

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended: December 31, 2005

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

For the transition period from:

to
1-4471 (Commission File Number)

XEROX CORPORATION

(Exact name of registrant as specified in its charter)

New York
(State of incorporation)

P.O. Box 1600, Stamford, Connecticut
(Address of principal executive offices)
06904
(Zip Code)

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

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

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

| Title of each Class | Name of Each Exchange on Which Registered |
|--|---|
| Common Stock, \$1 par value | New York Stock Exchange |
| 6.25% Series C Mandatory Convertible Preferred Stock | Chicago Stock Exchange |
| | New York Stock Exchange |

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes: No:

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes: No:

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

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

Indicate by a check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act Rule

Large accelerated filer: Accelerated filer: Non-accelerated filer:

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

The aggregate market value of the voting stock of the registrant held by non-affiliates as of June 30, 2005 was: \$13,231,185,100.

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

| Class | Outstanding at January 31, 2006 |
|-----------------------------|---------------------------------|
| Common Stock, \$1 par value | 931,310,151 Shares |

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the following documents are incorporated herein by reference:

| Document | Part of Form 10-K in Which Incorporated |
|--|---|
| Xerox Corporation 2005 Annual Report to Shareholders | I & II |
| Xerox Corporation Notice of 2006 Annual Meeting of Shareholders and Proxy Statement (to be filed not later than 120 days after the close of the fiscal year covered by this report on Form 10-K) | III |

Forward-Looking Statements

From time to time, we and our representatives may provide information, whether orally or in writing, including certain statements in this Annual Report on Form 10-K, which are deemed to be “forward-looking” within the meaning of the Private Securities Litigation Reform Act of 1995 (the “Litigation Reform Act”). These forward-looking statements and other information are based on our beliefs as well as assumptions made by us using information currently available.

The words “anticipate,” “believe,” “estimate,” “expect,” “intend,” “will,” “should” and similar expressions, as they relate to us, are intended to identify forward-looking statements. Such statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated, expected or intended. We do 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 that could cause actual results to differ materially from those contemplated by the forward-looking statements contained in this Annual Report on Form 10-K and other public statements we make. Such factors include, but are not limited to: the outcome of litigation and regulatory proceedings to which we may be a party; actions of competitors; changes and developments affecting our industry; quarterly or cyclical variations in financial results; development of new products and services; interest rates and cost of borrowing; our ability to maintain and improve cost efficiency of operations; changes in foreign currency exchange rates; changes in economic conditions, political conditions, trade protection measures, licensing requirements and tax matters in the foreign countries in which we do business; reliance on third parties for manufacturing of products and provision of services; and other risks that are set forth in the “Risk Factors” section, the “Legal Proceedings” section, the “Management’s Discussion and Analysis of Results of Operations and Financial Condition” section and other sections of this Annual Report on Form 10-K, as well as in our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K.

Item 1. Business

Overview

References herein to “we,” “us,” “our,” the “Company” and “Xerox” refers to Xerox Corporation and its subsidiaries unless the context specifically states or implies otherwise.

Xerox is a \$15.7 billion technology and services enterprise and a leader in the global document market. We develop, manufacture, market, service and finance a complete range of document equipment, software, solutions and services. We operate in over 160 countries worldwide and distribute our products in the Western Hemisphere through divisions, wholly-owned subsidiaries and third-party distributors. In Europe, Africa, the Middle East, India and parts of Asia, we distribute our products through Xerox Limited and related non-U.S. companies (collectively “Xerox Limited”). We had approximately 55,200 employees at December 31, 2005.

Our international operations represented approximately half of our total revenues in 2005. Our largest subsidiary outside the United States is Xerox Limited, which operates predominately in Europe. We conduct our Latin American operations through subsidiaries or distributors in over 38 countries. Fuji Xerox, an unconsolidated entity of which we own 25%, develops, manufactures and distributes document processing products in Japan, China, Hong Kong and other areas of the Pacific Rim, Australia and New Zealand.

The document industry is transitioning from older technology light lens devices to digital systems, from black and white to color and from paper documents to an increased reliance on electronic documents. More and more people are creating and storing documents digitally and using the internet to easily exchange electronic documents. We believe these trends play to the strengths of our product and service offerings and represent opportunities for future growth within the \$112 billion market we serve. (This estimate, and the market estimates which follow, is calculated by leveraging third party forecasts from firms such as International Data Corporation and InfoSource in conjunction with our assumptions about our markets.) In our core markets of Production (\$8 billion) and Office (\$67 billion), we believe we are well placed to capture core growth opportunities by leading the transition to color and by reaching new customers with our broadened offerings and expanded distribution channels. We are expanding our core markets with Document Services (\$20 billion) and we are creating new market opportunities with digital printing as a complement to traditional offset printing, which we refer to as the “Eligible Offset” market. Our Document Services are organized around three offerings: Xerox Office Services, where we help our customers reduce costs and maximize productivity by optimizing their print infrastructure; Document Outsourcing and Communication Services, which focuses on optimizing the production environment; and Business Process Services, where we show our customers how to improve their processes by using digital workflow. Within the Eligible Offset market, which is estimated at \$17 billion, we offer leading digital technology, led by our market-making Xerox iGen3[®] technology and accompanied by the industry’s broadest migration path to digital, which meets the increasing demand for short run, customized and quick turnaround offset quality printing.

Our products include high-end printing and publishing systems, digital multifunctional devices (“MFDs”) (which can print, copy, scan and fax), digital copiers, laser and solid ink printers, fax machines, document-management software, and supplies such as toner, paper and ink. We provide software and workflow solutions that can help businesses easily and affordably print books, create personalized documents for their customers and scan and route digital information. In addition, we provide a range of comprehensive document management services, such as operating in-house production centers, developing online document repositories and analyzing how customers can most efficiently create and share documents in the office.

Our business model is an annuity model, based on increasing equipment sales and installations in order to increase the number of machines in the field (“MIF”) that will produce pages and generate post sale and financing revenue streams. We sell the majority of our equipment through sales-type leases that are recorded as

equipment sale revenue. Equipment sales represented 29% of our 2005 total revenue. Post sale and financing revenue includes equipment maintenance and consumable supplies, among other elements. We expect this large, recurring revenue stream to approximate three times the equipment sale revenue over the life of a lease. Thus, the number of equipment installations is a key indicator of post sale and financing revenue trends. The mix of color pages is another significant indicator of post sale revenue trends because color pages use more consumables per page than black and white. Thus, color pages generate approximately five times the revenue and profit per page as compared to black and white. In addition, market development, particularly within the Eligible Offset market, is key to increasing pages and we have leading tools and resources to develop this large market opportunity.

Segment Information

Our reportable segments are Production, Office, Developing Markets Operations (“DMO”) and Other. Operating segment financial information is presented in Note 2 to the Consolidated Financial Statements, which is incorporated by reference. We have a very broad and diverse base of customers, both geographically and demographically, ranging from small and medium businesses to graphic communications companies, governmental entities, educational institutions and large (Fortune 1000) corporate accounts. None of our business segments depends upon a single customer, or a few customers, the loss of which would have a material adverse effect on our business.

Production

We provide high-end digital monochrome and color systems designed for customers in the graphic communications industry and for large enterprises. These high-end devices enable digital on-demand printing, digital full color printing and enterprise printing. We are the only manufacturer in the market that offers a complete family of monochrome production systems from 65 to 180 impressions per minute and color production systems from 40 to 110 pages per minute (“ppm”). In addition, we offer a variety of pre-press and post-press options and the industry’s broadest set of workflow software. The Xerox Freeflow™ digital workflow collection improves our customers work processes from content creation and management to production and fulfillment. Our digital technology, combined with total document solutions and services that enable personalization and printing on demand, delivers value that improves our customer’s business results.

Our goals in the Production segment in 2005 were to strengthen our leadership position in monochrome and color and leverage the power of digital printing in the Eligible Offset market. Our “New Business of Printing” strategy complements the traditional offset press market with digital printing capabilities, which includes introducing innovative production systems and solutions to expand our leadership position and focus on the higher growth digital color opportunities. To reach our 2005 goals, we:

- **Increased our presence in the monochrome digital light production market and scaled the new monochrome publishing platform (Xerox Nuvera™).** In February 2005, we launched the Xerox 4110, a 110 ppm copier/printer. We first entered the light production space in 2003 with the introduction of the Xerox 2101. We took market share in 2004 and continued to maintain a strong position in 2005 with the success of the 4110. We launched the Xerox Nuvera 100/120 full production systems in Europe in the fourth quarter 2004 and in North America in the 2005 first quarter. In September 2005, we announced the Xerox Nuvera 144 Digital Production System, which prints at 144 ppm (a 20% increase over the previous Nuvera production system) and features a more powerful print controller and finishing options. We will continue to add features and functionality to Nuvera platform products into 2006.
- **Expanded our leading product line of color systems and increased our presence in the graphic communications environment.** During 2005, we continued to increase installations of our flagship Xerox iGen3 Digital Production Press (“Xerox iGen3”). In March 2005 we announced the Xerox iGen3 110, a 110 ppm full color production system, which represents a 10% increase in speed from the previous system. At an operating cost of approximately 5 cents per image, the Xerox iGen3 uses next generation color technology which we expect will expand the digital color print on demand market as its

speed, image quality, personalization and cost advantages enable the device to capture valuable pages in the color offset printing market. In May 2005 we launched the DocuColor™ 7000 Digital Press, a 70 ppm production system, which provides a new digital full color entry point for our graphic communications and central reproduction center customers. In September 2005, we announced the production version of the DocuColor™ 240/250, a 40 and 50 ppm digital color MFD with three external controllers designed for the production environment. We now offer customers the broadest migration path to digital with digital color devices offered at 40, 45, 50, 52, 60, 70, 80 and 110 ppm.

- **Leveraged the power of digital printing in the offset printing market.** We continue to expand and improve our leading workflow collection. In September 2005, we introduced several enhancements to the FreeFlow Digital Workflow collection, expanded the remote services offering, PrinterAct, to include the DocuColor 7000 and 8000 (previously available for Xerox iGen3 and Xerox Nuvera systems), and ramped up our ProfitAccelerator™ program which helps customers maximize digital technology investments. All products are interoperable, consisting of open architecture that link and control print shop activities with digital and offset printing equipment. They help print providers streamline job ordering and management, reduce manual steps and automate error-prone parts of the printing process. These new workflow products make it easy to integrate digital printing into JDF (job definition format)-based workflows, enabling a common set of software instructions to direct a print job from creation to completion, in a consistent, uniform manner.

Office

Our Office segment serves global, national and small to medium sized commercial customers as well as government, education and other public sector customers. Office systems and services, which include monochrome devices at speeds up to 90 ppm and color devices up to 40 ppm, as well as, 50 ppm color devices with an embedded controller, include our family of CopyCentre®, WorkCentre®, and WorkCentre® Pro digital multifunction systems; DocuColor printer/copiers; color laser, LED (light emitting diode), solid ink and monochrome laser desktop printers; digital copiers; light-lens copiers and facsimile products. We are leading the transition to digital by mapping our feature rich, innovative laser and solid ink MFDs to powerful scanning technology in the enterprise environment, which enables our customers to maximize their document workflow. We provide further value to our customers by offering a range of solutions including the Office Document Assessment (“ODA”) in which we analyze a business’ workflow and document needs, and then we identify the most efficient, productive mix of office equipment and software for that business, thereby helping to reduce the customer’s document related costs.

Our goals in the Office segment in 2005 were to digitize the office by leading in MFDs, drive the transition to color and reach more customers with a broadened product line and expanded distribution channels. To reach our 2005 goals, we announced a significant refresh of our Office systems, including most of our black-and-white MFDs, and introduced new solid ink and laser color printers and MFDs. To reach our 2005 goals, we:

- **Announced new Office products, including:**
 - The March 2005 introduction of three new solid ink devices including the first solid ink MFD, the C2424, which runs at 24 ppm—in color or black-and-white, and offers copy, print and scan functions.
 - The June 2005 introduction of two new solid ink office printers including the Phaser 8500 and Phaser 8550, with speeds of 24 ppm and 30 ppm, respectively.
 - The June 2005 launch of 22 new offerings including:
 - The *WorkCentre Pro 232, 238, 245, 255, 265 and 275*—advanced black-and-white digital MFDs that combine high-performance printing, copying, scanning and faxing in one easy-to-use office system. These products are also available as *WorkCentre* offering copy/print capabilities and optional fax and *CopyCentre* standalone digital copiers.

- The Phaser 6300 and 6350 laser printers at speeds of 26 ppm color and 36 ppm black-and-white. These new laser printers have the fastest print speeds and fastest first page out speeds in their class.
- The DocuColor 240 and 250 “light production” color MFDs with speeds of 40 ppm and 50 ppm color, respectively. These devices include an embedded controller and smaller footprint which are geared toward the larger office. Further, these devices provided significant growth opportunity in the Office and Production segments (see “Production”) depending upon configuration.
- An expanded line of desktop management software and solutions including security features and remote services.
- The October 2005 launch of two new laser printers, the Phaser 7400 and Phaser 6120, as well as the WorkCentre Pro 133 advanced MFD (also available in WorkCentre and CopyCentre), and the WorkCentre PE 220.
- **Continued to drive the transition to color by making color more affordable, easier to use, faster and more reliable.** Our color capable devices provide an attractive entry point into color by offering black and white pages at the same cost as black-and-white systems. Our patented solid ink technology offers unmatched ease of use, vibrant color image quality, and economic color run cost that support color transition leadership.
- **Expanded distribution channels** through increased use of our indirect distribution model in Europe and greater use of Teleweb (a combination of telephone and internet selling) and OEM partnerships in the U.S.

DMO

DMO includes marketing, direct sales, distributors and service operations for Xerox products, supplies and services in Latin America, the Middle East, India, Eurasia and Central-Eastern Europe and Africa. Brazil, Eurasia and Central-Eastern Europe represented approximately 12% of total revenues in 2005. In countries with developing economies, DMO manages the Xerox business through operating companies, subsidiaries, joint ventures, product distributors, affiliates, concessionaires, resellers and dealers. Two-tiered distribution has proven very successful in the high growth geographies of Russia and Central-Eastern Europe and we are currently implementing it throughout Latin America. We manage our DMO operations separately as a segment because of the political and economic volatility and unique nature of its markets. Our 2005 DMO goals included revenue stabilization and improvement, a continued focus on cost structure to improve margins, and increased profitability for growth.

Other

The Other segment primarily includes revenue from paper sales, wide format systems and value-added services.

We sell cut-sheet paper to our customers for use in their document processing products. The market for cut-sheet paper is highly competitive and revenues are significantly affected by pricing. Our strategy is to charge a premium over mill wholesale prices, which is adequate to cover our costs and the value we add as a distributor.

We offer document processing products and devices in our wide format systems business designed to reproduce large engineering and architectural drawings up to three feet by four feet in size.

An increasingly important part of our offering is value-added services, which leverage our document industry knowledge and experience. Xerox value-added services deliver solutions, which not only optimize

enterprise output spend and infrastructure, but also streamline, simplify and digitize our customers' document-intensive business processes. Often the value-added services solutions lead to larger Xerox managed services contracts, which include Xerox equipment, supplies, service and labor. The revenue from these contracts is reported within the Production, Office or DMO segments. In 2005 value-added services and managed services revenue, including equipment, totaled \$3.3 billion.

Revenue

29% of our revenue comes from Equipment sales primarily from either lease arrangements that qualify as sales for accounting purposes or outright cash sales. The remaining 71% of our revenue, "Post sale and finance income" includes annuity based revenue from maintenance, service, supplies and financing as well as revenue from rentals or operating lease arrangements. We sell most of our products and services under bundled lease arrangements, in which our customers pay a monthly amount for the related equipment, maintenance, services, supplies and financing elements over the course of the lease agreement. These arrangements are beneficial to our customers and us since in addition to customers receiving a bundled offering, the arrangement allows us to maintain the customer relationship for subsequent sales of equipment and services.

We are required for accounting purposes to analyze these arrangements to determine whether the equipment component meets certain accounting requirements such that the equipment should be recorded as a sale at lease inception (i.e. sales-type lease). Sales-type leases require allocation of a portion of the monthly payment attributable to the fair value of the equipment which we report as "Equipment sales." The remaining portion of the monthly payment is allocated to the various remaining elements based on fair value—service, maintenance, supplies and financing—which are generally recognized over the term of the lease agreement and reported as "Post sale and other revenue" and "Finance income" revenue. In those arrangements that do not qualify as sales-type leases, which has been starting to occur more frequently as a result of our services led strategy, the entire monthly payment will be recognized over the term of the lease agreement (i.e. rental or operating lease) and is reported in "Post sale and other revenue." Our accounting policies related to revenue recognition for leases and bundled arrangements, are included in Note 1 to the Consolidated Financial Statements in our 2005 Annual Report.

Research and Development

Investment in R&D is critical to drive future growth and we have aligned our investments with our strategic planks: Office, Production and Services. Our goal is to continue to create innovative technologies that will expand current and future markets. Our R&D investments employ three key themes: 1) continue to reinvent our machines to deliver better quality, more functionality and improved productivity, 2) rethink how people work, including the use of variable information printing to customize documents and 3) redefine the document through new inventions. Our research scientists regularly meet with customers and have dialogues with our business groups to ensure they understand customer requirements and develop products and solutions that can be commercialized.

In 2005, R&D expense was \$755 million, compared with \$760 million in 2004. 2005 R&D spending focused primarily on the development of high-end business applications to drive the "New Business of Printing," on extending our color capabilities, and on lower cost platforms and customer productivity enablers to drive digitization of the office. The Xerox iGen3, an advanced next-generation digital printing press launched in October 2002 that uses our patented imaging technology to produce photographic quality prints indistinguishable from offset, is an example of the type of breakthrough technology we developed and that we expect will drive future growth. Our R&D is strategically coordinated with that of Fuji Xerox, which invested \$720 million in R&D in 2005.

Patents, Trademarks and Licenses

We are a technology company. With our PARC subsidiary, we were awarded nearly 450 U.S. utility patents in 2005, ranking us 35th on the list of companies that had been awarded the most U.S. patents during the year.

With our research partner, Fuji Xerox, we were awarded nearly 650 U.S. utility patents in 2005. Our patent portfolio evolves as new patents are awarded to us and as older patents expire. As of December 31, 2005, we held approximately 8,100 design and utility U.S. patents. These patents expire at various dates up to 20 years or more from their original filing dates. While we believe that our portfolio of patents and applications has value, in general no single patent is essential to our business or any individual segment. In addition, any of our proprietary rights could be challenged, invalidated or circumvented, or may not provide significant competitive advantages.

In the U.S., we are party to numerous patent licensing agreements, and in a majority of them, we are a licensee. Most of the patent licenses expire concurrently with the expiration of the last patent identified in the license. In 2005, with our PARC subsidiary, we added approximately 15 agreements to our portfolio of patent licensing agreements, and either we or our PARC subsidiary was a licensor in 13 of the agreements. Xerox's licensing efforts include a number of cross-licensing agreements with companies with substantial patent portfolios. Those agreements vary in subject matter, scope, compensation, significance and time. Among the more recent licenses are agreements with Canon, Microsoft, IBM and Hewlett Packard.

In the U.S., we own approximately 560 trademarks (either registered or applied for). These trademarks have a perpetual life, subject to renewal every ten years. We vigorously enforce and protect our trademarks. We hold a perpetual trademark license for "DocuColor."

Competition

Although we encounter aggressive competition in all areas of our business, we are the leader, or among the leaders, in each of our principal business segments. Our competitors range from large international companies to relatively small firms. We compete primarily on the basis of technology, performance, price, quality, reliability, brand, distribution and customer service and support. To remain competitive, we invest in and develop new products and services and continually enhance our existing offerings. Our key competitors include Canon, Ricoh, IKON, Hewlett Packard and in certain areas of the business, Pitney Bowes, Kodak, Océ, Konica-Minolta and Lexmark.

We believe that our brand recognition, reputation for document knowledge and expertise, innovative technology, breadth of product offerings, global distribution channels and our customer relationships and large customer base are important competitive advantages. We and our competitors continue to develop and market new and innovative products at competitive prices and, at any given time, we may set new market standards for quality, speed and function.

Marketing and Distribution

We manage our business based on the principal business segments described above. The marketing and selling of our products and solutions, however, are organized according to geography and channel types. Our products and solutions are sold directly to customers by our worldwide sales force of approximately 8,000 employees and through a network of independent agents, dealers, value-added resellers and systems integrators. Increasingly, we are utilizing our direct sales force to address our customers' more advanced technology, solutions and services requirements, while expanding our use of cost-effective indirect distribution channels, such as Teleweb, for basic product offerings.

We market our Phaser line of color and monochrome laser-class and solid ink printers through office information technology industry resellers, who typically access our products through distributors. In 2005, we increased the product offerings available through a two-tiered distribution model in Europe and DMO. Through a multi-phased roll-out, we will continue to increase offerings through this lower cost distribution channel for our Office portfolio. Additionally, we expanded our distribution channels in North America in 2005.

In Europe, Africa, the Middle East, India and parts of Asia, we distribute our products through Xerox Limited, a company established under the laws of England, and related non-U.S. companies (collectively "Xerox Limited"). Xerox Limited enters into distribution agreements with unaffiliated third parties covering distribution

of our products in certain countries located in these regions, including Iran, Sudan and Syria. Iran, Sudan and Syria, among others, have been designated as state sponsors of terrorism by the U.S. Department of State and are subject to U.S. economic sanctions. We maintain an export and sanctions compliance program and believe that we have been and are in compliance with applicable U.S. laws and government regulations related to these countries. In addition, we had no assets, liabilities or operations in these countries other than liabilities under the distribution agreements. As a result of the termination of these agreements, we anticipate that our revenues attributable to these countries will decline over time. Xerox Limited is terminating its distribution agreements related to these countries and expects that, by the end of 2006, it will have only legacy obligations such as providing spare parts and supplies to these third parties. In 2005, we had total revenues of \$15.7 billion, of which less than \$10 million was attributable to Iran, Sudan and Syria.

