio of earnings to fixed charges has been computed based on the Company's continuing operations by dividing total earnings available for fixed charges, excluding capitalized interest and preferred stock dividends of subsidiaries, by total fixed charges. Fixed charges consist of interest, including capitalized interest and preferred stock dividends of subsidiaries, and one-third of rent expense as representative of the interest portion of rentals. Debt has been assigned to discontinued operations based on historical levels assigned to the businesses when they were continuing operations, adjusted for subsequent paydowns. Discontinued operations consist of the Company's Insurance, Other Financial Services, and Third Party Financing and Real Estate businesses.

(2) The Company's ratio of earnings to fixed charges includes the effect of the Company's finance subsidiaries, which primarily finance Xerox equipment. Financing businesses are more highly leveraged and, therefore, tend to operate at lower earnings to fixed charges ratio levels than do non-financing businesses.

* Earnings for the six months of 1998 were inadequate to cover fixed charges. The coverage deficiency was $676 million. Excluding the restructuring charge, the ratio of earnings to fixed charges would have been 3.25 and 3.55 for the six months ended June 30, 1998 and the year ended December 31, 1998, respectively.

** Sum of Income before Income Taxes, Equity Income and Minorities' Interests and Equity in Net Income of Unconsolidated Affiliates.

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THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED
FROM XEROX CORPORATION'S 6-30-99 FINANCIAL STATEMENTS AND IS
QUALIFED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

1,000,000

6-MOS
DEC-31-1999
JUN-30-1999
103
0
16,394
487
3,091
12,482
5,249
2,882
28,631
7,218
15,513
638
678
665
3,914
28,631
4,677
9,162
2,154
4,985
3,050
123
405
1,127
349
791
0
0
0
791
1.16
1.09