In January 2006, Xerox Limited entered into a five-year distribution agreement with an unaffiliated third party covering distribution of our products in Libya. Libya is also designated as a state sponsor of terrorism by the U.S. Department of State. The decision to enter into this distribution agreement was made in light of recent U.S. federal government actions that have lifted the country-wide embargo previously imposed on Libya. Our sales in Libya through this distribution agreement will be subject to our export and sanctions compliance program and will be in accordance with applicable U.S. laws and government regulations as they relate to Libya.

We are increasing our use of partners to improve our market coverage. Through alliances with Premier Partners and Fuji Ennovation, we expanded coverage to market our DocuColor series to commercial printers. Our alliance with Electronic Data Systems ("EDS") is designed to integrate EDS' information technology ("IT") services with our document management systems and services to provide customers with full IT infrastructure support.

Our brand is a valuable resource and continues to be recognized in the top ten percent of all U.S. brands.

Service

As of December 31, 2005, we had a worldwide service force of approximately 13,000 employees and an extensive network of independent service agents. We are expanding our use of cost-effective remote service technology for basic product offerings while utilizing our direct service force and a variable contract service force to address customers' more advanced technology requirements. The increasing use of a variable contract service force is consistent with our strategy to reduce service costs while maintaining high quality levels of service. We believe that our service force represents a significant competitive advantage in that the service force is continually trained on our products and their diagnostic equipment is state-of-the-art. Twenty four-hours-a-day, seven-days-a-week service is available in major metropolitan areas around the world. As a result, we are able to provide a consistent and superior level of service worldwide.

Manufacturing Outsourcing

In the fourth quarter of 2001, we outsourced certain manufacturing activities for the Office segment to Flextronics, a global electronics manufacturing services company. Our inventory purchases from Flextronics currently represent approximately 25% of our overall worldwide inventory procurement. The initial term of the Flextronics supply agreement is five years through November 2006, and is subject to our right to extend for two years. Thereafter, it will automatically be renewed for one-year periods, unless either party elects to terminate the agreement. We have agreed to purchase from Flextronics most of our requirements for certain products in specified product families. Flextronics must acquire inventory in anticipation of meeting our forecasted requirements and must maintain sufficient manufacturing capacity to satisfy such forecasted requirements. Under certain circumstances, we may become obligated to repurchase inventory that remains unused for more than 180 days, becomes obsolete or upon termination of the supply agreement.

In addition, Xerox sources certain other Office products from various third parties, to maximize breadth of its product portfolio and to meet channel requirements. Xerox also has arrangements with Fuji Xerox whereby it purchases products from and sells products to Fuji Xerox. Certain of these purchases and sales are the result of mutual research and development arrangements. Our remaining manufacturing operations are primarily located in Rochester, New York, and Dundalk, Ireland, for our high-end production products and consumables and Wilsonville, Oregon for solid ink products, consumable supplies and components for our Office segment products.

Fuji Xerox

Fuji Xerox Co., Limited is an unconsolidated entity in which we currently own 25% and Fuji Photo Film Co., Ltd. ("FujiFilm") owns 75%. Fuji Xerox develops, manufactures and distributes document processing products in Japan, China, Hong Kong and other areas of the Pacific Rim, Australia and New Zealand. We retain significant rights as a minority shareholder. Our technology licensing agreements with Fuji Xerox ensure that the two companies retain uninterrupted access to each other's portfolio of patents, technology and products.

International Operations

Certain financial measures by geographical area for 2005, 2004 and 2003, included in Note 2 to the Consolidated Financial Statements in our 2005 Annual Report, are hereby incorporated by reference.

Backlog

We believe that backlog, or the value of unfilled orders, is not a meaningful indicator of future business prospects due to the significant proportion of our revenue that follows equipment installation, the large volume of products delivered from shelf inventories and the shortening of product life cycles.

Seasonality

Our revenues are affected by such factors as the introduction of new products, the length of the sales cycles and the seasonality of technology purchases. As a result, our operating results are difficult to predict. These factors have historically resulted in lower revenue in the first quarter than in the immediately preceding fourth quarter.

Other Information

Xerox is a New York corporation and our principal executive offices are located at 800 Long Ridge Road, P. O. Box 1600, Stamford, Connecticut 06904-1600. Our telephone number is (203) 968-3000.

Through the Investor Information section of our Internet website, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all related amendments are available, free of charge, as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Our Internet address is <http://www.xerox.com>.

Item 1A. Risk Factors

We face significant competition and our failure to compete successfully could adversely affect our results of operations and financial condition.

We operate in an environment of significant competition, driven by rapid technological advances and the demands of customers to become more efficient. Our competitors range from large international companies to relatively small firms. Some of the large international companies have significant financial resources and compete with us globally to provide document processing products and services in each of the markets we serve. We compete primarily on the basis of technology, performance, price, quality, reliability, brand, distribution and

customer service and support. Our success in future performance is largely dependent upon our ability to compete successfully in the markets we currently serve and to expand into additional market segments. To remain competitive, we must develop new products, services, and applications and periodically enhance our existing offerings. If we are unable to compete successfully, we could lose market share and important customers to our competitors and that could materially adversely affect our results of operations and financial condition.

We need to develop and expand the use of color printing and copying.

Increasing the proportion of pages which are printed in color and transitioning color pages currently produced on offset devices to Xerox technology represent key growth opportunities. A significant part of our strategy and ultimate success in this changing market is our ability to develop and market technology that produces color prints and copies quickly, easily, with high quality and at reduced cost. Our continuing success in this strategy depends on our ability to make the investments and commit the necessary resources in this highly competitive market, as well as the pace of color adoption by our existing and prospective customers. If we are unable to develop and market advanced and competitive color technologies or the pace of color adoption by our existing and prospective customers is less than anticipated, we may be unable to capture these opportunities and it could materially adversely affect our results of operations and financial condition.

If we fail to successfully develop new products and technologies, we may be unable to retain and gain customers and our revenues would be reduced.

The process of developing new high technology products and solutions is inherently complex and uncertain. It requires accurate anticipation of customers' changing needs and emerging technological trends. We must 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 desired returns. We also must ensure that all of our products comply with existing and newly enacted applicable regulatory requirements in the countries in which they are sold, particularly European Union environmental directives. If we fail to accurately anticipate and meet our customers' needs through the development of new products or if our new products are not widely accepted or if our current or future products fail to meet applicable worldwide regulatory requirements, we could lose market share and customers to our competitors and that could materially adversely affect our results of operations and financial condition.

Our profitability is dependent upon our ability to obtain adequate pricing for our products and to improve our cost structure.

Our success depends on our ability to obtain adequate pricing for our products and services which provides a reasonable return to our shareholders. Depending on competitive market factors, future prices we obtain for our products and services may decline from previous levels. In addition, pricing actions to offset the effect of currency devaluations may not prove sufficient to offset further devaluations or may not hold in the face of customer resistance and/or competition. If we are unable to obtain adequate pricing for our products and services, it could materially adversely affect our results of operations and financial condition.

Since 2000, we have engaged in a series of restructuring programs related to downsizing our employee base, exiting certain businesses, outsourcing some internal functions and engaging in other actions designed to reduce our cost structure. If we are unable to continue to maintain our cost base at or below the current level and maintain process and systems changes resulting from the restructuring actions, it could materially adversely affect our results of operations and financial condition.

Our ability to sustain and improve profit margins is dependent on a number of factors, including our ability to continue to improve the cost efficiency of our operations through such programs as Lean Six Sigma, pricing pressures on our products and services, the proportion of our equipment sales to high-end as opposed to low-end equipment, the trend in our post-sale revenue growth, and, our ability to successfully complete information technology initiatives. If any of these factors adversely materialize or if we are unable to achieve productivity

improvements through design efficiency, supplier and manufacturing cost improvements and information technology initiatives, our ability to offset labor cost inflation, potential materials cost increases and competitive price pressures would be impaired, all of which could materially adversely affect our results of operations and financial condition.

Our current credit ratings result in higher borrowing costs, which in turn may affect our ability to fund our customer financing activities at economically competitive levels.

The long-term viability and profitability of our customer financing activities is dependent, in part, on our ability to borrow and the cost of borrowing in the credit markets. This ability and cost, in turn, is dependent on our credit ratings. Our access to the public debt markets could be limited to the non-investment grade segment, which results in higher borrowing costs, until our credit ratings have been restored to investment grade. We are currently funding our customer financing activity through a combination of capital market offerings, third-party funding arrangements, including General Electric (“GE”), Merrill Lynch, and De Lage Landen Bank, cash generated from operations, cash on hand, other secured and unsecured borrowings. Our ability to continue to offer customer financing and be successful in the placement of equipment with customers is largely dependent on our ability to obtain funding at a reasonable cost. If we are unable to continue to offer customer financing, it could materially adversely affect our results of operations and financial condition.

We have outsourced approximately half of our overall world manufacturing operations and face the risks associated with relying on third party manufacturers and external suppliers.

We have outsourced a significant portion of our overall worldwide manufacturing operations to third parties and various service providers. To the extent that we rely on third party manufacturing relationships, we face the risk that those manufacturers may not be able to develop manufacturing methods appropriate for our products, they may not be able to quickly respond to changes in customer demand for our products, they may not be able to obtain supplies and materials necessary for the manufacturing process, they may experience labor shortages and/or disruptions, manufacturing costs could be higher than planned and the reliability of our products could decline. If any of these risks were to be realized, and assuming similar third-party manufacturing relationships could not be established, we could experience an interruption in supply or an increase in costs that might result in our being unable to meet customer demand for our products, damage our relationships with our customers, and reduce our market share, all of which could materially adversely affect our results of operations and financial condition.

Our business, results of operations and financial condition may be negatively impacted by economic conditions abroad, including fluctuating foreign currencies and shifting regulatory schemes.

Approximately half of our revenue is generated from operations outside the United States. In addition, we manufacture or acquire many of our products and/or their components from, and maintain significant operations, outside the United States. Our future revenues, costs and results of operations could be significantly affected by changes in foreign currency exchange rates, as well as by a number of other factors, including changes in economic conditions from country to country, changes in a country’s political conditions, trade protection measures, licensing requirements local tax issues, capitalization and other related legal matters. We generally hedge foreign currency denominated assets, liabilities and anticipated transactions primarily through the use of currency derivative contracts. The use of derivative contracts is intended to mitigate or reduce transactional level volatility in the results of foreign operations, but does not completely eliminate volatility. We do not hedge the translation effect of international revenues and expenses, which are denominated in currencies other than our U.S. parent functional currency, within our consolidated financial statements.

Our operating results may be negatively impacted by revenue trends.

Our ability to return to and maintain a consistent trend of revenue growth over the intermediate to longer term is largely dependent upon expansion of our worldwide equipment placements, as well as sales of services and supplies occurring after the initial equipment placement (post sale revenue) in the key growth markets of digital printing, color and multifunction systems. We expect that revenue growth can be further enhanced

through our document management and consulting services in the areas of personalized and product life cycle communications, office and production services and document content and imaging. The ability to achieve growth in our equipment placements is subject to the successful implementation of our initiatives to provide advanced systems, industry-oriented global solutions and services for major customers, improve direct sales productivity and expand our indirect distribution channels in our developing markets operations and other geographic areas in the face of global competition and pricing pressures. Our ability to increase post sale revenue is largely dependent on our ability to increase the volume of pages printed, the mix of color pages, equipment utilization and color adoption. Equipment placements typically occur through leases with original terms of three to five years. There will be a lag between the increase in equipment placement and an increase in post sale revenues. The ability to grow our customers' usage of our products may continue to be adversely impacted by the movement toward distributed printing and electronic substitutes and the impact of lower equipment placements in prior periods. If we are unable to return to and maintain a consistent trend of revenue growth, it could materially adversely affect our results of operations and financial condition.

Our substantial debt could adversely affect our financial health and pose challenges for conducting our business.

We have and will continue to have a substantial amount of debt and other obligations, primarily to support our customer financing activities. As of December 31, 2005, we had \$7.3 billion of total debt (\$3.0 billion of which is secured by finance receivables) and \$724 million of liabilities to trusts issuing preferred securities, which includes \$98 million recorded as a component of Other current liabilities. The total value of financing activities, shown on the balance sheet as Finance Receivables and On-Lease equipment, was \$8.3 billion at December 31, 2005. The total cash, cash equivalents and short-term investments balance was \$1.6 billion at December 31, 2005. Our substantial debt and other obligations could have important consequences. For example, it could (i) increase our vulnerability to general adverse economic and industry conditions; (ii) limit our ability to obtain additional financing for future working capital, capital expenditures, acquisitions and other general corporate requirements; (iii) increase our vulnerability to interest rate fluctuations because a portion of our debt has variable interest rates; (iv) require us to dedicate a substantial portion of our cash flows from operations to service debt and other obligations thereby reducing the availability of our cash flows from operations for other purposes; (v) limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate; (vi) place us at a competitive disadvantage compared to our competitors that have less debt; and (vii) become due and payable upon a change in control. If new debt is added to our current debt levels, these related risks could increase.

We need to maintain adequate liquidity in order to have sufficient cash to meet operating cash flow requirements and to repay maturing debt and other obligations. If we fail to comply with the covenants contained in our various borrowing agreements, it may adversely affect our liquidity, results of operations and financial condition.

Our liquidity is a function of our ability to successfully generate cash flows from a combination of efficient operations and improvements therein, funding from third parties, access to capital markets, securitizations and secured borrowings for our finance receivables portfolios. With \$1.6 billion of total cash, cash equivalents and short-term investments as of December 31, 2005, borrowing capacity under our 2003 Credit Facility of approximately \$700 million and funding available through our customer financing arrangements, we believe our liquidity (including operating and other cash flows that we expect to generate) will be sufficient to meet operating requirements as they occur and to satisfy all scheduled debt maturities for at least the next twelve months; however, our ability to maintain sufficient liquidity going forward depends on our ability to generate cash from operations and access to the capital markets, both of which are subject to general economic, financial, competitive, legislative, regulatory and other market factors that are beyond our control.

The 2003 Credit Facility contains affirmative and negative covenants including limitations on: issuance of debt and preferred stock; investments and acquisitions; mergers; certain transactions with affiliates; creation of liens; asset transfers; hedging transactions; payment of dividends and certain other payments and intercompany

loans. The 2003 Credit Facility contains financial maintenance covenants, including minimum EBITDA, as defined, maximum leverage (total adjusted debt divided by EBITDA), annual maximum capital expenditures limits and minimum consolidated net worth, as defined. The indentures governing our outstanding senior notes contain similar covenants. They do not, however, contain any financial maintenance covenants, except the fixed charge coverage ratio applicable to certain types of payments. Our U.S. Loan Agreement with General Electric Capital Corporation (“GECC”) (effective through 2010) relating to our customer financing program (the “Loan Agreement”) provides for secured loans up to \$5 billion outstanding at any time. As of December 31, 2005, \$2.5 billion was outstanding under the Loan Agreement, including similar loan agreements with GE in the U.K. and Canada. These agreements incorporate the financial maintenance covenants contained in the 2003 Credit Facility and contains other affirmative and negative covenants.

At December 31, 2005, we were in full compliance with the covenants and other provisions of the 2003 Credit Facility, the senior notes and the Loan Agreement and expect to remain in full compliance for at least the next twelve months. Any failure to be in compliance with any material provision or covenant of the 2003 Credit Facility or the senior notes could have a material adverse effect on our liquidity, results of operations and financial condition. Failure to be in compliance with the covenants in the Loan Agreement, including the financial maintenance covenants incorporated from the 2003 Credit Facility, would result in an event of termination under the Loan Agreement and in such case GECC would not be required to make further loans to us. If GECC were to make no further loans to us, and assuming a similar facility was not established and that we were unable to obtain replacement financing in the public debt markets, it could materially adversely affect our liquidity and our ability to fund our customers’ purchases of our equipment and this could materially adversely affect our results of operations.

Our business, results of operations and financial condition may be negatively impacted by legal and regulatory matters.

We have various contingent liabilities that are not reflected on our balance sheet, including those arising as a result of being involved in a variety of claims, lawsuits, investigations and proceedings concerning securities law, intellectual property law, environmental law, employment law and the Employee Retirement Income Security Act (“ERISA”), as discussed in Note 16 to the Consolidated Financial Statements. We determine whether an estimated loss from a contingency should be accrued by assessing whether a loss is deemed probable and can be reasonably estimated. We assess potential liability by analyzing our litigation and regulatory matters using available information. We develop our views on estimated losses in consultation with legal counsel handling our defense in these matters, which involves an analysis of potential results, assuming a combination of litigation and settlement strategies. Should developments in any of our legal matters cause a change in our determination as to an unfavorable outcome and result in the need to recognize a material accrual, or should any of these matters result in a final adverse judgment or be settled for significant amounts, they could have a material adverse effect on our results of operations, cash flows and financial position in the period or periods in which such change in determination, judgment or settlement occurs.

Our operations are subject to environmental regulations in each of the jurisdictions in which we conduct our business. Some of our manufacturing operations use, and some of our products contain, substances that are regulated in various jurisdictions. The European Union Directive known as the Restriction on the Use of Hazardous Substances (“RoHS”), for example, requires the removal of lead, cadmium and certain other substances from product designs put on the market in the European Union beginning in July 2006. We do not expect the RoHS directive to have a material impact on our product lines. If we do not comply with applicable rules and regulations in connection with the use of such substances and the sale of products containing such substances, then we could be subject to liability and could be prevented from selling our products, which could have a material adverse effect on our results of operations and financial condition. Further, we could also face substantial costs and liabilities in connection with product take-back legislation. Beginning in 2005, we became subject to the European Union Directive on Waste Electrical and Electronic Equipment (“WEEE”) as enacted by individual European Union countries (“WEEE Legislation”), which makes producers of electrical goods, including computers and printers, responsible for collection, recycling, treatment and disposal of recovered

products. We continue to evaluate the impact of specific registration and compliance activities required by WEEE Legislation. If we are unable to collect, recycle, treat and dispose of our products in a cost-effective manner and in accordance with applicable country WEEE Legislation, it could materially adversely affect our results of operations and financial condition.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

We own several manufacturing, engineering and research facilities and lease additional facilities. The principal manufacturing and engineering facilities, located in California, New York, Oklahoma, Canada, UK, Ireland and the Netherlands, are used jointly by the Production and Office Segments, those in Oregon by the Office Segment, and those in Brazil and India by the DMO Segment. Our principal research facilities are located in California, New York, Canada, France and the U.K. The research activities in our principal research centers benefit all our operating segments.

As we implemented our restructuring programs (discussed in Note 9 to the Consolidated Financial Statements in our Annual Report, incorporated by reference), several leased properties became surplus. The surplus properties have leases that we are obligated to maintain through required contractual periods. We have disposed or subleased certain of these properties and are aggressively pursuing the successful disposition and subleasing of all remaining surplus properties anticipating the majority to be disposed by 2009. With respect to United States properties, at year-end 2005 there were approximately 29 surplus facilities totaling approximately 1.1 million square feet.

Commencing in 2003, a Virtual Office Program was implemented for the United States sales force locations. As part of this program, approximately 2,300 employees are working virtually. In combination with other right-sizing initiatives, this program has reduced our real estate portfolio by approximately 0.6 million square feet. Overall, this program has been a success and is generally well received.

In December 2003, STHQ Realty LLC was formed to finance the acquisition of the Company's headquarters in Stamford, Connecticut. While the assets and liabilities of this special purpose entity are included in the Company's Consolidated Financial Statements, STHQ Realty LLC is a bankruptcy-remote separate legal entity. As a result, its assets of \$42 million at December 31, 2005, are not available to satisfy the debts and other obligations of the Company.

In addition, we have numerous facilities, which encompass general offices, sales offices, service locations and distribution centers. The principal owned facilities are located in the United States, France, Ireland, Brazil, India and Mexico. The principal leased facilities are located in the United States, Brazil, Canada, UK, Mexico, France, Germany and Italy. In 2002, we entered into a joint venture (Xerox Capital Services) with General Electric to manage our administrative billing, credit and collection function. Xerox Capital Services licenses several of our owned and leased facilities totaling approximately 500,000 square feet for their use. The three principal Xerox Capital Services administrative facilities are located in Florida, Illinois and Texas. We also lease a portion of a training facility, located in Virginia. It is our opinion that our properties have been well maintained, are in sound operating condition and contain all the necessary equipment and facilities to perform our functions.

Item 3. Legal Proceedings

The information set forth under Note 16 to the Consolidated Financial Statements, "Contingencies" of the Xerox Corporation 2005 Annual Report is hereby incorporated by reference.

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

None

PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

(a) Market Information, Holders and Dividends

The information set forth under the following captions of the Xerox Corporation 2005 Annual Report to Shareholders is hereby incorporated by reference:

Caption

Stock Listed and Traded
 Xerox Common Stock Prices and Dividends
 Five Years in Review—Common Shareholders of Record at Year-End
 Securities Authorized for Issuance Under Equity Compensation Plans

(b) Sales of Unregistered Securities During the Quarter ended December 31, 2005

During the quarter ended December 31, 2005, registrant issued no securities in transactions which were not registered under the Securities Act of 1993, as amended.

(c) Issuer Purchases of Equity Securities during the Quarter ended December 31, 2005

Repurchases of Xerox Common Stock, par value \$1.00 per Share

| | Total Number of Shares Purchased | Average Price Paid per Share ⁽²⁾ | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ⁽¹⁾ | Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased under the Plans or Programs ⁽¹⁾ |
|---|-------------------------------------|--|---|--|
| October 19 ⁽¹⁾ through 31 | 1,085,000 | \$ 13.3031 | 1,085,000 | \$ 485,566,130 |
| November 1 through 30 | 15,500,300 | 13.8612 | 15,500,300 | 270,713,704 |
| December 1 through 31 | 13,916,900 | \$ 14.5733 | 13,916,900 | \$ 67,899,122 |
| Total | 30,502,200 | | 30,502,200 | |

⁽¹⁾ On October 19, 2005 our Board of Directors authorized a Stock Repurchase Program covering the repurchase of up to \$500 million of our common stock, par value \$1.00 per share, through the period ending October 31, 2006. The \$500 million is exclusive of fees and costs. The repurchases may be made on the open market or through negotiated transactions. We expect to repurchase stock primarily through open-market purchases. Open-market repurchases will be made in compliance with the Securities and Exchange Commission's Rule 10b-18, and are subject to market conditions as well as applicable legal and other considerations.

⁽²⁾ Exclusive of fees and costs.

Item 6. Selected Financial Data

The following selected financial data for the five years ended December 31, 2005, as set forth and included under the caption “Five Years in Review,” of the Xerox Corporation 2005 Annual Report to Shareholders, is incorporated by reference in this Form 10-K.

Revenues
Income (loss) from continuing operations before cumulative effect of change in accounting principle
Per-Share Data
Income (loss) from continuing operations before cumulative effect of change in accounting principle—Basic and Diluted
Earnings (Loss)—Basic and Diluted
Common stock dividends
Total assets
Long-term debt
Liabilities to subsidiary trusts issuing preferred securities
Series B convertible preferred stock
Series C mandatory convertible preferred stock

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

The information set forth under the caption “Management’s Discussion and Analysis of Results of Operations and Financial Condition,” of the Xerox Corporation 2005 Annual Report is hereby incorporated by reference.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The information set forth under the caption “Financial Risk Management”, in the Xerox Corporation 2005 Annual Report is hereby incorporated by reference.

Item 8. Financial Statements and Supplementary Data

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP, included in the Xerox Corporation 2005 Annual Report, are incorporated by reference in this Form 10-K. With the exception of the aforementioned information and the information incorporated in Items 5, 6, 7, 7A and 8, the Xerox Corporation 2005 Annual Report is not to be deemed filed as part of this Form 10-K.

The quarterly financial data included under the caption “Quarterly Results of Operations (Unaudited)” of the Xerox Corporation 2005 Annual Report is incorporated by reference in this Annual Report on Form 10-K.

The financial statement schedule required herein is filed as referenced in Item 15 of this Form 10-K.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures**Management’s Responsibility for Financial Statements**

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

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

Disclosure Controls and Procedures

We have established disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to the officers who certify the Company's financial reports and to other members of senior management and the Board of Directors. Based on their evaluation as of December 31, 2005, our principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Management's Report on Internal Control Over Financial Reporting

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

Based on the above evaluation, management concluded that, our internal control over financial reporting was effective as of December 31, 2005. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included in the Xerox Corporation 2005 Annual Report to Shareholders, which is incorporated by reference in this Form 10-K.

Changes in Internal Control Over Financial Reporting

In connection with the evaluation required by paragraph (d) of Rule 13a-15 under the Exchange Act, there was no change identified in our internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

Directors

On February 16, 2006, Xerox Corporation's Board of Directors elected Mary Agnes "Maggie" Wilderotter to the Board effective March 1, 2006. Ms. Wilderotter is Chairman and Chief Executive Officer of Citizens Communications, a full-service communications provider of telephone, television, and Internet products and services. Ms. Wilderotter has not yet been named to any committee of the Board.

On February 13, 2006, Stephen Robert, a member of our Board of Directors and the Finance Committee of the Board of Directors, gave notice to us of his decision not to stand for re-election to our Board of Directors at

the 2006 annual meeting of stockholders. Mr. Robert's decision not to stand for re-election is related to his increased and additional business obligations and, to the knowledge of our executive officers, is not because of any disagreement with our operations, policies or practices.

Executive Compensation

On February 16 and February 17, 2006, the Compensation Committee of the Board of Directors of the Company took the following actions:

2005 and 2006 Annual Performance Incentive Plan (APIP):

The Compensation Committee approved the payments of cash awards under the Xerox 2004 Performance Incentive Plan (the "2004 PIP"). The measures on which awards are based for the 2005 fiscal year are set out on Exhibit 10(e)(4) attached hereto and the measures for awards for fiscal year 2006 are set out on Exhibit 10(e)(5) attached hereto. The Compensation Committee approved cash awards under the 2004 PIP for fiscal year 2005 to Mrs. Anne Mulcahy, Chairman and Chief Executive Officer of the Company, and certain other officers, including Ursula M. Burns, James A. Firestone, Michael C. MacDonald and Lawrence A. Zimmerman, our other four most highly compensated executive officers for fiscal year 2005 (collectively with Mrs. Mulcahy, the "Named Officers"). The Compensation Committee approved a cash award of \$1,188,000 to Mrs. Mulcahy, \$350,595 to Ms. Burns, \$330,750 to Mr. Firestone, \$342,619 to Mr. MacDonald and \$346,500 to Mr. Zimmerman.

The Compensation Committee increased the targeted levels of cash awards for 2006 as follows: Mrs. Mulcahy 150% of base salary; Ms. Burns 100% of base salary; Mr. Firestone 100% of base salary and Mr. Zimmerman 100% of base salary.

Base Salary:

The base salaries of the Named Officers were increased as follows, each effective as of April 1, 2006: Ms. Burns will receive a base salary of \$640,000, Mr. Firestone will receive a base salary of \$600,000, Mr. MacDonald will receive a base salary of \$509,300 and Mr. Zimmerman will receive a base salary of \$600,000. The base salary of Mrs. Mulcahy was maintained at the previously disclosed level of \$1,320,000.

2005 E-LTIP Awards:

The Compensation Committee determined that one-third of the performance shares granted under the 2005 Executive Long-Term Incentive Program ("2005 E-LTIP") were earned based on the Company's 2005 performance against the annual targets established for Diluted Earnings Per Share from Continuing Operations and Net Cash provided by Operating Activities. The number of shares earned for 2005 for each Named Officer is as follows: Mrs. Mulcahy, 98,033 shares; Ms. Burns, 35,300 shares; Mr. Firestone, 31,367 shares; Mr. MacDonald, 21,567 shares and Mr. Zimmerman, 31,367 shares. Earned shares vest three years from their grant date.

2006 E-LTIP Awards:

The Compensation Committee approved grants, including the measures for awards of performance shares to be made effective April 1, 2006 to the Named Officers under the 2006 Executive Long-Term Incentive Program ("2006 E-LTIP"), a component of our 2004 PIP. The amounts awarded are as follows: Mrs. Mulcahy received 444,000 shares, Ms. Burns received 170,800 shares, Mr. Firestone received 136,700 shares, Mr. MacDonald received 75,200 shares and Mr. Zimmerman received 109,300 shares. The specific performance measures for the 2006 E-LTIP for fiscal year 2006 are set out on Exhibit 10(e)(6) attached hereto and the form of award agreement pursuant to which such grants were made is attached hereto as Exhibit 10(e)(9).

2006 E-LTIP awards made to officers reflect their leadership role in the Company, their individual performance, and competitive award levels. The purpose of the 2006 E-LTIP is to provide the necessary incentives to retain and reward executives for sustained performance improvements over the next three-year period. Awards under the 2006 E-LTIP for officers are comprised entirely of performance shares that may be earned based on achieving annual performance targets and three-year cumulative performance between threshold and maximum as determined by the Committee. All performance shares that are earned vest in 2009. Executives who retire, are involuntarily terminated (without cause) or voluntarily terminate due to a reduction in force prior to the end of the three-year performance cycle will vest in a portion of the performance shares earned on a pro rata basis.

Performance metrics for the 2006 E-LTIP are Earnings Per Share (weighted 60%) and Core Cash Flow from Operations (weighted 40%). Earnings Per Share and Core Cash Flow from Operations are defined in Exhibit 10(e)(6) attached hereto. The Committee has established annual and cumulative targets. Based on annual or cumulative performance versus targets, the number of performance shares earned by officers under the 2006 E-LTIP may vary from 0% to 150% of the initial number of shares subject to the grant.

Participants in the 2006 E-LTIP are subject to meaningful ownership requirements and mandatory share holding requirements of 50% of the net vested shares until their ownership requirements have been met. The Company believes that the 2006 E-LTIP provides strong performance-based incentives that are in full alignment with the interests of all shareholders of the Company.

Other Arrangements:

The Compensation Committee has authorized Mr. Lawrence Zimmerman to utilize commercial and company aircraft for travel to and from his residence located outside Connecticut at an aggregate cost to the Company not to exceed \$250,000 per year, inclusive of any applicable tax-related payments.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information regarding directors is incorporated herein by reference from the section entitled "Proposal 1—Election of Directors" in our definitive Proxy Statement ("2006 Proxy Statement") to be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, for our Annual Meeting of Stockholders to be held on May 24, 2006. The Proxy Statement will be filed within 120 days after the end of our fiscal year ended December 31, 2005.

The information regarding compliance with Section 16(a) of the Securities and Exchange Act of 1934 is incorporated herein by reference from the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" of our 2006 Proxy Statement.

The information regarding audit committee financial experts is incorporated by reference herein from the subsection entitled "Committee Functions, Membership and Meetings" in the section entitled "Proposal 1—Election of Directors" in our 2006 Proxy Statement.

The information regarding the code of ethics applicable to our principal executive officer, principal financial officer and principal accounting officer is incorporated herein by reference from the subsection entitled—"Corporate Governance" in the section entitled "Proposal 1—Election of Directors" in our 2006 Proxy Statement.

Executive Officers of Xerox

The following is a list of the executive officers of Xerox, their current ages, their present positions and the year appointed to their present positions. Anne M. Mulcahy, Chairman of the Board and CEO and Thomas J. Dolan, Senior Vice President, are sister and brother. There are no other family relationships between any of the executive officers named.

Each officer is elected to hold office until the meeting of the Board of Directors held on the day of the next annual meeting of shareholders, subject to the provisions of the By-Laws.

| <u>Name</u> | <u>Age</u> | <u>Present Position</u> | <u>Year Appointed to Present Position</u> | <u>Officer Since</u> |
|-----------------------|------------|--|---|--------------------------|
| Anne M. Mulcahy* | 53 | Chairman of the Board and Chief Executive Officer | 2002 | 1992 |
| Lawrence A. Zimmerman | 63 | Senior Vice President and Chief Financial Officer | 2002 | 2002 |
| Ursula M. Burns | 47 | Senior Vice President President, Business Group Operations | 2002 | 1997 |
| Thomas J. Dolan | 61 | Senior Vice President President, Xerox Global Services | 2001 | 1997 |
| James A. Firestone | 51 | Senior Vice President President, Xerox North America | 2004 | 1998 |
| Michael C. Mac Donald | 52 | Senior Vice President President, Global Accounts and Marketing Operations | 2004 | 1997 |
| Hector J. Motroni | 62 | Senior Vice President, Chief Staff Officer and Chief Ethics Officer | 2003 | 1994 |

Executive Officers of Xerox, Continued

| <u>Name</u> | <u>Age</u> | <u>Present Position</u> | <u>Year Appointed to Present Position</u> | <u>Officer Since</u> |
|------------------------|------------|---|---|----------------------|
| Jean-Noel Machon | 53 | Senior Vice President President, Developing Markets Operations | 2004 | 2000 |
| Harry R. Beeth | 60 | Vice President and Controller | 2002 | 2002 |
| J. Michael Farren | 53 | Vice President, External and Legal Affairs, General Counsel and Corporate Secretary | 2004 | 1994 |
| Gary R. Kabureck | 52 | Vice President and Chief Accounting Officer | 2003 | 2000 |
| James H. Lesko | 54 | Vice President, Investor Relations | 2004 | 1993 |
| John E. McDermott | 52 | Vice President, Corporate Strategy and Alliances | 2004 | 2004 |
| Rhonda L. Seegal | 55 | Vice President and Treasurer | 2003 | 2003 |
| Armando Zagalo de Lima | 47 | Vice President, President Xerox Europe | 2004 | 2000 |

* Member of Xerox Board of Directors

Each officer named above, with the exception of Lawrence A. Zimmerman, Harry R. Beeth, Rhonda L. Seegal and John E. McDermott, has been an officer or an executive of Xerox or its subsidiaries for at least the past five years.

Prior to joining Xerox in 2002, Mr. Zimmerman had been with System Software Associates, Inc. where he was Executive Vice President and Chief Financial Officer from 1998–1999. Prior to that, he retired from International Business Machines Corporation (IBM), where he was Senior Finance Executive for IBM’s Server group from 1996–1998, Vice President of Finance for Europe, Middle East and Africa Operations from 1994–1996 and IBM Corporate Controller from 1991–1994. He held various other positions at IBM from 1967–1991.

Prior to joining Xerox in 2002, Mr. Beeth had retired from IBM where he was Vice President, Finance for the Server group from 1998 until his retirement in 2000; Vice President, Finance, Microelectronics division from 1996-1998; Assistant Controller from 1994–1996; Group Director of Finance and Planning Operations for the North American sales organization from 1991–1994; and Vice President, Finance and Planning for the National Services organization from 1988–1990. He held various positions at IBM from 1967–1988.

Prior to joining Xerox in 2002, Mr. McDermott had been a partner at Marakon Associates, a management-consulting firm, from 1996-2002 and had been a consultant at that firm from 1988-1996. He worked on issues of business strategy, operations improvement and organizational design.

Prior to joining Xerox in 2003, Ms. Seegal had been with Avaya Inc., where she was Vice President and Treasurer from 2000–2003. Prior to that, she was Deputy Treasurer at General Electric Company from 1996–2000.

Item 11. Executive Compensation

Information regarding executive compensation is incorporated herein by reference from the section entitled “Executive Officer Compensation” in our 2006 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information regarding security ownership of certain beneficial owners and management and securities authorized for issuance under equity compensation plans is incorporated herein by reference from the sections entitled “Ownership of Company Securities” and “Equity Compensation Plan Information” in our 2006 Proxy Statement.

Item 13. Certain Relationships and Related Transactions

Information regarding certain relationships and related transactions is incorporated herein by reference from the section entitled “Certain Transactions” in our 2006 Proxy Statement.

Item 14. Principal Auditor Fees and Services

The information regarding principal auditor fees and services is incorporated herein by reference from the section entitled “Proposal 2—Ratification of Election of Independent Registered Public Accounting Firm” in our 2006 Proxy Statement.

Item 15. Exhibits and Financial Statement Schedules

(a) (1) Index to Financial Statements and Financial Statement Schedule, incorporated by reference or filed as part of this report:

Report of Independent Registered Public Accounting Firm

Consolidated Statements of Income for each of the years in the three-year period ended December 31, 2005

Consolidated Balance Sheets as of December 31, 2005 and 2004

Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2005

Consolidated Statements of Common Shareholders' Equity for each of the years in the three-year period ended December 31, 2005

Notes to Consolidated Financial Statements

Financial Statement Schedule:

Report of Independent Registered Public Accounting Firm on Financial Statement Schedule

II—Valuation and qualifying accounts

All other schedules are omitted as they are not applicable, or the information required is included in the financial statements or notes thereto.

(2) Supplementary Data:

Quarterly Results of Operations (unaudited)

Five Years in Review

(3) The exhibits filed herewith or incorporated herein by reference are set forth in the Index of Exhibits included herein.

(b) The management contracts or compensatory plans or arrangements listed in the Index of Exhibits that are applicable to the executive officers named in the Summary Compensation Table which appears in Registrant's 2006 Proxy Statement are preceded by an asterisk (*).

(c) Financial statements required by Regulation S-X which are excluded from the annual report to shareholders by Rule 14a-3(b), including schedules filed under Item 15(a) of this Report which is incorporated herein by reference.

Report of Independent Registered Public Accounting Firm on Financial Statement Schedule

To the Board of Directors of Xerox Corporation:

Our audits of the consolidated financial statements, of management's assessment of the effectiveness of internal control over financial reporting and of the effectiveness of internal control over financial reporting referred to in our report dated February 17, 2006, appearing in the 2005 Annual Report to Shareholders of Xerox Corporation (which report and consolidated financial statements and assessment are incorporated by reference in this Annual Report on Form 10-K) also included an audit of the financial statement schedule listed in Item 15(a)(1) of this Form 10-K. In our opinion, this financial statement schedule presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements.

/s/ PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP
Stamford, Connecticut
February 17, 2006

SCHEDULE II

Valuation and Qualifying Accounts
Year ended December 31, 2005, 2004 and 2003

| (in millions) | Balance at beginning of period | Additions charged to bad debt provision ⁽¹⁾ | Amounts (credited) charged to other income statement accounts ⁽¹⁾ | Deductions and other, net of recoveries ⁽²⁾ | Balance at end of period |
|--------------------------|--------------------------------------|---|---|--|--------------------------------|
| 2005 | | | | | |
| Allowance for Losses on: | | | | | |
| Accounts Receivable | \$ 183 | \$ 36 | \$ (14) | \$ (69) | \$ 136 |
| Finance Receivables | 276 | 36 | (8) | (75) | 229 |
| | <u>\$ 459</u> | <u>\$ 72</u> | <u>\$ (22)</u> | <u>\$ (144)</u> | <u>\$ 365</u> |
| 2004 | | | | | |
| Allowance for Losses on: | | | | | |
| Accounts Receivable | \$ 218 | \$ 68 | \$ (27) | \$ (76) | \$ 183 |
| Finance Receivables | 315 | 42 | 3 | (84) | 276 |
| | <u>\$ 533</u> | <u>\$ 110</u> | <u>\$ (24)</u> | <u>\$ (160)</u> | <u>\$ 459</u> |
| 2003 | | | | | |
| Allowance for Losses on: | | | | | |
| Accounts Receivable | \$ 282 | \$ 99 | \$ (27) | \$ (136) | \$ 218 |
| Finance Receivables | 324 | 125 | 27 | (161) | 315 |
| | <u>\$ 606</u> | <u>\$ 224</u> | <u>\$ —</u> | <u>\$ (297)</u> | <u>\$ 533</u> |

⁽¹⁾ Bad debt provisions relate to estimated losses due to credit and similar collectability issues. Other charges (credits) relate to adjustments to reserves necessary to reflect events of non-payment such as customer accommodations and contract terminations.

⁽²⁾ Deductions and other, net of recoveries primarily relates to receivable write-offs, but also includes the impact of foreign currency translation adjustments and recoveries of previously written off receivables.

INDEX OF EXHIBITS

Document and Location

- (3)(a) Restated Certificate of Incorporation of Registrant filed with the Department of State of New York on November 7, 2003, as amended by Certificate of Amendment to Certificate of Incorporation filed with the Department of State of New York on August 19, 2004.
Incorporated by reference to Exhibit 3(a) to Registrant's Annual Report on Form 10-K for the Year Ended December 31, 2004.
- (b) By-Laws of Registrant, as amended through December 10, 2003.
Incorporated by reference to Exhibit 4(a)(2) to Registrant's Registration Statement No. 333-111623.
- (4)(a)(1) Indenture dated as of December 1, 1991, between Registrant and Citibank, N.A., as trustee, relating to unlimited amounts of debt securities, which may be issued from time to time by Registrant when and as authorized by or pursuant to a resolution of Registrant's Board of Directors (the "December 1991 Indenture").
Incorporated by reference to Exhibit 4(a) to Registrant's Registration Statement Nos. 33-44597, 33-49177 and 33-54629.
- (2) Instrument of Resignation, Appointment and Acceptance dated as of February 1, 2001, among Registrant, Citibank, N.A., as resigning trustee, and Wilmington Trust Company, as successor trustee, relating to the December 1991 Indenture.
Incorporated by reference to Exhibit 4(a)(2) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 filed on June 7, 2001.
- (b)(1) Indenture dated as of September 20, 1996, between Registrant and Citibank, N.A., as trustee, relating to unlimited amounts of debt securities, which may be issued from time to time by Registrant when and as authorized by or pursuant to a resolution of Registrant's Board of Directors (the "September 1996 Indenture").
Incorporated by reference to Exhibit 4(a) to Registration Statement No. 333-13179.
- (2) Instrument of Resignation, Appointment and Acceptance dated as of February 1, 2001, among Registrant, Citibank, N.A., as resigning trustee, and Wilmington Trust Company, as successor trustee, relating to the September 1996 Indenture.
Incorporated by reference to Exhibit 4(b)(2) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 filed on June 7, 2001.
- (c)(1) Indenture dated as of January 29, 1997, between Registrant and Bank One, National Association (as successor by merger with The First National Bank of Chicago) ("Bank One"), as trustee (the "January 1997 Indenture"), relating to Registrant's Junior Subordinated Deferrable Interest Debentures ("Junior Subordinated Debentures").
Incorporated by reference to Exhibit 4.1 to Registration Statement No. 333-24193.
- (2) Form of Certificate of Exchange relating to Junior Subordinated Debentures.
Incorporated by reference to Exhibit A to Exhibit 4.1 to Registration Statement No. 333-24193.
- (3) Certificate of Trust of Xerox Capital Trust I executed as of January 23, 1997.
Incorporated by reference to Exhibit 4.3 to Registration Statement No. 333-24193.
- (4) Amended and Restated Declaration of Trust of Xerox Capital Trust I dated as of January 29, 1997.
Incorporated by reference to Exhibit 4.4 to Registration Statement No. 333-24193.
- (5) Form of Exchange Capital Security Certificate for Xerox Capital Trust I.
Incorporated by reference to Exhibit A-1 to Exhibit 4.4 to Registration Statement No. 333-24193.

- (6) Series A Capital Securities Guarantee Agreement of Registrant dated as of January 29, 1997, relating to Series A Capital Securities of Xerox Capital Trust I.
Incorporated by reference to Exhibit 4.6 to Registration Statement No. 333-24193.
- (7) Registration Rights Agreement dated January 29, 1997, among Registrant, Xerox Capital Trust I and the initial purchasers named therein.
Incorporated by reference to Exhibit 4.7 to Registration Statement No. 333-24193.
- (8) Instrument of Resignation, Appointment and Acceptance dated as of November 30, 2001, among Registrant, Bank One as resigning trustee, and Wells Fargo Bank Minnesota, National Association (“Wells Fargo”), as successor Trustee, relating to the January 1997 Indenture.
Incorporated by reference to Exhibit (c)(8) to Registrant’s Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
- (d)(1) Indenture dated as of October 21, 1997, among Registrant, Xerox Overseas Holding Limited (formerly Xerox Overseas Holding PLC), Xerox Capital (Europe) plc (formerly Rank Xerox Capital (Europe) plc) and Citibank, N.A., as trustee, relating to unlimited amounts of debt securities which may be issued from time to time by Registrant and unlimited amounts of guaranteed debt securities which may be issued from time to time by the other issuers when and as authorized by or pursuant to a resolution or resolutions of the Board of Directors of Registrant or the other issuers, as applicable (the “October 1997 Indenture”).
Incorporated by reference to Exhibit 4(b) to Registrant’s Registration Statement No. 333-34333.
- (2) Instrument of Resignation, Appointment and Acceptance dated as of February 1, 2001, among Registrant, the other issuers under the October 1997 Indenture, Citibank, N.A., as resigning trustee, and Wilmington Trust Company, as successor trustee, relating to the October 1997 Indenture.
Incorporated by reference to Exhibit 4(d)(2) to Registrant’s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 filed on June 7, 2001.
- (e)(1) Indenture dated as of April 21, 1998, between Registrant and Bank One, as trustee, relating to \$1,012,198,000 principal amount at maturity of Registrant’s Convertible Subordinated Debentures due 2018 (the “April 1998 Indenture”).
Incorporated by reference to Exhibit 4(b) to Registrant’s Registration Statement No. 333-59355.
- (2) Instrument of Resignation, Appointment and Acceptance dated as of July 26, 2001, among Registrant, Bank One as resigning trustee, and Wells Fargo, as successor Trustee, relating to the April 1998 Indenture (the “April 1998 Indenture Trustee Assignment”).
Incorporated by reference to Exhibit 4(e)(2) to Registrant’s Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
- (3) Amendment to Instrument of Resignation, Appointment and Acceptance dated as of October 22, 2001, among Registrant, Bank One as resigning trustee, and Wells Fargo, as successor Trustee, relating to the April 1998 Indenture Trustee Assignment.
Incorporated by reference to Exhibit 4(e)(3) to Registrant’s Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
- (f)(1) Indenture, dated as of January 17, 2002, between Registrant and Wells Fargo, as trustee, relating to Registrant’s 9³/₄% Senior Notes due 2009 (Denominated in U.S. Dollars) (the “January 17, 2002 U.S. Dollar Indenture”).
Incorporated by reference to Exhibit 4(h)(1) to Registrant’s Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
- (2) Indenture, dated as of January 17, 2002, between Registrant and Wells Fargo, as trustee, relating to Registrant’s 9³/₄% Senior Notes due 2009 (Denominated in Euros) (the “January 17, 2002 Euro Indenture”).
Incorporated by reference to Exhibit 4(h)(2) to Registrant’s Annual Report on Form 10-K for the fiscal year ended December 31, 2001.

- (3) Registration Rights Agreement, dated as of January 17, 2002, among Registrant and the initial purchasers named therein, relating to Registrant's \$600,000,000 9³/₄% Senior Notes due 2009.
Incorporated by reference to Exhibit 4(h)(3) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
- (4) Registration Rights Agreement, dated as of January 17, 2002, among Registrant and the initial purchasers named therein, relating to Registrant's (euro) 225,000,000 9³/₄% Senior Notes due 2009.
Incorporated by reference to Exhibit 4(h)(4) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2001.
- (5) First Supplemental Indenture dated as of June 21, 2002 between Registrant and Wells Fargo, as trustee, to the January 17, 2002 U.S. Dollar Indenture.
Incorporated by reference to Exhibit (4)(h)(5) to Registrant's Current Report on Form 8-K dated June 21, 2002.
- (6) First Supplemental Indenture dated as of June 21, 2002 between Registrant and Wells Fargo, as trustee, to the January 17, 2002 Euro Indenture.
Incorporated by reference to Exhibit (4)(h)(6) to Registrant's Current Report on Form 8-K dated June 21, 2002.
- (7) Second Supplemental Indenture dated as of July 30, 2002 between Registrant, the guarantors named therein and Wells Fargo, as trustee, to the January 17, 2002 U.S. Dollar Indenture.
Incorporated by reference to Exhibit 4 (h)(7) to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
- (8) Second Supplemental Indenture dated as of July 30, 2002 between Registrant, the guarantors named therein and Wells Fargo, as trustee, to the January 17, 2002 Euro Indenture.
Incorporated by reference to Exhibit 4 (h)(8) to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
- (9) Third Supplemental Indenture, dated June 25, 2003 among Registrant, the guarantors named therein and Wells Fargo, as trustee, to the January 17, 2002 U.S. Dollar Indenture.
Incorporated by reference to Exhibit 4.11 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (10) Third Supplemental Indenture, dated June 25, 2003 among Registrant, the guarantors named therein and Wells Fargo, as trustee, to the January 17, 2002 U.S. Euro Indenture.
Incorporated by reference to Exhibit 4.12 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (g) Indenture dated as of October 2, 1995, between Xerox Credit Corporation ("XCC") and State Street Bank and Trust Company ("State Street"), as trustee, relating to unlimited amounts of debt securities which may be issued from time to time by XCC when and as authorized by XCC's Board of Directors or Executive Committee of the Board of Directors.
Incorporated by reference to Exhibit 4(a) to XCC's Registration Statement Nos. 33-61481 and 333-29677.
- (h) Rights Agreement dated as of April 7, 1997 between Registrant and The First National Bank of Boston, as Rights Agent as amended February 7, 2000.
Incorporated by reference to Exhibit 4(h) to Registrant's Annual Report on Form 10-K for the Year Ended December 31, 2004.

- (i)(1) Indenture, dated as of June 25, 2003, between Registrant and Wells Fargo, as trustee, relating to unlimited amounts of debt securities which may be issued from time to time by Registrant when and as authorized by or pursuant to a resolution of Registrant's Board of Directors (the "June 25, 2003 Indenture").
Incorporated by reference to Exhibit 4.1 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (2) First Supplemental Indenture, dated June 25, 2003 among Registrant, the guarantors named therein and Wells Fargo, as trustee, to the June 25, 2003 Indenture.
Incorporated by reference to Exhibit 4.2 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (3) Form of Second Supplemental Indenture to the June 25, 2003 Indenture.
Incorporated by reference to Exhibit (4)(b)(3) to Registrant's Registration Statement No. 333-111623.
- (j)(1) Credit Agreement, dated as of June 19, 2003, among Registrant and Overseas Borrowers, as Borrowers, various Lenders, JPMorgan Chase Bank, as Administrative Agent, Collateral Agent and LC Issuing Bank, Deutsche Bank Securities Inc., as Syndication Agent, and Citicorp North America, Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated and UBS Securities LLC, as Co-Documentation Agents (the "Credit Agreement").
Incorporated by reference to Exhibit 4.6 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (2) Guarantee and Security Agreement dated as of June 25, 2003 among Registrant, the Subsidiary Guarantors and JPMorgan Chase Bank, as Collateral Agent, relating to the Credit Agreement.
Incorporated by reference to Exhibit 4.7 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (3) Mortgage, Assignment of Leases and Rents, Security Agreement, Financing Statement and Fixture Filing dated as of June 25, 2003 between Xerox Corporation and JPMorgan Chase Bank, as Collateral Agent, encumbering one property located in the State of Oklahoma and relating to the Credit Agreement.
Incorporated by reference to Exhibit 4.8 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (4) Mortgage, Assignment of Leases and Rents, Security Agreement, Financing Statement and Fixture Filing dated as of June 25, 2003 between Xerox Corporation and JPMorgan Chase Bank, as Collateral Agent, encumbering three properties located in the State of New York and relating to the Credit Agreement.
Incorporated by reference to Exhibit 4.9 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (5) Line of Credit Deed of Trust, Assignment of Leases and Rents, Security Agreement, Financing Statement and Fixture Filing dated as of June 25, 2003 between Xerox Corporation and JPMorgan Chase Bank, as Collateral Agent, encumbering one property located in the State of Oregon and relating to the Credit Agreement.
Incorporated by reference to Exhibit 4.10 to Registrant's Current Report on Form 8-K dated June 25, 2003.
- (k) Master Demand Note dated December 10, 2003 between Registrant and Xerox Credit Corporation.
Incorporated by reference to Exhibit 4(m) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

- (l) Instruments with respect to long-term debt where the total amount of securities authorized thereunder does not exceed 10 percent of the total assets of Registrant and its subsidiaries on a consolidated basis have not been filed. Registrant agrees to furnish to the Commission a copy of each such instrument upon request.
- (10) The management contracts or compensatory plans or arrangements listed below that are applicable to the executive officers named in the Summary Compensation Table which appears in Registrant's 2005 Proxy Statement are preceded by an asterisk (*).
- *(a) Registrant's Form of Salary Continuance Agreement.
Incorporated by reference to Exhibit 10(a) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2001, as amended.
- *(b)(1) Registrant's 1991 Long-Term Incentive Plan, as amended through October 9, 2000 ("1991 LTIP").
Incorporated by reference to Exhibit 10(b) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003.
- (2) Form of Amendment to Agreements under 1991 LTIP.
Incorporated by reference to Exhibit 10(b)(2) to Registrant's Current Report on Form 8-K dated May 19, 2005.
- (c) Registrant's 1996 Non-employee Director Stock Option Plan, as amended through May 20, 1999.
- (d)(1) Registrant's 2004 Equity Compensation Plan for Non-Employee Directors ("2004 ECPNED").
Incorporated by reference to Exhibit (VI) to Registrant's 2004 Proxy Statement filed on April 2, 2004.
- (2) Form of Agreement under 2004 ECPNED.
Incorporated by reference to Exhibit 10(d)(2) to Registrant's Quarterly Report on Form 10-Q for the Quarter ended March 31, 2005.
- (3) Form of Grant Summary under 2004 ECPNED.
Incorporated by reference to Exhibit 10(d)(3) to Registrant's Quarterly Report on Form 10-Q for the Quarter ended March 31, 2005.
- (4) Form of DSU Deferral under 2004 ECPNED.
Incorporated by reference to Exhibit 10(d)(4) to Registrant's Quarterly Report on Form 10-Q for the Quarter ended March 31, 2005.
- *(e)(1) Registrant's 2004 Performance Incentive Plan, as amended and restated as of December 6, 2005 ("2004 PIP").
- (2) Form of Officer Award Agreement under the 2004 PIP.
Incorporated by reference to Exhibit 10(e)(2) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (3) Form of Long Term Incentive Plan Award under the 2004 PIP.
Incorporated by reference to Exhibit 10(e)(3) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (4) Annual Performance Incentive Plan for 2005.
- (5) Annual Performance Incentive Plan for 2006.
- (6) 2006 Executive Long-Term Incentive Program.
- (7) Form of Amendment to Agreements under 2004 PIP.
Incorporated by reference to Exhibit 10(e)(7) to Registrant's Current Report on Form 8-K dated May 19, 2005.

- (8) Form of Long-Term Incentive Plan Award Summary under 2006 ELTIP.
- (9) 2006 Form of Officer Award Agreement under the 2004 PIP.
- (10) Form of 2006 ELTIP Deferral Election.
- *(f)(1) 2004 Restatement of Registrant's Unfunded Retirement Income Guarantee Plan, as amended through December 7, 2004 ("2004 URIGP").
Incorporated by reference to Exhibit 10(F) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (2) Amendment No. 1 2004 URIGP.
Incorporated by reference to Exhibit 10(f)(2) to Registrant's Quarterly Report on Form 10-Q for the Quarter ended September 30, 2005.
- *(g)(1) 2004 Restatement of Registrant's Unfunded Supplemental Executive Retirement Plan, as amended through December 7, 2004 ("2004 USERP").
Incorporated by reference to Exhibit 10(g) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (2) Amendment No. 2 to Registrant's 2004 USERP.
Incorporated by reference to Exhibit 10(g)(2) to Registrant's Quarterly Report on Form 10-Q for the Quarter ended September 30, 2005.
- (h) 1996 Amendment and Restatement of Registrant's Restricted Stock Plan for Directors, as amended through February 4, 2002.
Incorporated by reference to Exhibit 10(h) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- *(i) Form of Amended and Restated Severance Letter Agreement entered into with various executive officers, effective July 11, 2005.
- *(j) Registrant's Universal Life Plan effective July 1, 2003.
Incorporated by reference to Exhibit 10(j) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- (k) Registrant's Deferred Compensation Plan for Directors, 1997 Amendment and Restatement, as amended through December 7, 2004.
Incorporated by reference to Exhibit 10(k) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004.
- *(l) Registrant's Deferred Compensation Plan for Executives, 2004 Restatement, as amended through August 11, 2004.
Incorporated by reference to Exhibit 10(l) to Registrant's Quarterly Report on Form 10-Q for the Quarter ended September 30, 2004.
- *(m) Registrant's 1998 Employee Stock Option Plan, as amended through October 9, 2000.
Incorporated by reference to Exhibit 10(n) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 filed on June 7, 2001.
- (n) Separation Agreement dated May 11, 2000 between Registrant and G. Richard Thoman, former President and Chief Executive Officer of Registrant.
- (o) (1) Master Supply Agreement, dated as of November 30, 2001, between Registrant and Flextronics International Ltd. **
Incorporated by reference to Exhibit 10(t)(1) to Registrant's Current Report on Form 8-K dated June 2, 2003.

- (2) Amended and Restated Letter Agreement dated as of November 30, 2001 between Registrant and Flextronics International Ltd. regarding collateral matters relating to the relationship between Registrant and Flextronics.**
Incorporated by reference to Exhibit 10(t)(2) to Registrant's Current Report on Form 8-K dated June 2, 2003.
- *(p) Letter Agreement dated May 20, 2002 between Registrant and Lawrence A. Zimmerman, Senior Vice President and Chief Financial Officer of Registrant.
Incorporated by reference to Exhibit 10(u) to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.
- (q) Amended and Restated Loan Agreement dated as of October 21, 2002 between Xerox Lease Funding LLC and General Electric Capital Corporation.
Incorporated by reference to Exhibit 10(v) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2002.
- *(r) Form of Cash Retention Agreement entered into with various executive officers during 2003.
Incorporated by reference to Exhibit 10(w) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003.
- (12) Computation of Ratio of Earnings to Fixed charges and the Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends.
- (13) Registrant's 2005 Annual Report to Shareholders.
- (21) Subsidiaries of Registrant.
- (23) Consent of PricewaterhouseCoopers LLP.
- (31) (a) Certification of CEO pursuant to Rule 13a-14(a) or Rule 15d-14(a).
(b) Certification of CFO pursuant to Rule 13a-14(a) or Rule 15d-14(a).
- (32) Certification of CEO and CFO pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002.
- (99.1) Order under Section 36 of the Securities Exchange Act of 1934 Granting Exemptions from Certain Provisions of the Act and Rules Thereunder, dated April 11, 2002 (Release No. 45730).
Incorporated by reference to Exhibit 99.2 to Registrant's Current Report on Form 8-K dated April 11, 2002.

** Pursuant to the Freedom of Information Act, the confidential portion of this material has been omitted and filed separately with the Securities and Exchange Commission.

XEROX CORPORATION
1996 NON-EMPLOYEE DIRECTOR STOCK OPTION PLAN

ARTICLE I—PURPOSE OF THE PLAN

The purpose of the Xerox Corporation 1996 Non-Employee Director Stock Option Plan (“Plan”) is to increase the ownership interest in the Company of non-employee directors whose services are considered essential to the Company’s continued progress, to align such interests with those of the shareholders of the Company and to provide a further incentive to serve as a director of the Company.

ARTICLE II—DEFINITIONS

Unless the context clearly indicates otherwise, the following terms shall have the following meanings:

2.1 “1996 Annual Meeting” means the annual meeting of shareholders of the Company scheduled to be held on May 16, 1996, or any adjournment thereof.

2.2 “Award Summary” means the award summary delivered by the Administrator to each Non-Employee Director upon grant of an Option under the Plan.

2.3 “Board” means the Board of Directors of Xerox Corporation.

2.4 “Change in Control” shall be deemed to have occurred if (A) any “person”, as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) other than the Company, any trustee or other fiduciary holding securities under an employee benefit plan of the Company, or any company owned, directly or indirectly, by the shareholders of the Company in substantially the same proportions as their ownership of stock of the Company, is or becomes the “beneficial owner” (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company representing 20 percent or more of the combined voting power of the Company’s then outstanding securities; or (B) during any period of two consecutive years, individuals who at the beginning of such period constitute the Board, including for this purpose any new director (other than a director designated by a person who has entered into an agreement with the Company to effect a transaction described in this Section) whose election or nomination for election by the Company’s shareholders was approved by a vote of at least two-thirds of the directors then still in office who were directors at the beginning of the period or whose election or nomination for election was previously so approved, cease for any reason to constitute a majority thereof.

2.5 “Company” means Xerox Corporation.

2.6 “Exercise Period” means the date which is ten years after the Option Grant Date of such Option.

2.7 “Fair Market Value” means, with respect to any date, the average between the highest and lowest sale prices per Share on the New York Stock Exchange Composite Transactions Tape on such date, provided that if there should be no sale of Shares reported on such date, the Fair Market Value of a Share on such date shall be deemed equal to the average between the highest and lowest sale prices per Share on such Composite Tape for the last preceding date on which sales of Shares were reported.

2.8 “Option” means an option to purchase Shares awarded under Article VIII which does not meet the requirements of Section 422 of the Internal Revenue Code of 1986, as amended, or any successor law.

2.9 “Option Grant Date” means the date upon which an Option is granted to a Non-Employee Director except that for purposes of the Option granted as of the 1996 Annual Meeting, the Option Grant Date shall be on the effective date of the Stock Split.

2.10 "Optionee" means a Non-Employee Director of the Company to whom an Option has been granted.

2.11 "Non-Employee Director" means a director of the Company who is neither an employee of the Company nor any subsidiary of the Company.

2.12 "Plan" means the Xerox Corporation 1996 Non-Employee Director Stock Option Plan, as amended and restated from time to time.

2.13 "Shares" means shares of the Common Stock, par value \$1.00 per share, of the Company after giving effect to the three for one stock split declared by the Board of Directors on January 23, 1996 subject to shareholder approval of an increase in the number of authorized shares of stock at the 1996 Annual Meeting (the "Stock Split").

ARTICLE III—ADMINISTRATION OF THE PLAN

3.1 ADMINISTRATOR OF PLAN. The Plan shall be administered by the Office of Corporate Secretary ("Administrator").

3.2 AUTHORITY OF THE ADMINISTRATOR. Except as otherwise provided herein, the Administrator shall have full power and authority to (i) interpret and construe the Plan and to adopt such rules and regulations it shall deem necessary and advisable to implement and administer the Plan and (ii) designate persons to carry out his or her responsibilities, subject to such limitations, restrictions and conditions as he or she may prescribe, such determinations to be made in accordance with the Administrator's best business judgment as to the best interests of the Company and its shareholders and in accordance with the purposes of the Plan subject to applicable conditions of Rule 16b-3 under the Securities Exchange Act of 1934, as amended ("Rule 16b-3"). The Administrator may delegate administrative duties under the Plan to one or more agents as he or she shall deem necessary or advisable.

ARTICLE IV—AWARDS UNDER THE PLAN

Awards in the form of Options shall be granted to Non-Employee Directors in accordance with Article VIII. Each Option granted under the Plan shall be evidenced by an Award Summary.

ARTICLE V—ELIGIBILITY

Non-Employee Directors of the Company shall be eligible to participate in the Plan in accordance with Article VIII.

ARTICLE VI—SHARES SUBJECT TO THE PLAN

Subject to adjustment as provided in Article XI, the aggregate number of Shares which may be issued upon the exercise of Options shall not exceed 1,000,000 Shares. To the extent an outstanding Option expires or terminates unexercised or is canceled or forfeited, the Shares subject to the expired, unexercised, canceled or forfeited portion of such Option shall again be available for grants of Options under the Plan.

ARTICLE VII—NON-TRANSFERABILITY OF OPTIONS

All Options under the Plan will be nontransferable and shall not be assignable, alienable, salable or otherwise transferable by the Optionee other than by will or the laws of descent and distribution except pursuant to a domestic relations order entered by a court of competent jurisdiction or as otherwise determined by the Administrator. During the life of the Optionee, Options under the Plan shall be exercisable only by him or her.

If so permitted by the Administrator, an Optionee may designate a beneficiary or beneficiaries to exercise the rights of the Optionee under this Plan upon the death of the Optionee. However, any contrary requirement of Rule 16b-3 under the 1934 Act or any successor rule shall prevail over the provisions of this section.

ARTICLE VIII—OPTIONS

Each Non-Employee Director shall be granted Options, subject to the following terms and conditions:

8.1 TIME OF GRANT. On the date of the 1996 Annual Meeting of shareholders of the Company and, thereafter, on the date of each annual meeting of shareholders of the Company through 1998 each person who is a Non-Employee Director immediately after such meeting of shareholders shall be granted an Option to purchase 2,500 Shares. On the date of each Annual Meeting of shareholders of the Company (or any adjournment thereof) for the calendar years 1999 and thereafter, each person who is a Non-Employee Director immediately after such meeting of shareholders shall be granted an Option to purchase 5,000 Shares. The number referred to in the preceding sentence shall be subject to adjustment as provided in Article XI. Any person elected to the Board subsequent to the 1996 Annual Meeting at a time other than at any other annual meeting of shareholders who becomes a Non-Employee Director, upon the date of such election, shall be granted an Option to purchase a number of Shares determined by multiplying the number set forth in the preceding sentence by a fraction, the numerator of which shall be the number of days between the date of such election and the date which is the first anniversary of the date of the last preceding annual meeting of shareholders and the denominator of which shall be 365.

8.2 PURCHASE PRICE. The purchase price per Share under each Option granted pursuant to this Article shall be 100% of the Fair Market Value per Share on the Option Grant Date.

8.3 OPTION WAITING PERIOD AND EXERCISE DATES. The Shares subject to an Option may be purchased commencing on the January 1 next following the annual meeting of shareholders (the "Waiting Period") as follows:

33% of such Shares commencing at the end of the Waiting Period;

33% of such Shares commencing on the first day of the first year following the Waiting Period; and

34% of such Shares commencing on the first day of the second year following the Waiting Period.

Subject to Article IX, an Option may be exercised until the end of the Exercise Period. An Option, or portion thereof, may be exercised in whole or in part only with respect to whole Shares.

To the extent that an Option is not exercised when it becomes initially exercisable, it shall not expire but shall be carried forward and shall be exercisable until the expiration of the Exercise Period. Partial exercise will be permitted from time to time within the percentage limitation described above provided that no partial exercise may be for less than twenty Shares.

Upon the occurrence of a Change in Control, the Waiting Period shall terminate and all outstanding Options shall become immediately fully exercisable pursuant to the other terms and conditions of the Option until the expiration of the Exercise Period.

8.4 METHOD OF EXERCISING OPTION. The Options may be exercised from time to time by written notice to the Company, which shall state the election to exercise the Options and the number of shares with respect to which the Options are being exercised, and shall be signed by the person exercising the Options. Such notice must be accompanied by a check payable to the Company in payment of the full purchase price. After receipt of such notice, the Company will advise the person exercising the option of the amount of withholding tax which must be paid under U.S. Federal, and where applicable, U.S., state and local law resulting from such exercise. Upon receipt of payment of the purchase price and the withholding tax the Company shall, without transfer or issue tax to the person exercising the Options, issue a certificate or certificates for the number of shares covered by such notice of exercise.

ARTICLE IX—TERMINATION OF DIRECTORSHIP

9.1 **TERMINATION OF SERVICE.** If an Optionee ceases to be a director of the Company other than by reason of disability, retirement from service on the Board, or death, each Option held by such Optionee may thereafter be exercised by such Optionee (or such Optionee's executor, administrator, guardian, legal representative, beneficiary or similar person) solely to the extent that they were exercisable on the date of such termination and shall expire on the earlier of: (i) three months from the date of such termination or (ii) expiration of the Exercise Period. Options which are not exercisable on the date the Optionee ceases to be a director of the Company shall terminate.

9.2 **DISABILITY, RETIREMENT OR DEATH.** If an Optionee ceases to be a director of the Company by reason of disability or retirement from service on the Board, each Option held by such Optionee may thereafter be exercised by such Optionee in accordance with the provisions of Article VIII. If the Optionee dies following termination of service from the Board by reason of retirement or disability, outstanding Options shall be exercisable to the extent that they were exercisable on the date of death by such Optionee's executor, administrator, guardian, legal representative, beneficiary or similar person and shall expire on the earlier of: one year following the date of death or expiration of the Exercise Period. If the Optionee ceases to be a director as a result of death after the expiration of the Waiting Period for an Option award, such Option shall be immediately vested and exercisable by the Optionee's legal representative at any time within one year of the Optionee's death but in no event after the expiration of the Exercise Period. Options which are not exercisable on the date the Optionee ceases to be a director of the Company in accordance with the foregoing shall terminate.

ARTICLE X—AMENDMENT AND TERMINATION

The Board may amend the Plan from time to time or terminate the Plan at any time; provided, however, that no action authorized by this Article shall adversely change the terms and conditions of an outstanding Option without the Optionee's consent and, subject to Article XI, the number of Shares subject to an Option granted under Article VIII, the purchase price therefor, the date of grant of any such Option and the termination provisions relating to such Option, shall not be amended more than once every six months, other than to comply with changes in the Internal Revenue Code of 1986, as amended, or any successor law, or the Employee Retirement Income Security Act of 1974, as amended, or any successor law, or the rules and regulations thereunder.

ARTICLE XI—ADJUSTMENT PROVISIONS

11.1 If the Company shall at any time change the number of issued Shares without new consideration to the Company (such as by stock dividend, stock split, recapitalization, reorganization, exchange of shares, liquidation, combination or other change in corporate structure affecting the Shares) or make a distribution of cash or property which has a substantial impact on the value of issued Shares, the total number of Shares reserved for issuance under the Plan and the number of Shares subject to Options to be granted under Section 8.1 shall be appropriately adjusted and the number of Shares covered by each outstanding Option and the purchase price per Share under each outstanding Option shall be adjusted so that the aggregate consideration payable to the Company and the value of each such Option shall not be changed.

11.2 Notwithstanding any other provision of the Plan, and without affecting the number of Shares reserved or available hereunder, the Administrator shall authorize the issuance, continuation or assumption of outstanding Options or provide for other equitable adjustments after changes in the Shares resulting from any merger, consolidation, sale of assets, acquisition of property or stock, recapitalization, reorganization or similar occurrence in which the Company is the continuing or surviving corporation, upon such terms and conditions as it may deem necessary to preserve their rights under the Plan.

11.3 In the case of any sale of assets, merger, consolidation or combination of the Corporation with or into another corporation other than a transaction in which the Company is the continuing or surviving corporation and which does not result in the outstanding Shares being converted into or exchanged for different securities, cash or other property, or any combination thereof (an "Acquisition"), any Non-Employee Director who holds an outstanding Option shall have the right (subject to the provisions of the Plan and any limitation applicable to the Option) thereafter and during the term of the Option, to receive upon exercise thereof the Acquisition Consideration (as defined below) receivable upon the Acquisition by a holder of the number of Shares which would have been obtained upon exercise of the Option or portion thereof, as the case may be, immediately prior to the Acquisition. The term "Acquisition Consideration" shall mean the kind and amount of shares of the surviving or new corporation, cash, securities, evidence of indebtedness, other property or any combination thereof receivable in respect of one Share of the Company upon consummation of an Acquisition.

ARTICLE XII—EFFECTIVE DATE

The Plan shall be submitted to the shareholders of the Company for adoption in accordance with the provisions of Section 505 of the Business Corporation Law of the State of New York and, if adopted by a majority of all outstanding shares entitled to vote thereon at the 1996 annual meeting of shareholders, shall become effective as of the date of adoption by shareholders.

ARTICLE XIII—MISCELLANEOUS PROVISIONS

13.1 GOVERNING LAW. The validity, construction and effect of the Plan and any actions taken or relating to the Plan shall be determined in accordance with the laws of the State of New York and applicable Federal law.

13.2 SUCCESSORS AND ASSIGNS. The Plan shall be binding on all successors and permitted assigns of a Non-Employee Director, including, without limitation, the estate of such Non-Employee Director and the executor, administrator or trustee of such estate, or any receiver or trustee in bankruptcy or representative of the Non-Employee Director's creditors.

13.3 GENERAL RESTRICTION. Each Option shall be subject to the requirement that, if at any time the Administrator shall determine, in its sole discretion, that the listing, registration or qualification of any Option under the Plan upon any securities exchange or under any state or federal law, or the consent or approval of any government regulatory body, is necessary or desirable as a condition of, or in connection with, the granting of such Options or the grant or settlement thereof, such Option may not be exercised or settled in whole or in part unless such listing, registration, qualification, consent or approval shall have been effected or obtained free of any conditions not acceptable to the Administrator.

13.4 FUTURE RIGHTS. No Non-Employee Director shall have any claim or rights to be granted an Option under the Plan, and no Non-Employee Director shall have any rights by reason of the grant of any Options under the Plan to continue as a Director for any period of time, or at any particular rate of compensation.

13.5 RIGHTS AS A SHAREHOLDER. A Non-Employee Director shall have no rights as a shareholder with respect to shares covered by Options granted hereunder until the date of issuance of a stock certificate therefor, and no adjustment will be made for dividends or other rights for which the record date is prior to the date such certificate is issued.

13.6 FRACTIONS OF SHARES. The Company shall not be required to issue fractions of shares. Whenever under the terms of the Plan a fractional share would be required to be issued the Optionee shall be paid in cash for such fractional share based upon Fair Market Value at the time of exercise of the Option.

**RESTATEMENT
OF
XEROX CORPORATION
2004 PERFORMANCE INCENTIVE PLAN**

1. Purpose

The purpose of the Xerox Corporation 2004 Performance Incentive Plan (the "2004 Plan" or the "Plan") is to advance the interests of Xerox Corporation (the "Company") and to increase shareholder value by providing officers and employees of the Company, its subsidiaries and its Affiliates (as hereinafter defined) with a proprietary interest in the growth and performance of the Company and with incentives for current or future service with the Company, its subsidiaries and Affiliates. The Plan is a successor plan to (i) the Xerox Corporation 1991 Long-Term Incentive Plan, (ii) the Xerox Corporation 1998 Employee Stock Option Plan, (iii) the Xerox Executive Performance Incentive Insurance Plan, (iv) the Xerox Mexicana, S.A. de C.V. Executive Rights Plan and (v) the Xerox Canada Inc. Executive Rights Plan, any or all of which may be referred to as a "Predecessor Plan".

2. Effective Date and Term

The Plan shall be effective as of May 20, 2004, subject to the approval of the Company's shareholders at the 2004 annual meeting. No awards or grants can be made after January 1, 2008 unless terminated sooner pursuant to Section 13 by the Company's Board of Directors (the "Board"). Effective May 20, 2004, no further awards shall be made under a Predecessor Plan, but outstanding awards under any Predecessor Plan shall remain outstanding in accordance with their applicable terms and conditions.

3. Plan Administration

(a) The independent Compensation Committee of the Board, or such other independent committee as the Board shall determine, comprised of not less than three members, shall be responsible for administering the Plan (the "Compensation Committee"). To the extent specified by the Compensation Committee, it may delegate its administrative responsibilities to a subcommittee of the Compensation Committee comprised of not less than three members (the Compensation Committee, such subcommittee, and any individual to whom powers are delegated pursuant to subsection (c), being hereinafter referred to as the "Committee"). The Committee shall be qualified to administer the Plan as contemplated by (i) Rule 16b-3 under the Securities Exchange Act of 1934 (the "1934 Act") or any successor rule, (ii) Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations thereunder, and (c) any rules and regulations of a stock exchange on which Common Stock (as defined in Section 5) of the Company is listed.

(b) The Committee shall have full and exclusive power to interpret, construe and implement the Plan and any rules, regulations, guidelines or agreements adopted hereunder and to adopt such rules, regulations and guidelines for carrying out the Plan as it may deem necessary or proper. These powers shall include, but not be limited to, (i) determination of the type or types of awards to be granted under the Plan; (ii) determination of the terms and conditions of any awards under the Plan; (iii) determination of whether, to what extent and under what circumstances awards may be settled, paid or exercised in cash, shares, other securities, or other awards, or other property, or cancelled, forfeited or suspended; (iv) adoption of such modifications, amendments, procedures, subplans and the like as are necessary to enable participants employed in other countries in which the Company may operate to receive advantages and benefits under the Plan consistent with the laws of such countries, and consistent with the rules of the Plan; (v) subject to the rights of participants, modification, change, amendment or cancellation of any award to correct an administrative error and (vi) taking any other action the Committee deems necessary or desirable for the administration of the Plan. All determinations, interpretations, and other

decisions under or with respect to the Plan or any award by the Committee shall be final, conclusive and binding upon the Company, any participant, any holder or beneficiary of any award under the Plan and any employee of the Company.

(c) Except for the power to amend the Plan as provided in Section 13 and except for determinations regarding employees who are subject to Section 16 of the 1934 Act or certain key employees who are, or may become, as determined by the Committee, subject to the Code Section 162(m) compensation deductibility limit (the "Covered Employees"), and except as may otherwise be required under applicable New York Stock Exchange rules, the Committee may delegate any or all of its duties, powers and authority under the Plan pursuant to such conditions or limitations as the Committee may establish to any officer or officers of the Company. The term "Committee" herein shall include any individual exercising powers to the extent delegated pursuant to the preceding sentence.

4. Eligibility

Any employee of the Company shall be eligible to receive an award under the Plan. For purposes of this Section 4, "Company" shall include any entity that is directly or indirectly controlled by the Company or any entity in which the Company has a significant equity interest, as determined by the Committee ("Affiliate"). If a participant who is an employee or former employee of the Company is deemed by the Committee, in the Committee's sole discretion, to have engaged in detrimental activity against the Company, any awards granted to such employee or former employee on or after January 1, 2006, shall be canceled and be of no further force or effect and any payment or delivery of an award within six months prior to such detrimental activity may be rescinded. In the event of any such rescission, the participant shall pay to the Company the amount of any gain realized or payment received as a result of the rescinded exercise, payment or delivery, in such manner and on such terms and conditions as may be required by the Committee.

5. Shares of Stock Subject to the Plan

(a) A total number of 10.0 million (10,000,000) shares of common stock¹, par value \$1.00 per share, of the Company ("Common Stock") shall become available for issuance under the Plan, provided that any shares issued in connection with options or SARs shall be counted against this limit as 0.6 shares for each one (1) share issued. Any shares available for grant under any Predecessor Plan on the Effective Date not subject to outstanding awards shall become available for issuance under the Plan. (As of May 20, 2004, approximately 15.7 million shares² are expected to be available for issuance under Predecessor Plans.) Thus, the total number available for grant under the 2004 Plan is expected to be 25.7 million (25,700,000)³. In addition, any shares underlying awards outstanding on May 20, 2004 under any Predecessor Plan that are cancelled, are forfeited, or lapse shall become available for issuance under the Plan.

(b) For purposes of the preceding paragraph, the following shall not be counted against shares available for issuance under the Plan: (i) settlement of stock appreciation rights ("SAR") in cash or any form other than shares and (ii) payment in shares of dividends and dividend equivalents in conjunction with outstanding awards. Any shares that are issued by the Company, and any awards that are granted by, or become obligations of, the

¹ 10.0 million reflects the number of shares if all grants were made in "whole value" shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the number available is 16.7 million.

² 15.7 million reflects the number of shares if all grants were made in "whole value" shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the number available is 26.1 million.

³ 25.7 million reflects the number of shares if all grants were made in "whole value" shares (e.g., restricted stock or performance shares). If all grants were made in the form of options or SARs, the number available is 42.8 million.

Company, through the assumption by the Company or an affiliate of, or in substitution for, outstanding awards previously granted by an acquired company shall not be counted against the shares available for issuance under the Plan.

(c) In determining shares available for issuance under the Plan, any awards granted under the Plan that are cancelled, are forfeited, or lapse shall become eligible again for issuance under the Plan. In addition, shares withheld to pay taxes pursuant to Section 14, and shares tendered to exercise stock options, shall be treated as shares again eligible for issuance under the Plan.

(d) In no event, however, except as subject to adjustment as provided in Section 6, shall more than (i) 10.0 million (10,000,000) shares of Common Stock be available for issuance pursuant to the exercise of incentive stock options (“ISOs”) awarded under the Plan; and (ii) 15.0 million (15,000,000) shares of Common Stock be made the subject of awards under any combination of awards under Sections 7(b), 7(c) or 7(d) of the Plan to any single individual, of which no more than 10.0 million (10,000,000) may be shares of restricted stock. SARs whether settled in cash or shares of Common Stock shall be counted against the limit set forth in(ii).

(e) Any shares issued under the Plan may consist in whole or in part, of authorized and unissued shares or of treasury shares, and no fractional shares shall be issued under the Plan. Cash may be paid in lieu of any fractional shares in settlements of awards under the Plan.

6. Adjustments and Reorganizations

(a) The Committee may make such adjustments as it deems appropriate to meet the intent of the Plan in the event of changes that impact the Company’s share price or share status, provided that any such actions are consistently and equitably applicable to all affected participants.

(b) In the event of any stock dividend, stock split, combination or exchange of shares, merger, consolidation, spin-off or other distribution (other than normal cash dividends) of Company assets to shareholders, or any other change affecting shares, such adjustments, if any, as the Committee in its discretion may deem appropriate to reflect such change shall be made with respect to (i) the aggregate number of shares that may be issued under the Plan; (ii) the number of shares subject to awards of a specified type or to any individual under the Plan; and/or (iii) the price per share for any outstanding stock options, SARs and other awards under the Plan.

(c) Notwithstanding anything to the contrary in this Section 6 or any other provision of the Plan, the Committee may increase the maximum aggregate number of shares that may be issued under the Plan only to the extent necessary to reflect a change in the number of outstanding shares of Common Stock, such as a stock dividend or stock split.

7. Awards

(a) The Committee shall determine the type or types of award(s) to be made to each participant under the Plan and shall approve the terms and conditions governing such awards in accordance with Section 12. Awards may include but are not limited to those listed in this Section 7. Awards may be granted singly, in combination or in tandem so that the settlement or payment of one automatically reduces or cancels the other. Awards may also be made in combination or in tandem with, in replacement of, as alternatives to, or as the payment form for, grants or rights under any other employee or compensation plan of the Company, including the plan of any acquired entity. However, under no circumstances may stock option awards be made which provide by their terms for the automatic award of additional stock options upon the exercise of such awards, including, without limitation, “reload options”.

(b) A Stock Option is a grant of a right to purchase a specified number of shares of Common Stock during a specified period. The purchase price of each option shall be not less than 100% of Fair Market Value (as defined

in Section 10) on the effective date of grant. A Stock Option may be exercised in whole or in installments, which may be cumulative. A Stock Option may be in the form of an ISO which complies with Section 422 of the Internal Revenue Code of 1986, as amended, and the regulations thereunder at the time of grant. The price at which shares of Common Stock may be purchased under a Stock Option shall be paid in full at the time of the exercise in cash or such other method as provided by the Committee at the time of grant or as provided in the form of agreement approved in accordance herewith, including tendering (either constructively or by attestation) Common Stock, surrendering a stock award valued at market value at the time of surrender, surrendering a cash award, or any combination thereof. Notwithstanding any provision of the Plan, a repricing of a Stock Option shall be allowed by the Committee only with the approval of the Company's shareholders to the extent required under the rules of the New York Stock Exchange. For this purpose, a "repricing" shall be defined as described in the New York Stock Exchange rules.

(c) A Stock Appreciation Right ("SAR") is a right to receive a payment, in cash and/or Common Stock, as determined by the Committee, equal to the excess of the market value of a specified number of shares of Common Stock at the time the SAR is exercised over the Fair Market Value on the effective date of grant of the SAR as set forth in the applicable award agreement.

(d) Stock Award is an award made in stock or denominated in units of stock. All or part of any Stock Award may be subject to conditions established by the Committee, and set forth in the award agreement, which may include, but are not limited to, continuous service with the Company, achievement of specific business objectives, and other measurements of individual, business unit or Company performance. A restricted stock award made pursuant to this Section 7(d) shall be subject to a vesting schedule of no less than three (3) years unless such award is performance based, in which case vesting shall be no less than one (1) year.

(e) Cash Award may be any of the following:

(i) an annual incentive award in connection with which the Committee will establish specific performance periods (not to exceed twelve months) to provide cash awards for the purpose of motivating participants to achieve goals for the performance period. An annual incentive award shall specify the minimum, target and maximum amounts of awards for a performance period for a participant or any groups of participants, and, to the extent applicable to Covered Employees, comply with the requirements of Section 23; or

(ii) a long-term award denominated in cash with the eventual payment amount subject to future service and such other restrictions and conditions as may be established by the Committee, and as set forth in the award agreement, including, but not limited to, continuous service with the Company, achievement of specific business objectives, and other measurement of individual, business unit or Company performance; or

(iii) Cash Awards under this Section 7(e) to any single Covered Employee, including dividend equivalents in cash or shares of Common Stock payable based upon attainment of specific performance goals, may not exceed in the aggregate \$10,000,000 in the case of the Chief Executive Officer and \$5,000,000 in the case of any other participant, such limits being applicable to each twelve-month performance period established by the Committee under this Section 7(e) or under Section 23.

(f) The Committee shall have the discretion with respect to any award granted under the Plan to establish upon its grant conditions under which (i) the award may be later forfeited, cancelled, rescinded, suspended, withheld or otherwise limited or restricted; or (ii) gains realized by the grantee in connection with an award or an award's exercise may be recovered; provided that such conditions and their consequences are clearly set forth in the grant agreement or other grant document and fully comply with applicable laws. These conditions may include, without limitation, actions by the participant which constitute a conflict of interest with the Company, are prejudicial to the Company's interests, or are in violation of any non-compete agreement or obligation, any confidentiality agreement or obligation, the Company's applicable policies, its Code of Business Conduct and Ethics, or the participant's terms and conditions of employment.

8. Dividends and Dividend Equivalents

The Committee may provide that awards denominated in stock earn dividends or dividend equivalents. Such dividend equivalents may be paid currently in cash or shares of Common Stock or may be credited to an account established by the Committee under the Plan in the name of the participant. In addition, dividends or dividend equivalents paid on outstanding awards or issued shares may be credited to such account rather than paid currently. Any crediting of dividends or dividend equivalents may be subject to such restrictions and conditions as the Committee may establish, including reinvestment in additional shares or share equivalents.

9. Deferrals and Settlements

Payment of awards may be in the form of cash, stock, other awards, or in such combinations thereof as the Committee shall determine at the time of grant, and with such restrictions as it may impose. Except as provided in Section 24 herein, the Committee may also require or permit participants to elect to defer the issuance of shares or the settlement of awards in cash under such rules and procedures as it may establish under the Plan. It may also provide that deferred settlements include the payment or crediting of interest on the deferral amounts or the payment or crediting of dividend equivalents on deferred settlements denominated in shares.

10. Fair Market Value

Fair Market Value for all purposes under the Plan shall mean the average of the high and low prices of Common Stock as reported in The Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions reports for the relevant date, or if no sales of Common Stock were made on said exchange on that date, the average of the high and low prices of Common Stock as reported in said composite transaction report for the preceding day on which sales of Common Stock were made on said exchange. Under no circumstances shall Fair Market Value be less than the par value of the Common Stock.

11. Transferability and Exercisability

Except as otherwise provided in this Section 11, all awards under the Plan shall be nontransferable and shall not be assignable, alienable, saleable or otherwise transferable by the participant other than by will or the laws of descent and distribution except pursuant to a domestic relations order entered by a court of competent jurisdiction. Notwithstanding the preceding sentence, the Committee may provide that any award of non-qualified Stock Options may be transferable by the recipient to family members or family trusts established by the recipient. The Committee may also provide that, in the event that a participant terminates employment with the Company to assume a position with a governmental, charitable, educational or similar non-profit institution, a third party, including but not limited to a "blind" trust, may be authorized by the Committee to act on behalf of and for the benefit of the respective participant with respect to any outstanding awards. Except as otherwise provided in this Section 11, during the life of the participant, awards under the Plan shall be exercisable only by him or her except as otherwise determined by the Committee. In addition, if so permitted by the Committee, a participant may designate a beneficiary or beneficiaries to exercise the rights of the participant and receive any distributions under the Plan upon the death of the participant.

12. Award Agreements; Notification of Award

Awards under the Plan (other than annual incentive awards described in Section 7(e)(i)) shall be evidenced by one or more agreements approved by the Committee that set forth the terms and conditions of and limitations on an award, except that in no event shall the term of any Stock Option exceed a period of ten years from the date of its grant. The Committee need not require the execution of any such agreement by a participant in which case acceptance of the award by the respective participant will constitute agreement to the terms of the award. In the case of an annual incentive cash award, the participant shall receive notification of such award in such form as the Committee may determine.

13. Plan Amendment and Termination

(a) The Compensation Committee may amend the Plan as it deems necessary or appropriate, except that no such amendment which would cause the Plan not to comply with the requirements of (i) Code Section 162(m) with respect to performance-based compensation, (ii) the Code with respect to ISOs or (iii) the New York Business Corporation Law as in effect at the time of such amendment shall be made without the approval of the Company's shareholders. No such amendment shall adversely affect any outstanding awards under the Plan without the consent of all of the holders thereof.

(b) Notwithstanding the foregoing, an amendment that constitutes a "material revision", as defined by the rules of the New York Stock Exchange, shall be submitted to the Company's shareholders for approval. In addition, any revision that deletes or limits the scope of the provision in Section 7 prohibiting repricing of options without shareholder approval will be considered a material revision.

(c) The Board may terminate the Plan at any time. Upon termination of the Plan, no future awards may be granted, but previously-made awards shall remain outstanding in accordance with their applicable terms and conditions, and the terms of the Plan.

14. Tax Withholding

The Company shall have the right to deduct from any settlement of an award made under the Plan, including the delivery or vesting of shares, an amount sufficient to cover withholding required by law for any federal, state or local taxes or to take such other action as may be necessary to satisfy any such withholding obligations. The Committee may permit shares to be used to satisfy required tax withholding and such shares shall be valued at the fair market value as of the settlement date of the applicable award.

15. Other Company Benefit and Compensation Programs

Unless otherwise determined by the Committee, settlements of awards received by participants under the Plan shall not be deemed a part of a participant's regular, recurring compensation for purposes of calculating payments or benefits from any Company benefit plan, severance program or severance pay law of any country.

16. Unfunded Plan

Unless otherwise determined by the Committee, the Plan shall be unfunded and shall not create (or be construed to create) a trust or a separate fund or funds. The Plan shall not establish any fiduciary relationship between the Company and any participant or other person. To the extent any person holds any rights by virtue of a grant awarded under the Plan, such right (unless otherwise determined by the Committee) shall be no greater than the right of an unsecured general creditor of the Company.

17. Future Rights

No person shall have any claim or right to be granted an award under the Plan, and no participant shall have any right by reason of the grant of any award under the Plan to continued employment by the Company or any subsidiary of the Company.

18. General Restriction

Each award shall be subject to the requirement that, if at any time the Committee shall determine, in its sole discretion, that the listing, registration or qualification of any award under the Plan upon any securities exchange or under any state or federal law, or the consent or approval of any government regulatory body, is necessary or desirable as a condition of, or in connection with, the granting of such award or the exercise settlement thereof, such award may not be granted, exercised or settled in whole or in part unless such listing, registration, qualification, consent or approval shall have been effected or obtained free of any conditions not acceptable to the Committee.

19. *Governing Law*

The validity, construction and effect of the Plan and any actions taken or relating to the Plan shall be determined in accordance with the laws of the state of New York and applicable Federal law.

20. *Successors and Assigns*

The Plan shall be binding on all successors and permitted assigns of a participant, including, without limitation, the estate of such participant and the executor, administrator or trustee of such estate, or any receiver or trustee in bankruptcy or representative of such participant's creditors.

21. *Rights as a Shareholder*

A participant shall have no rights as a shareholder until he or she becomes the holder of record of Common Stock.

22. *Change in Control*

Notwithstanding anything to the contrary in the Plan, the following shall apply to all awards granted and outstanding under the Plan:

(a) *Definitions.* Unless otherwise defined by the Compensation Committee, the following definitions shall apply to this Section 22:

(i) A "Change in Control" shall be deemed to have occurred if (aa) any "person", as such term is used in Section 13(d) and 14(d) of the 1934 Act, other than (1) the Company, (2) any trustee or other fiduciary holding securities under an employee benefit plan of the Company, (3) any company owned, directly or indirectly, by the shareholders of the Company in substantially the same proportions as their ownership of stock of the Company, or (4) any person who becomes a "beneficial owner" (as defined below) in connection with a transaction described in clause (1) of subparagraph (cc) below, is or becomes the "beneficial owner" (as defined in Rule 13d-3 under the 1934 Act), directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20 percent or more of the combined voting power of the Company's then outstanding voting securities; (bb) the following individuals cease for any reason to constitute a majority of the directors then serving; individuals who on May 20, 2004 constitute the Board and any new director (other than a director whose initial assumption of office is in connection with an actual or threatened election contest, including but not limited to a consent solicitation, relating to the election of directors of the Company) whose appointment or election by the Board or nomination for election by the Company's shareholders was approved or recommended by a vote of at least two-thirds of the directors then still in office who were directors on May 20, 2004, or whose appointment, election or nomination for election was previously so approved or recommended; (cc) there is consummated a merger or consolidation of the Company or any direct or indirect subsidiary of the Company with any other corporation, other than (1) a merger or consolidation which results in the directors of the Company immediately prior to such merger or consolidation continuing to constitute at least a majority of the board of directors of the Company, the surviving entity or any parent thereof or (2) a merger or consolidation effected to implement a recapitalization of the Company (or similar transaction) in which no person is or becomes the beneficial owner, directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20% or more of the combined voting power of the Company's then outstanding securities; or (dd) the shareholders of the Company approve a plan of complete liquidation or dissolution of the Company or there is consummated an agreement for the sale or disposition by the Company of all or substantially all of the Company's assets, other than a sale or disposition by the Company of all or substantially all of the Company's assets to an entity, at least 50% of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the Company immediately prior to such sale.

(ii) "CIC Price" shall mean the higher of (aa) the highest price paid for a share of the Company's Common Stock in the transaction or series of transactions pursuant to which a Change in Control of the Company shall have occurred, or (bb) the highest price paid for a share of the Company's Common Stock during the 60-day period immediately preceding the date upon which the event constituting a Change in Control shall have occurred as reported in The Wall Street Journal in the New York Stock Exchange Composite Transactions or similar successor consolidated transactions reports.

(iii) An award is "Nonforfeitable" in whole or in part to the extent that, under the terms of the Plan or the award agreement or summary under the Plan, (aa) the award is vested in whole or part, or (bb) an entitlement to present or future settlement of such award in whole or part has otherwise arisen. Notwithstanding an award having become Nonforfeitable in whole or part, the award shall be cancelled in its entirety, and no settlement shall be made, if a participant is terminated by the Company for Cause (as defined in the award agreement), if the participant refuses to sign any releases or waivers required for settlement of the award, if the participant shall have engaged in detrimental activity against the Company, or for any other reason set forth in the Plan or any award agreement or award summary, or as determined by the Committee.

(iv) A "Key Employee" is identified in the following manner: There shall be identified every employee who, at any time during a 12-month period ending December 31, is one of the 50 highest paid officers of the Company (or any member of its controlled group, as defined by Code Section 414(b)) having compensation in excess of the amount specified in Code Section 416(i)(1)(A) as indexed by Treasury guidance. Every individual so identified for any period ending December 31 is a Key Employee for the 12-month period beginning on the first April 1 following such December 31, and ending on the next March 31.

(v) A "Section 409A-Conforming Change in Control" is a change in control of the Company that conforms to the definition under Code Section 409A of a change in ownership or effective control of the Company, or in the ownership of a substantial portion of the assets of the Company, as such definition is set forth in Treasury guidance.

(vi) A "Termination for Good Reason" by a participant shall mean the Termination of Employment of a participant upon any of the following circumstances, if such circumstance occurs without the participant's express written consent after a Change in Control:

(aa) The assignment of any participant's duties inconsistent with the participant's job status or a substantial adverse alteration in the nature or status of a participant's responsibilities from those in effect immediately prior to a Change in Control of the Company (including, without limitation, if the participant is an executive officer of the Company prior to a Change in Control, ceasing to be an executive officer of a public company);

(bb) Any of the following: (1) A reduction in a participant's annual base salary and/or annual target bonus, (2) a failure by the Company to increase a participant's annual base salary following a Change in Control at such periodic intervals consistent with the Company's practice prior thereto by at least a percentage equal to the average of the percentage increases in a participant's base salary for the three merit pay periods immediately preceding such Change in Control, or (3) the failure to increase a participant's salary as the same may be increased from time to time for similarly situated individuals, except that this clause (bb) shall not apply to across-the-board salary reductions similarly affecting all similarly situated employees of the Company and all similarly situated employees of any person in control of the Company;

(cc) The Company's requiring a participant to be based anywhere other than in the metropolitan area in which a participant was based immediately before the Change in Control, except for required travel on the Company's business to an extent substantially consistent with a participant's present business travel obligations;

(dd) The failure by the Company to continue in effect any compensation or benefit plan, vacation policy or any material perquisites in which a participant participates immediately before the Change in

Control, (except to the extent such plan terminates in accordance with its terms), unless an equitable arrangement (embodied in an ongoing substitute or alternative plan) has been made with respect to such plan in connection with the Change in Control, or the failure by the Company to continue a participant's participation therein (or in such substitute or alternative plan) on a basis not materially less favorable, both in terms of the amount of benefits provided and the level of a participant's participation relative to other participants, than existed at the time of the Change in Control; or

(ee) The failure of the Company to obtain a satisfactory agreement from any successor to assume responsibility to perform under this Plan.

(ff) A termination by a participant of employment shall not fail to be a Termination For Good Reason by participant merely because of a participant's incapacity due to physical or mental illness, or because a participant's employment continued after the occurrence of any of the events listed in this subsection.

(b) *Acceleration of Nonforfeitability of SARs, Stock Awards, Cash Awards, and Dividends and Dividend Equivalents.* Upon the occurrence of a Change in Control or a Section 409A-Conforming Change in Control, all SARs, stock awards, stock options (to the extent the CIC Price exceeds the exercise price), cash awards, dividends and dividend equivalents outstanding on such date shall become 100% Nonforfeitable.

(c) *Payment Schedule.* In accordance with the uniform payment rule set forth in subsection (c) of Section 24 hereof,

(i) Following a Change In Control that is not a Section 409A-Conforming Change in Control, awards shall be settled on the Vesting Date specified in the award summary, and

(ii) Following a Section 409A-Conforming Change in Control, awards shall be settled on the earlier of (aa) termination of employment (in the case of a Key Employee, to the extent required by Section 409A, the date that is 6 months after termination of employment) or (bb) the Vesting Date specified in the award summary.

(iii) If a participant has made a valid election under Code Section 409A to defer settlement beyond the Vesting Date specified in the award summary, such award shall be settled pursuant to clauses (i) and (ii) by substituting the date so elected for the Vesting Date specified in the award summary.

(d) *Alternate Payment Schedule for Post-2005 Grants in Lieu of Subsection (c) If Allowed by Section 409A.* In the case of any award granted after December 31, 2005, to the extent permitted by Section 409A,

(i) Following a Change in Control or a Section 409A-Conforming Change in Control, awards shall not be settled in accordance with the foregoing subsection (c) hereof, but shall be settled on the earlier of (aa) termination of employment (in the case of a Key Employee, to the extent required by Section 409A, the date that is 6 months after termination of employment), or (bb) the Vesting Date specified in the award summary, except that

(ii) If such Change in Control or Section 409A-Conforming Change in Control is effectuated other than by a cash purchase of the Company's voting securities, and is followed by a voluntary termination of employment by a participant that is not a Termination for Good Reason, awards payable to such participant shall be settled on the Vesting Date specified in the award summary.

(iii) If such Change in Control or Section 409A-Conforming Change in Control is effectuated only in part by a cash purchase of the Company's voting securities, and is followed by a voluntary termination of employment by a participant that is not a Termination for Good Reason, a fraction of each award shall be settled pursuant to clause (i). The numerator of this fraction shall be the total amount of such cash paid, and the denominator shall be the total consideration paid to Company shareholders pursuant to the event constituting the Change in Control or Section 409A-Conforming Change in Control. The remaining portion of each such award shall be settled pursuant to clause (ii).

(iv) If a participant has made a valid election under Code Section 409A to defer settlement beyond the Vesting Date specified in the award summary, such award shall be settled pursuant to clauses (i), (ii) and (iii) by substituting the date so elected for the Vesting Date specified in the award summary.

(v) To the extent that clause (ii) of this subsection (d) is not permitted by Section 409A, then awards shall be settled solely under clause (i). To the extent that neither clause (ii) nor clause (i) of this subsection (d) is permitted by Section 409A, then this subsection (d) is inapplicable and awards shall be settled under subsection (c).

(e) *Cancellation.* Upon settlement under this Section, such awards and any related stock options shall be cancelled.

(f) *Discretionary Awards.* Upon or in anticipation of the occurrence of a Change in Control, the Committee may grant additional awards (e.g., above-target awards for performance-based Stock Awards) at its sole discretion. Any such discretionary grants shall be settled on the date specified by the terms of such grant.

(g) The amount of cash to be paid shall be determined by multiplying the number of such awards, as the case may be, by: (i) in the case of stock awards, the CIC Price; (ii) in the case of SARs, the difference between the exercise price of the related option per share and the CIC Price; (iii) in the case of cash awards where the award period, if any, has not been completed upon the occurrence of a Change in Control, the pro-rata target value of such awards or such higher amount as determined by the Committee, without regard to the performance criteria, if any, applicable to such award; (iv) in the case of stock options, the difference between the exercise price of the option and the CIC Price; and (v) in the case of cash awards where the award period, if any, has been completed on or prior to the occurrence of a Change in Control: (aa) where the cash award is payable in cash, the value of such award as determined in accordance with the award agreement, and (bb) where the cash award is payable in shares of Common Stock, the CIC Price.

(h) Notwithstanding the foregoing, any SARs and any stock-based award held by an officer or director subject to Section 16 of the 1934 Act which have been outstanding less than six months (or such other period as may be required by the 1934 Act) upon the occurrence of an event constituting a Change in Control shall not be paid in cash until the expiration of such period, if any, as shall be required pursuant to such Section, and the amount to be paid shall be determined by multiplying the number of SARs, stock awards, or unexercised shares under such stock options, as the case may be, by the CIC Price determined as though the event constituting the Change in Control had occurred on the first day following the end of such period.

23. *Certain Provisions Applicable to Awards to Covered Employees*

Performance-based awards made to Covered Employees shall be made by the Committee within the time period required under Section 162(m) for the establishment of performance goals and shall specify, among other things, the performance period(s) for such award (which shall be not less than one year), the performance criteria and the performance targets. The performance criteria shall be any one or more of the following as determined by the Committee and may differ as to type of award and from one performance period to another: earnings per share, cash flow, document processing profit, cost reduction, days sales outstanding, cash conversion cycle, cash management (including, without limitation, inventory and/or capital expenditures), total shareholder return, return on shareholders' equity, economic value added measures, return on assets, pre-or post-currency revenue, pre-or post-currency performance profit, profit before tax, profit after tax, revenues, stock price and return on sales. Payment or vesting of awards to Covered Employees shall be contingent upon satisfaction of the performance criteria and targets as certified by the Committee by resolution of the Committee. To the extent provided at the time of an award, the Committee may in its sole discretion reduce any award to any Covered Employee to any amount, including zero. Any performance-based awards made pursuant to this Section 23 may include annual incentive awards and long-term awards.

24. Section 409A Compliance

(a) *No Taxation Under Code Section 409A.* It is intended that no awards under the Plan shall cause any amount to be taxable under Code Section 409A with respect to any individual. All provisions of this Plan and of any agreement, award or award summary thereunder shall be construed in a manner consistent with this intent. Any provision of and amendment to this Plan, or of any agreement, award or award summary thereunder, that would cause any amount to be taxable under Section 409A of the Internal Revenue Code with respect to any individual is void and without effect. Any election by any participant, and any administrative action by the Committee that would cause any amount to be taxable under Section 409A of the Code with respect to any individual is void and without effect under the Plan.

(b) *Election Rule.* A participant may elect to defer awards under the Plan only if the election is made not later than December 31 of the year preceding the year in which related service is performed, except to the extent otherwise permitted by Section 409A and Treasury guidance thereunder (where such exceptions include but are not limited to initial deferral elections with respect to Nonforfeitable rights, deferral elections in the first year in which an employee becomes eligible to participate, and deferral elections with respect to performance-based compensation).

(c) *Uniform Payment Rule*

(i) All awards shall be settled on the date that is the earlier of (1) or (2) below, where

(1) is the later of (A) a Section 409A-Conforming Change in Control or (B) termination of employment (in the case of a Key Employee, to the extent required by Section 409A, the date that is 6 months after termination of employment); and

(2) is the Vesting Date specified in the award summary.

(ii) If a participant has made a valid election under Code Section 409A to defer settlement beyond the Vesting Date specified in the award summary, such award shall be settled pursuant to clause (i) by substituting the date so elected for the Vesting Date specified in the award summary.

(iii) To the extent permitted by Code Section 409A, following a Change in Control or a Section 409A-Conforming Change in Control, settlement of awards shall be governed by subsection (d) of Section 22 herein, rather than by clauses (i) and (ii) of this subsection (c).

(iv) Settlement pursuant to the death or disability of a participant is governed by the award agreement.

(d) *Accelerations.* In the case of an award that is deferred compensation for purposes of Code Section 409A, acceleration of settlement is not permitted, except that, if permitted by the Committee, acceleration of settlement is permitted in order to (i) allow the participant to comply with a certificate of divestiture (within the meaning of Code Section 1043); (ii) pay payroll and withholding taxes with respect to amounts deferred, to the extent permitted by Treasury guidance; or (iii) effect any other purpose that is a permitted Code Section 409A acceleration event under Treasury guidance.

(e) *Permitted Payment Delays.* At the Committee's sole discretion, settlement of awards may be delayed beyond the date specified in subsection (c) under the following circumstance. The Committee reserves the right to amend an award granted on or after January 1, 2006 if the Committee determines that the deduction for such settlement would be limited by Code Section 162(m), except that such settlement will be made on the earliest date on which the Committee determines that such limitation no longer exists.

IN WITNESS WHEREOF, the Company has caused this Restatement to be signed as of the 8th day of December, 2005.

XEROX CORPORATION

/PATRICIA M. NAZEMETZ/

By: _____

Annual Performance Incentive Plan for 2005 (“2005 APIP”)

Under the 2005 APIP, executive officers of the Company are eligible to receive performance related cash payments. Payments are, in general, only made if annual performance objectives established by the Compensation Committee of the Board of Directors (the “Committee”) are met.

The Committee approved an annual incentive target and maximum opportunity for 2005, expressed as a percentage of base salary for each participating officer. Certain additional goals were established for some officers based on business unit goals and/or individual performance goals and objectives. The Committee also established overall threshold, target and maximum measures of performance for the 2005 APIP. The performance measures and weightings for 2005 were total revenue (30%), earnings per share (40%) and cash flow from operations (30%).

For 2005, the performance against the 2005 APIP goals was as follows: Total revenue was below threshold, earnings per share was above target and cash flow from operations exceeded maximum.

Annual Performance Incentive Plan for 2006 (“2006 APIP”)

Under the 2006 APIP, executive officers of the Company are eligible to receive performance related cash payments. Payments are, in general, only made if annual performance objectives established by the Compensation Committee of the Board of Directors (the “Committee”) are met.

The Committee approved annual incentive opportunities for 2006, expressed as a percentage of base salary for each participating officer. Certain additional goals were established for some officers based on business unit goals and/or individual performance goals and objectives. The Committee also established overall threshold, target and maximum measures of performance for the 2006 APIP. The performance measures and weightings for 2006 are total revenue (30%), operational earnings per share (40%) and core cash flow from operations (30%).

Individual payments will be subject to the review and approval of the Committee following the completion of the 2006 fiscal year.

2006 Executive Long-Term Incentive Program (“2006 E-LTIP”)

Under the 2006 E-LTIP, executive officers of the Company are eligible to receive performance shares based on certain performance measures established by the Compensation Committee of the Board of Directors (the “Committee”).

The performance elements and corresponding weights for the 2006 E-LTIP are: (i) (60%) Earnings Per Share: Diluted Earnings Per Share from Continuing Operations as reported in the Company’s audited financial statements, as adjusted on an after-tax basis for the following discretely disclosed (in either Management’s Discussion and Analysis/MD&A or the footnotes to the financial statements) items (if equal to or greater than \$50 million pre-tax on an individual basis, or in the aggregate): gains/(losses) from litigation, regulatory matters or any changes in enacted law (including tax law); gains/(losses) from asset sales or business divestitures; restructuring and asset impairment charges; gains/(losses) resulting from acts of war, terrorism or natural disasters; the initial effect of changes in accounting principles that are included within Income from Continuing Operations; impairment of goodwill and other intangibles; gains/(losses) from the settlement of tax audits; gains/(losses) on early extinguishment of debt; non-restructuring related impairments of long-lived assets; and (ii) (40%) Core Cash Flow from Operations: Net Cash provided by (used for) Operating Activities as reported in the Company’s audited financial statements, as adjusted for the following items: exclusion of net changes in finance receivables and on-lease equipment; cash flow impacts (inflows and outflows) resulting from those items as identified above; any special discretionary pension fundings in excess of \$250 million shall be excluded. Any other items approved by the Committee for adjustment of EPS or Core Cash Flow from Operations will be considered a modification of the award.

Award Summary**Executive Long-Term Incentive
Program Grant (Officers)**

«First_Name» «Last_Name»

Date of Agreement and Award: **April 1, 2006**

Value on February 16, 2006:

«Approved_Value_»

Performance Shares

Number of Performance Shares:

«Performance_Shares_»

Vesting Date of All Performance Shares Earned:

– on 04/01/09

Performance Shares Earned if Annual Target Performance is Achieved:

– 1/3 of grant on: 4/1/07, 4/1/08 and 4/1/09

*Performance Shares Earned if Three-Year Cumulative Performance between**Threshold and Maximum is Achieved:*

– 25% - 150% of grant (net of shares earned for Annual Achievement) on 04/01/09

Automatic Deferral: If the deduction for delivery of shares would be limited by section 162(m) of the Internal Revenue Code ("Code"), shares will automatically be deferred until the Committee reasonably believes that the deduction will no longer be limited by section 162(m), unless otherwise required under Code section 409A. Notwithstanding the above, in no event shall shares of Common Stock be delivered prior to the Vesting Date set forth above.

*Notwithstanding the above, at the Company's discretion, Employee may irrevocably elect, on or before June 30, 2006, to defer receipt of Common Stock in connection with Performance Shares in the manner described to the Employee in writing in the Deferral Form.

*Performance measures which may include, but are not limited to, continuous service with the Company, achievement of specific business objectives, and other measurements of individual, business unit or Company performance shall be determined by the Committee in its sole discretion.

XEROX CONFIDENTIAL

**AGREEMENT PURSUANT TO
XEROX CORPORATION
2004 PERFORMANCE INCENTIVE PLAN**

AGREEMENT, by Xerox Corporation, a New York corporation (the “Company”), dated as of the date which appears as the “Date of Agreement and Award” in the Award Summary attached hereto (the “Award Summary”) in favor of the individual whose name appears on the Award Summary, an employee of the Company, one of the Company’s subsidiaries or one of its affiliates (the “Employee”).

In accordance with the provisions of the “2004 Performance Incentive Plan” (the “Plan”), the Compensation Committee of the Board of Directors of the Company (the “Committee”) or the Chief Executive Officer of the Company (the “CEO”) has authorized the execution and delivery of this Agreement.

Terms used herein that are defined in the Plan or in this Agreement shall have the meanings assigned to them in the Plan or this Agreement, respectively.

The Award Summary contains the details of the awards covered by this Agreement and is incorporated herein in its entirety.

NOW, THEREFORE, in consideration of the premises and for other good and valuable consideration the Company agrees as follows:

AWARDS

1. *Award of Performance Shares.* Subject to all terms and conditions of the Plan and this Agreement, the Company has awarded to the Employee on the date indicated on the Award Summary the number of Performance Shares (individually, the “PS”) as shown on the Award Summary.

TERMS OF THE PERFORMANCE SHARES

2. *Entitlement to Shares.* As soon as practicable on or after the Vesting Date indicated on the Award Summary in connection with the PSs (the “Vesting Date”), the Company shall, without transfer or issue tax to the person entitled to receive the shares, deliver to such person a certificate or certificates for a number of shares of Common Stock equal to the number of vested PSs (subject to reduction for payment of withholding taxes as described below). The number of shares to be issued to Employee shall be reduced by the amount of withholding taxes which must be paid under U.S. Federal and, where applicable, state and local law at the time of each distribution. No fractional shares shall be issued. Instead, the Company shall apply the equivalent of any fractional share amount to Federal, and where applicable, state and local, withholding taxes.

The award of PSs covered hereby shall be earned based on achieving one hundred percent (100%) of a target on an annual basis based on certain performance measures as shall be determined from time to time by the Committee. To the extent that performance measures are achieved at or between threshold and maximum levels (as shall be determined by the Committee) on a three-year cumulative basis, an additional award of PSs will be earned, net of shares previously earned for annual achievement. The Vesting Date for earned PS awards granted shall be set forth in the Award Summary.

Upon the occurrence of an event constituting a Change in Control, all PSs and dividend equivalents outstanding on such date shall be treated pursuant to the terms set forth in the Plan. Upon payment pursuant to the terms of the Plan, such awards shall be cancelled.

3. *Dividend Equivalents.* The Employee shall be entitled to receive from the Company cash payments at the same time and in the same amounts that the holder of record of a number of shares of Common Stock equal to the number of PSs covered by this Agreement would be entitled to receive as dividends on such Common Stock. Such right to cash payment on a PS covered hereby shall apply to all dividends the record date for which occurs at any time during the period commencing on the date hereof and ending on the date that the Employee becomes a shareholder of record with respect to such share as a result of (i) the entitlement to shares on or after the Vesting Date as provided under Paragraph 2, or (ii) the date this PS otherwise terminates, whichever occurs first. Payments under this Paragraph shall be net of any required U.S. Federal, state or local withholding taxes.

4. *Ownership Guidelines.* Guidelines pertaining to the Employee’s required ownership of Common Stock shall be determined by the Committee in its sole discretion at or before the making of the Award as communicated to Employee in writing at the time this Agreement is delivered to Employee.

5. *Holding Requirements.* The Employee must retain fifty percent (50%) of the net shares of Common Stock acquired in connection with the PSs (net of withholding tax and exercise fees) until ownership guidelines are met under Paragraph 4 hereof. Such shares shall be held in the Employee’s Smith Barney account or at another account acceptable to the Company.

If employment terminates due to the death of the Employee, such holding requirements shall cease at the date of death. If the Employee terminates for any other reason, the holding requirement will be applicable for up to a one year period following termination.

OTHER TERMS

6. *Rights of a Shareholder.* Employee shall have no rights as a shareholder with respect to any shares covered by this Agreement until the date of issuance of a stock certificate to him for such shares. Except as otherwise provided herein, no adjustment shall be made for dividends or other rights for which the record date is prior to the date such stock certificate is issued.

7. *Non-Assignability.* This Agreement shall not be assignable or transferable by Employee except by will or by the laws of descent and distribution.

8. *Effect of Termination of Employment or Death.*

(a) *Effect on PSs.* In the event the Employee

- (i) voluntarily ceases to be an Employee of the Company or any subsidiary or affiliate for any reason other than retirement, and the PSs have not vested in accordance with Paragraph 2, the PSs shall be cancelled on the date of such voluntary termination of employment.
- (ii) involuntarily ceases to be an Employee of the Company or any subsidiary or affiliate due to a reduction in workforce, contingent upon Employee executing a general release, which may include an agreement with respect to engagement in detrimental activity, in a form acceptable to the Company, shares will vest on a pro-rata basis for annual and three-year cumulative performance if achieved in accordance with Paragraph 2, based on the Employee's actual months of service. For the year in which termination occurs, shares earned for that year will be calculated as follows: multiply the total award earned for that year by a fraction, the numerator of which will be the number of months of full service for that year and the denominator will be 12. Any shares earned for annual performance pursuant to this grant for years prior to such involuntary termination of employment and shares earned on a pro-rata basis for annual performance as described herein will be paid out as soon as practicable following the Vesting Date noted in the Award Summary. For three-year cumulative performance, vesting will be calculated as follows: multiply the total three-year cumulative award earned by a fraction, the numerator of which will be the number of months of full service during the three years and the denominator will be 36, and subtract from the sum the number of shares previously earned for annual performance pursuant to this grant. Payout shall occur as soon as practicable following the Vesting Date noted in the Award Summary.
- (iii) ceases to be an Employee of the Company or any subsidiary or affiliate by reason of death, 100% of the PSs pursuant to this grant shall vest on the date of death and the certificates for shares shall be delivered in accordance with Paragraph 7 to the personal representatives, heirs or legatees of the deceased Employee.
- (iv) ceases to be an Employee of the Company or any subsidiary or affiliate by reason of retirement, contingent upon Employee executing a general release, which may include an agreement with respect to engagement in detrimental activity, in a form acceptable to the Company, shares will vest on a pro-rata basis for annual and three-year cumulative performance, if achieved in accordance with Paragraph 2, based on the Employee's actual months of service. For the year in which retirement occurs, shares earned for that year will be calculated as follows: multiply the total award earned for that year by a fraction, the numerator of which will be the number of months of full service for that year and the denominator will be 12. Any shares earned for annual performance pursuant to this grant for years prior to retirement and shares earned on a pro-rata basis for annual performance as described herein will be paid out as soon as practicable following the Vesting Date noted in the Award Summary. For three-year cumulative performance, vesting will be calculated as follows: multiply the total three-year cumulative award earned by a fraction, the numerator of which will be the number of months of full service during the three years and the denominator will be 36, and subtract from the sum the number of shares previously earned for annual performance pursuant to this grant. Payout shall occur as soon as practicable following the Vesting Date noted in the Award Summary; and
- (v) ceases to be an Employee of the Company or any subsidiary or affiliate due to termination for Cause, the PSs shall be cancelled.

(b) *Disability.* Cessation of active employment due to commencement of long-term disability under the Company's long-term disability plan shall not be deemed to constitute a termination of employment for purposes of this Paragraph 8 and during the continuance of such Xerox-sponsored long-term disability plan benefits the Employee shall be deemed to continue active employment with the Company. If the Employee is terminated because the Employee has received the maximum coverage under the Xerox long-term disability plan, the vesting of PSs shall be provided pursuant to Paragraph 8 (a)(ii) above.

(c) *Cause.* "Cause" means (i) a violation of any of the rules, policies, procedures or guidelines of the Company, including but not limited to the Company's Business Ethics Policy and the Proprietary Information and Conflict of Interest Agreement (ii) any conduct which qualifies for "immediate discharge" under the Company's Human Resource Policies as in effect from time to time (iii) rendering services to a firm which engages, or engaging directly or indirectly, in any business that is competitive with the Company or represents a conflict of interest with the interests of the Company; (iv) conviction of, or entering a guilty plea with respect to, a crime whether or not connected with the Company; or (v) any other conduct determined to be injurious, detrimental or prejudicial to any interest of the Company.

9. *General Restrictions.* If at any time the Committee or CEO, as applicable, shall determine, in its or her discretion, that the listing, registration or qualification of any shares subject to this Agreement upon any securities exchange or under any state or Federal law, or the consent or approval of any government regulatory body, is necessary or desirable as a condition of, or in connection with, the awarding of the PSs or the issue or purchase of shares hereunder, the certificates for shares may not be issued in respect of PSs in whole or in part unless such listing, registration, qualification, consent or approval shall have been effected or obtained free of any conditions not acceptable to the Committee or CEO, as applicable, and any delay caused thereby shall in no way affect the date of termination of the PSs.

10. *Amendment of This Agreement.* With the consent of the Employee, the Committee or CEO, as applicable, may amend this Agreement in a manner not inconsistent with the Plan.

11. *Subsidiary.* As used herein the term "subsidiary" shall mean any present or future corporation which would be a "subsidiary corporation" of the Company as the term is defined in Section 425 of the Internal Revenue Code of 1986 on the date of award.

12. *Affiliate.* As used herein the term "affiliate" shall mean any entity in which the Company has a significant equity interest, as determined by the Committee.
13. *Non-engagement in Detrimental Activity Against the Company.* If an Employee or former Employee of the Company is deemed by the Committee or its authorized delegate, as applicable, in the Committee's or such delegate's sole reasonable discretion, to have engaged in detrimental activity against the Company, any awards granted to such Employee or former Employee on or after January 1, 2006 shall be canceled and be of no further force or effect and any payment or delivery of an award within six months prior to such detrimental activity may be rescinded. In the event of any such rescission, the Employee shall pay to the Company the amount of any gain realized or payment received as a result of the rescinded exercise, payment or delivery, in such manner and on such terms and conditions as may be required by the Committee or its delegate, as applicable.
14. *Notices.* Notices hereunder shall be in writing and if to the Company shall be mailed to the Company at P.O. Box 1600, 22B, Stamford, Connecticut 06904, addressed to the attention of Stock Plan Administrator, and if to the Employee shall be delivered personally or mailed to the Employee at his address as the same appears on the records of the Company.
15. *Interpretation of This Agreement.* The Committee or the CEO, as applicable, shall have the authority to interpret the Plan and this Agreement and to take whatever administrative actions, including correction of administrative errors in the awards subject to this Agreement and in this Agreement, as the Committee or the CEO in its or her sole good faith judgment shall be determined to be advisable. All decisions, interpretations and administrative actions made by the Committee or the CEO hereunder or under the Plan shall be binding and conclusive on the Company and the Employee. In the event there is inconsistency between the provisions of this Agreement and of the Plan, the provisions of the Plan shall govern.
16. *Successors and Assigns.* This Agreement shall be binding and inure to the benefit of the parties hereto and the successors and assigns of the Company and to the extent provided in Paragraph 8 to the personal representatives, legatees and heirs of the Employee.
17. *Governing Law.* The validity, construction and effect of the Agreement and any actions taken under or relating to this Agreement shall be determined in accordance with the laws of the state of New York and applicable Federal law.
18. *Separability.* In case any provision in the Agreement, or in any other instrument referred to herein, shall become invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions in the Agreement, or in any other instrument referred to herein, shall not in any way be affected or impaired thereby.
19. *Integration of Terms.* Except as otherwise provided in this Agreement, this Agreement contains the entire agreement between the parties relating to the subject matter hereof and supersedes any and all oral statements and prior writings with respect thereto.

IN WITNESS WHEREOF, the Company has executed this Agreement as of the day and year set forth on the Award Summary.

XEROX CORPORATION

By: _____
Signature



Executive Long-Term Incentive Program

2006 DEFERRAL ELECTION FORM

Complete this form only if you are electing to defer 2006 Performance Shares

Personal Information (Please print)

Participant Name _____

Social Security Number _____

(or Smith Barney Global ID Number) _____

External Office Phone Number _____

Your Deferral Election

Select one of the options below and enter, in 5 percent increments, your deferral election(s) for the receipt of Xerox Common Stock in connection with your 2006 grant of Performance Shares:

Receipt of ____ % of shares earned under the terms of the grant, including annual and cumulative components, to be deferred until January 1, _____. (you must enter a date no sooner than 2010)

OR

Receipt of ____% of shares earned under the terms of the grant, including annual and cumulative components, to be deferred until one year after separation from service.

Note: Your total deferral cannot exceed 100%. Your right to receive Common Stock in connection with your deferral is subject to satisfying the vesting requirements of the grant. The portion of your award not subject to deferral will be available under the normal vesting schedule. Any FICA and/or any other withholding taxes due on the Vesting Date will be settled by shares of your award not subject to deferral, if applicable, with any additional withholding taxes due on the Vesting Date to be settled in cash.

In the event of your death before the deferral date, receipt of shares shall be delivered to your personal representatives, heirs or legatees in accordance with the terms of your award.

Recent tax legislation significantly reduced the ability to accelerate receipt of deferred amounts upon a change in control. If receipt of deferred shares upon a change in control cannot be accelerated, you will receive your shares according to your deferral election.

Your Authorization (Sign below to authorize your election)

In accordance with the provisions of the Xerox Corporation 2004 Performance Incentive Plan and the Executive Long-Term Incentive Program Agreement thereunder, I hereby authorize the irrevocable deferral election(s) indicated above for the 2006 E-LTIP grant.

Participant Signature: _____ Date: _____

Please send completed original by **June 30, 2006** to:

Ivonne Cruz
Executive Compensation
Fax: 8*344-3861
STHQ 2-2-B

XEROX CORPORATION
800 Long Ridge Road
Stamford, CT 06904

Amended and Restated Severance Letter Agreement
Providing Certain Benefits Upon Termination of Employment
Following a Change In Control

[Date]

Dear [Name]:

Xerox Corporation (“the Company”) considers it in the best interests of its shareholders to foster the continuous employment of key management personnel. The Board recognizes that, as with many publicly held corporations, the possibility of a Change in Control may arise, and that the uncertainty raised by this possibility may cause the departure or distraction of management personnel, to the detriment of the Company and its shareholders.

The Board has determined that appropriate steps should be taken to reinforce the continued dedication of key management personnel to their duties, without potential distraction arising from a possible Change in Control, although no such change is now contemplated.

In order to induce you to remain in the employ of the Company and in consideration of your agreement set forth in Section 3, the Company accordingly agrees that you shall receive the severance benefits set forth in this Agreement if your employment with the Company is terminated under certain circumstances following a Change in Control.

1. *Definitions.*

(a) *Agreement* shall mean the letter agreement set forth herein.

(b) *Board* shall mean the Board of Directors of the Company.

(c) *Change in Control* of the Company shall be deemed to have occurred if:

(i) Any “person” (as such term is used in Sections 13(d) and 14(d) of the Exchange Act), other than (A) the Company, (B) any trustee or other fiduciary holding securities under an employee benefit plan of the Company, (C) any company owned, directly or indirectly, by the shareholders of the Company in substantially the same proportions as their ownership of stock of the Company, or (D) any person who becomes a “beneficial owner” (as defined below) in connection with a transaction described in subclause (A) of clause (iii) below, is or becomes the “beneficial owner” (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20% or more of the combined voting power of the Company’s then outstanding securities;

(ii) The following individuals cease for any reason to constitute a majority of the directors then serving: (A) individuals who, on the date hereof constitute the Board, and (B) any new director (other than a director whose initial assumption of office is in connection with an actual or threatened election contest, including but not limited to a consent solicitation, relating to the election of directors of the Company) whose appointment or election by the Board or nomination for election by the Company’s shareholders was approved or recommended by a vote of at least two-thirds of the directors then still in office who were directors on the date hereof or whose appointment, election or nomination for election was previously so approved or recommended;

(iii) There is consummated a merger or consolidation of the Company or any direct or indirect subsidiary of the Company with any other corporation, other than (A) a merger or consolidation which results in the directors of the Company immediately before such merger or consolidation continuing to

constitute at least a majority of the board of directors of the Company, the surviving entity or any parent thereof, or (B) a merger or consolidation effected to implement a recapitalization of the Company (or similar transaction) in which no person is or becomes the beneficial owner, directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 20% or more of the combined voting power of the Company's then outstanding securities; or

(iv) The shareholders of the Company approve a plan of complete liquidation or dissolution of the Company, or there is consummated an agreement for the sale or disposition by the Company of all or substantially all of the Company's assets, other than a sale or disposition by the Company of all or substantially all of the Company's assets to an entity, at least 50% of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the Company immediately before such sale.

(d) *Code* shall mean the Internal Revenue Code of 1986, as amended.

(e) *Company* shall mean the Company or any successor thereto, including any successor to its business and/or assets which assumes and agrees to perform this Agreement by operation of law or otherwise.

(f) *Date of Termination* shall mean:

(i) If your employment is terminated pursuant to a Termination by the Company For Disability, thirty (30) days after Notice of Termination is given (if you do not return to the performance of your duties on a full-time basis during such thirty (30) day period); and

(ii) If your employment is terminated for any other reason, the date specified in the Notice of Termination, subject to clauses (iii), (iv) and (v) of this subsection.

(iii) In the case of a Termination by the Company For Cause, the specified date shall not be less than thirty (30) days from the date the Notice of Termination is given.

(iv) In the case of a Termination by You For Good Reason, the specified date shall not be less than fifteen (15) days nor more than sixty (60) days, from the date the Notice of Termination is given.

(v) The Date of Termination may be extended pursuant to Section 13.

(g) *Disability* shall mean a physical or mental incapacity incurred after a Potential Change in Control which would allow you to receive benefits under the Company's Long-Term Disability Income Plan (or any substitute plans adopted before a Change in Control).

(h) *Exchange Act* shall mean the Securities Exchange Act of 1934, as amended.

(i) *Notice of Termination* shall mean the notice required to be given by you or the Company in accordance with the terms of Section 12.

(j) *Potential Change in Control* of the Company shall be deemed to have occurred if:

(i) The Company enters into an agreement, the consummation of which would result in the occurrence of a Change in Control;

(ii) Any person, including the Company, publicly announces an intention to take or to consider taking actions which if consummated would constitute a Change in Control;

(iii) Any person, other than a trustee or other fiduciary holding securities under an employee benefit plan of the Company (or a company owned, directly or indirectly, by the shareholders of the Company in substantially the same proportions as their ownership of stock of the Company), becomes the beneficial owner, directly or indirectly, of securities of the Company (not including in the securities beneficially owned by such person any securities acquired directly from the Company or its affiliates) representing 10% or more of the combined voting power of the Company's then outstanding securities; or

(iv) the Board adopts a resolution to the effect that a Potential Change in Control for purposes of this Agreement has occurred.

(k) *Termination by the Company For Cause* shall mean termination by the Company of your employment upon:

(i) The willful and continued failure by you to substantially perform your duties with the Company (other than any such failure resulting from your incapacity due to physical or mental illness or any such actual or anticipated failure after the issuance of a Notice of Termination by You For Good Reason), after a written demand for substantial performance is delivered to you by the Board which specifically identifies the manner in which the Board believes that you have not substantially performed your duties;

(ii) The willful engaging by you in conduct which is demonstrably and materially injurious to the Company, monetarily or otherwise; or

(iii) The conviction of any crime (whether or not involving the Company) which constitutes a felony.

(iv) For purposes of this subsection, no act or failure to act on your part shall be considered “willful” unless done, or omitted to be done, by you not in good faith and without reasonable belief that your action or omission was in the best interest of the Company.

(v) A termination of your employment is not a Termination by the Company For Cause until there is delivered to you a copy of a resolution duly adopted by the affirmative vote of not less than three-quarters of the entire membership of the Board at a meeting of the Board called and held for the purpose (after reasonable notice to you and an opportunity for you, together with your counsel, to be heard before the Board), finding that in the good faith opinion of the Board you were guilty of conduct set forth in this subsection, and specifying the particulars thereof in detail.

(l) *Termination by the Company For Disability* shall mean a termination by the Company of your employment following a Change in Control and during the term of this Agreement as follows. If, as a result of your incapacity due to physical or mental illness, you fail to perform your duties and shall have been receiving payments under the Company’s Long-Term Disability Income Plan, or any substitute plans adopted before the Change in Control, for a period of twelve (12) consecutive months and, within thirty (30) days after Notice of Termination is given, you shall not have returned to the full-time performance of your duties, the Company may terminate your employment pursuant to a Termination by the Company For Disability. You shall continue to receive your full base salary at the rate then in effect and your bonus and all compensation shall be paid during the period until this Agreement is terminated pursuant to this subsection. Your benefits shall thereafter be determined in accordance with the Company’s welfare benefits programs then in effect and the Company’s retirement plans then in effect.

(m) *Termination by You For Good Reason* shall mean the termination by you of your employment upon any of the following circumstances, if such circumstance occurs without your express written consent after a Change in Control and during the term of this Agreement:

(i) The assignment to you of any duties inconsistent with your status as a senior executive of the Company or a substantial adverse alteration in the nature or status of your responsibilities from those in effect immediately prior to a Change in Control of the Company (including, without limitation, if you are an executive officer of the Company prior to a Change in Control, ceasing to be an executive officer of a public company);

(ii) (A) a reduction in your annual base salary and/or annual target bonus as in effect on the date hereof, or as the same may be increased from time to time, (B) a failure by the Company to increase your annual base salary following a Change in Control at such periodic intervals consistent with the Company’s practice prior thereto by at least a percentage equal to the average of the percentage increases in your base salary for the three merit pay periods immediately preceding such Change in Control, or (C) the failure to increase your salary as the same may be increased from time to time for similarly situated senior executives, except that this clause (ii) shall not apply to across-the-board salary reductions similarly affecting all executives of the Company and all executives of any person in control of the Company;

(iii) The Company's requiring you to be based anywhere other than in the metropolitan area in which you were based immediately before the Change in Control, except for required travel on the Company's business to an extent substantially consistent with your present business travel obligations;

(iv) The failure by the Company to continue in effect any compensation or benefit plan, vacation policy or any material perquisites in which you participate immediately before the Change in Control, (except to the extent such plan terminates in accordance with its terms), unless an equitable arrangement (embodied in an ongoing substitute or alternative plan) has been made with respect to such plan in connection with the Change in Control, or the failure by the Company to continue your participation therein (or in such substitute or alternative plan) on a basis not materially less favorable, both in terms of the amount of benefits provided and the level of your participation relative to other participants, than existed at the time of the Change in Control; or

(v) The failure of the Company to obtain a satisfactory agreement from any successor to assume and agree to perform this Agreement, as contemplated in Section 11.

(vi) A Termination by You For Good Reason shall be deemed to occur if, after a Change in Control, there occurs any termination or purported termination by the Company of your employment which is not accompanied by any Notice of Termination required by Section 12, and does not comply with the notice requirements (if applicable) of subsection (l) of this section (defining Termination by the Company For Cause).

(vii) A termination by you of your employment shall not fail to be a Termination by You For Good Reason merely because of your incapacity due to physical or mental illness, or because your employment continued after the occurrence of any of the events listed in this subsection.

(n) *Termination by You Without Good Reason* shall mean a termination by you of your employment that is not a Termination by You For Good Reason.

2. Term of Agreement

(a) This Agreement shall be effective on [date], and shall continue in effect through December 31, [year], or the later date provided by subsection (b) or (c) of this section.

(b) Commencing on January 1, [year], and each January 1 thereafter, the term of this Agreement shall automatically be extended for one additional year unless, not later than the later of November 1 or thirty days following the meeting of the Compensation Committee of the Board held in October of the preceding year, the Company gives notice that it does not wish to extend this Agreement. No such notice may be given during the pendency of a Potential Change in Control.

(c) If a Change in Control occurs while this Agreement is in effect, then notwithstanding subsections (a) and (b) of this section, this Agreement shall continue in effect until the last day of the 24th month following the month in which occurs such Change in Control.

3. *Your Agreement to Certain Continued Employment.* You agree that, subject to the terms and conditions of this Agreement, in the event of a Potential Change in Control, you will remain in the employ of the Company until the earliest of:

(a) The expiration of nine (9) months from the occurrence of such Potential Change in Control,

(b) The termination by you of your employment by reason of Disability;

(c) The date on which you first become entitled under this Agreement to receive the benefits provided in Section 4 (or would be so entitled, except for the application of Section 14 herein, relating to section 409A of the Code.)

4. Benefits Upon Termination.

(a) You shall be entitled to the benefits provided by this section upon termination of your employment, if such termination occurs after a Change in Control and during the term of this Agreement and you sign a

release of claims in a form acceptable to the Company, and is not (i) because of your death, (ii) a Termination by the Company For Cause, (iii) a Termination by the Company For Disability, or (iv) a Termination by You Without Good Reason.

(b) The Company shall pay you your full base salary through the Date of Termination at the rate in effect at the time Notice of Termination is given, plus all other amounts to which you are entitled under any compensation plan of the Company, at the time such payments are due.

(c) In lieu of any further salary payments to you for periods after the Date of Termination, the Company shall pay a lump sum severance payment equal to [two (2) or 2.99] times the sum of:

(i) the greater of (A) your annual rate of base salary in effect on the date Notice of Termination is given, and (B) your annual rate of base salary in effect immediately before the Change in Control, and

(ii) the greater of (A) the annual target bonus applicable to you for the year in which Notice of Termination is given and (B) the annual target bonus applicable to you for the year in which the Change in Control occurs.

(d) The payment under subsection (c) will be paid immediately upon the fifth day following the Date of Termination, except that it may not be paid before the earliest date permitted under Section 14 herein (relating to section 409A of the Code).

(e) In addition to all other amounts payable to you under this section, you shall be entitled to receive all benefits payable under any other plan or agreement relating to retirement benefits or to compensation previously earned and not yet paid, in accordance with the terms of such plans or agreements.

(f) For the [24 or 36] month period immediately following the Date of Termination, the Company shall arrange to provide you and your dependents life, disability, accident and health insurance benefits substantially similar to those provided to you and your dependents immediately before the Date of Termination or, if more favorable to you, those provided to you and your dependents immediately before the occurrence of a Change in Control, at no greater cost to you than the cost to you immediately before such date or occurrence. Benefits otherwise receivable by you pursuant to this section shall be reduced to the extent benefits of the same type are received by or made available at no greater cost to you by a subsequent employer during the [24 or 36] month period following the Date of Termination (and any such benefits received by or made available to you shall be reported by you to the Company).

(g) *Deeming rules for certain terminations of employment before a Change in Control.* For purposes of this Agreement:

(i) Termination of your employment shall be deemed to occur after a Change in Control if (A) your employment is terminated by the Company before a Change in Control, (B) such termination was not a Termination by the Company For Cause, and (C) either such termination was at the request or direction of a person who has entered into an agreement with the Company the consummation of which would constitute a Change in Control, or you reasonably demonstrate that such termination was otherwise in connection with or in anticipation of a Change in Control.

(ii) Termination of you employment shall be deemed to be a Termination by You For Good Reason after a Change in Control if (A) before a Change in Control, you incur a Termination by You For Good Reason (or what would be such but for the fact that it occurs before a Change in Control), and (B) the circumstance or event which constitutes Good Reason occurs at the request or direction of a person who has entered into an agreement with the Company the consummation of which would constitute a Change in Control.

(iii) Clauses (i) and (ii) apply whether or not a Change in Control actually occurs.

5. Benefits upon Termination For Cause or Without Good Reason. If, following a Change in Control, your employment is terminated pursuant to a Termination by the Company For Cause, or a Termination by You Without Good Reason, the Company shall pay you your full base salary through the Date of Termination at the rate in effect at the time Notice of Termination is given, plus all other amounts to which you are entitled under

any compensation plan of the Company at the time such payments are due, and the Company shall have no further obligations to you under this Agreement.

6. No Duty to Mitigate. You shall not be required to mitigate the amount of any payment provided for in Sections 4, 5, 9 or 10 herein by seeking other employment or otherwise, nor shall the amount of any payment or benefit provided for in such sections be reduced by any compensation earned by you as the result of employment by another employer or by retirement benefits after the Date of Termination, or otherwise, other than under subsection (f) of Section 4 (relating to certain continuing welfare benefits) and Section 8.

7. No Waiver. Your continued employment after any event which is or might be an event listed under the definition of Termination by You For Good Reason herein shall not constitute your consent to, or your waiver of rights with respect to, any circumstances surrounding a Termination by You For Good Reason.

8. Offset for Certain Severance Pay. If you become entitled to the lump sum severance benefit under subsection (c) of Section 4 herein, you shall not be entitled to receive severance pay under any severance pay plan, policy or arrangement maintained by the Company or any of its subsidiaries. If the Company is obligated by law or by contract to pay severance pay, a termination indemnity, notice pay, or the like, or if the Company is obligated by law or by contract to provide advance notice of separation, then the lump sum severance benefit under subsection (c) of Section 4 herein shall be reduced, but not below zero, by the amount of any such severance pay, termination indemnity, notice pay or the like, as applicable, and by the amount of any compensation received by you during the period of such advance notice.

9. Gross-Up Payments.

(a) For purposes of this Section, the following terms shall have the following meanings:

(i) Total Payments shall mean all of the payments or benefits received or to be received by you in connection with a Change in Control or your termination of employment, whether pursuant to the terms of this Agreement or any other plan, arrangement or agreement with the Company, any person whose actions result in a Change in Control or any person affiliated with the Company or such person, excluding the Gross-Up Payment.

(ii) Excise Tax shall mean the excise tax imposed under section 4999 of the Code.

(iii) Gross-Up Payment shall mean the additional amount paid to you by the Company pursuant to this section such that (A) the net amount retained by you, after (B) deduction of required withholding taxes (required to be withheld at the time of payment of the Gross-Up Payment) plus any amounts payable with your personal federal, state and local income tax returns for any Excise Tax on the Total Payments and any federal, state and local income and employment taxes and Excise Tax upon the Gross-Up Payment (but not including any taxes payable pursuant to section 409A of the Code), (C) shall be equal to the Total Payments.

(b) The Company shall pay to you the Gross-Up Payment not later than the later of (i) the fifth day following the Date of Termination, or (ii) the tenth day following the date of initial determination of the amount of the Gross-Up Payment (as set forth in subsection (c)), except that the amount may not be paid to you before the earliest date permitted by Section 14 herein (relating to section 409A of the Code).

(c) An initial determination of the amount of the Gross-Up Payment (if any) shall be made by tax counsel not later than ten days following the Date of Termination. For purposes of determining whether any of the Total Payments will be subject to the Excise Tax and the amount of such Excise Tax, (i) all of the Total Payments shall be treated as "parachute payments" (within the meaning of section 280G(b)(2) of the Code) unless, in the opinion of tax counsel reasonably acceptable to you and the Company and selected by the accounting firm which was, immediately before the Change in Control, the Company's independent auditor (the "Auditor"), such payments or benefits (in whole or in part) do not constitute parachute payments, including by reason of section 280G(b)(4)(A) of the Code, (ii) all "excess parachute payments" within the meaning of section 280G(b)(1) of the Code shall be treated as subject to the Excise Tax unless, in

the opinion of Tax Counsel, such excess parachute payments (in whole or in part) represent reasonable compensation for services actually rendered (within the meaning of section 280G(b)(4)(B) of the Code) in excess of the base amount allocable to such reasonable compensation, or are otherwise not subject to the Excise Tax, and (iii) the value of any noncash benefits or any deferred payment or benefit shall be determined by the Auditor in accordance with the principles of sections 280G(d)(3) and (4) of the Code. For purposes of determining the amount of the Gross-Up Payment, you shall be deemed to pay federal income tax (taking into account your filing status for the year(s) the Gross-Up Payment(s) are made) at the highest marginal rate of federal income taxation in the calendar year(s) in which the Gross-Up Payment(s) are to be made and state and local income taxes at the highest marginal rate of taxation in the state and locality of your residence on the Date of Termination (or if there is no Date of Termination, then the date on which the Gross-Up Payment is calculated for purposes of this section), net of the maximum reduction in federal income taxes which could be obtained from deduction of such state and local taxes.

(d) In the event that the Excise Tax is finally determined by the Internal Revenue Service to be less than the amount taken into account hereunder in calculating the Gross-Up Payment, you shall repay to the Company, within five business days following the time that the amount of such reduction in the Excise Tax is finally determined, the portion of the Gross-Up Payment attributable to such reduction (plus that portion of the Gross-Up Payment attributable to the Excise Tax and federal, state and local income and employment taxes imposed on the Gross-Up Payment being repaid by you), to the extent that such repayment results in a reduction in the Excise Tax and a dollar-for-dollar reduction in your taxable income and wages for purposes of federal, state and local income and employment taxes, plus interest on the amount of such repayment at 120% of the rate provided in section 1274(b)(2)(B) of the Code. In the event that the Excise Tax is finally determined by the Internal Revenue Service to exceed the amount taken into account hereunder in calculating the Gross-Up Payment (including by reason of any payment the existence or amount of which cannot be determined at the time of the Gross-Up Payment), the Company shall make an additional Gross-Up Payment in respect of such excess (plus any interest, penalties or additions payable by you with respect to such excess) within five business days following the time that the amount of such excess is finally determined. The Company and you shall each cooperate with the other in connection with any administrative or judicial proceedings concerning the existence or amount of liability for Excise Tax with respect to the Total Payments. For purposes of the foregoing sentence, cooperation shall include (but not be limited to) providing to the Company and/or tax counsel copies of your Forms W-2 issued by the Company, together with your federal, state and local income tax returns, for the five calendar years immediately preceding the calendar year in which the Change in Control occurs (excluding any such year, if at no point during such year were you employed by the Company),

10. Legal Fees. The Company also shall pay to you all reasonable legal fees and expenses incurred by you with respect to the initial determination by tax counsel of the amount of the Gross-Up Payment (if any), as well as in disputing in good faith any issue hereunder relating to the termination of your employment, in seeking in good faith to obtain or enforce any benefit or right provided by this Agreement or in connection with any tax audit or proceeding to the extent attributable to the application of section 4999 of the Code to any payment or benefit provided hereunder. Such payment shall be made immediately upon the date that is five business days after delivery of your written request for payment accompanied with such evidence of fees and expenses incurred as the Company reasonably may require, except that such amount shall not be paid before the earliest date permitted by Section 14 herein (relating to section 409A of the code).

11. Successors; Binding Agreement.

(a) The Company will require any successor (whether direct or indirect, by purchase, merger, consolidation or otherwise) to all or substantially all of the business and/or assets of the Company to expressly assume and agree to perform this Agreement in the same manner and to the same extent that the Company would be required to perform it if no succession had taken place.

(b) Failure of the Company to obtain such assumption and agreement before the effectiveness of any such succession shall be a breach of this Agreement and shall entitle you to compensation from the

Company in the same amount and on the same terms as you would be entitled hereunder if you terminated your employment for Good Reason following a Change in Control, except that for purposes of implementing the foregoing, the date on which any such succession becomes effective shall be deemed the Date of Termination.

(c) This Agreement shall inure to the benefit of and be enforceable by your personal or legal representatives, executors, administrators, successors, heirs, distributees, devisees and legatees. If you should die while any amount would still be payable to you hereunder if you had continued to live, all such amounts, unless otherwise provided herein, shall be paid in accordance with the terms of this Agreement to your devisee, legatee or other designee or if no such designee, to your estate.

12. Notice Requirement. Any termination or purported termination of your employment (except by reason of your death) by the Company or by you following a Change in Control and during the term of this Agreement shall be communicated by written Notice of Termination to the other party hereto in accordance with this section. The Notice of Termination shall indicate the specific termination provision in this Agreement relied upon and shall set forth in reasonable detail the facts and circumstances claimed to provide a basis for termination of your employment under the provision so indicated. For the purposes of this Agreement, notices and all other communications provided for in the Agreement shall be in writing and shall be deemed to have been duly given when delivered or mailed by United States registered mail, return receipt requested, postage prepaid, addressed to the respective addresses set forth on the first page of this Agreement, provided that all notices to the Company shall be directed to the attention of the Board with a copy to the Secretary of the Company, or to such other address as either party may have furnished to the other in writing in accordance herewith, except that notice of change of address shall be effective only upon receipt.

13. Extension of Date of Termination. If, within thirty (30) days after any Notice of Termination is given the party receiving such Notice of Termination notifies the other party that a dispute exists concerning the termination, the Date of Termination shall be the date on which the dispute is finally determined, either by mutual written agreement of the parties, by a binding arbitration award, or by a final judgment, order or decree of court of competent jurisdiction (the time for appeal therefrom having expired and no appeal having been perfected). The Date of Termination shall be extended by a notice of dispute only if such notice is given in good faith and the party giving such notice pursues the resolution of such dispute with reasonable diligence. Notwithstanding the pendency of any such dispute, the Company will continue to pay you your full compensation in effect when the notice giving rise to the dispute was given (including, but not limited to, base salary) and continue you as a participant in all compensation, benefit and insurance plans in which you were participating when the notice giving rise to the dispute was given, until the dispute is finally resolved in accordance with this section. Amounts paid under this section are in addition to all other amounts due under this Agreement and shall not be offset against or reduce any other amounts due under this Agreement and shall not be reduced by any compensation earned by you as the result of employment by another employer.

14. No Payment Triggering Taxation Under Code Section 409A.

(a) In no event shall any amount be paid to you under this Agreement before the date that is the earliest of:

(i) your death;

(ii) the date you become disabled (as defined for purposes of Code section 409A(a)(2));or

(iii) the date of your separation from service (as defined for purposes of Code section 409A(a)(2)), plus 6 months after such date if you are a specified employee (as defined for purposes of Code section 409A(a)(2)(B)).

(b) No amount may be paid under this Agreement in any manner or according to any time or schedule that would cause inclusion of any amount in gross income for any person under Code section 409A(a)(1) or any regulations promulgated thereunder.

15. *Amendment.*

(a) Except as provided in subsection (b), no provision of this Agreement may be modified, waived or discharged unless such waiver, modification or discharge is agreed to in writing and signed by you and such officer as may be specifically designated by the Board.

(b) To the extent deemed necessary or desirable by the Board of Directors of Xerox Corporation, the Agreement may be amended by an affirmative vote of the majority of the directors described in section 1(c)(ii) hereof in order to comply with Code section 409A and to avoid any additional tax or penalty related solely to Code section 409A. Such amendments will be effective if signed by such officer as may be specifically designated by the Board of Directors of Xerox Corporation. The provisions of this subsection (b) shall not apply at any time after the occurrence of either a Potential Change in Control or a Change in Control.

16. *Miscellaneous.* No waiver by either party hereto at any time of any breach by the other party hereto of, or compliance with, any condition or provision of this Agreement to be performed by such other party shall be deemed a waiver of similar or dissimilar provisions or conditions at the same or at any prior or subsequent time. No agreements or representations, oral or otherwise, express or implied, with respect to the subject matter hereof have been made by either party which are not expressly set forth in this Agreement. The validity, interpretation, construction and performance of this Agreement shall be governed by the laws of the State of New York without regard to its conflicts of law principles. All references to sections of the Exchange Act or the Code shall be deemed also to refer to any successor provisions to such sections. Any payments provided for hereunder shall be paid net of any applicable withholding required under federal, state or local law. The obligations of the Company under Sections 4, 5, 9 and 10 shall survive the expiration of the term of this Agreement. This Agreement shall not be construed as creating an express or implied contract of employment and, except as otherwise agreed in writing between you and the Company, you shall not have any right to be retained in the employ of the Company.

17. *Validity.* The invalidity or unenforceability of any provision of this Agreement shall not affect the validity or enforceability of any other provision of this Agreement, which shall remain in full force and effect.

18. *Counterparts.* This Agreement may be executed in several counterparts, each of which shall be deemed to be an original but all of which together will constitute one and the same instrument.

19. *Entire Agreement.* This Agreement sets forth the entire agreement of the parties hereto in respect of the subject matter contained herein and during the term of the Agreement supersedes the provisions of all prior agreements, promises, covenants, arrangements, communications, representations or warranties, whether oral or written, by any officer, employee or representative of any party hereto with respect to the subject matter hereof (including, without limitation, the Severance Agreement previously entered into between you and the Company as thereafter amended and/or extended).

20. *Effective Date.* This Agreement shall become effective as of the date set forth above. If this letter correctly sets forth our agreement on the subject matter hereof, please sign and return to the Company the enclosed copy of this letter which will then constitute our agreement on this subject.

Sincerely,

XEROX CORPORATION

By: _____
Name: Anne M. Mulcahy
Title: Chairman and Chief Executive Officer

Agreed to as of the Date: _____

Name: _____

Separation Agreement dated May 11, 2000 between Registrant and G. Richard Thoman, former President and Chief Executive Officer of Registrant.

**THE DOCUMENT COMPANY
XEROX**

Paul A. Allaire
Chairman of the Board
Xerox Corporation
800 Long Ridge Road
Stamford, CT 06904
(203) 968-4515

May 11, 2000

Mr. G. Richard Thoman
28 Fox Run Lane
Greenwich, CT 06831

Dear Rick:

The following information summarizes the arrangements for your separation from Xerox Corporation (the Company) subject to approval by the Board of Directors or the Executive Compensation and Benefits Committee commencing May 11, 2000.

If you obtain employment as an employee of, or consultant to, another firm or corporation (other than the Company or an affiliate) that is a direct competitor of the Company in any business presently engaged in by the Company or in which the Company as of the date hereof may reasonably be expected to engage in the future, or is or may become such a competitor indirectly through a partnership, joint venture or other business arrangement with, or as a supplier or consultant to, such a direct competitor ("Competitor"), the stock options both vested and non-vested specified in the table below under Options and Rights (the "Stock Options") will be cancelled immediately. However, if the Company advises you in advance in writing that in its reasonable judgment such other firm or corporation is not a Competitor, the remaining salary continuance will continue to be paid. We will provide notice to you upon your request as to the competitive nature of a prospective employer.

The Company may cancel the Stock Options in the event you disclose confidential business information or if you publicly make any derogatory or disparaging statements about the Company, its management or its business. The Company agrees not to publicly make any derogatory or disparaging statements about you.

BONUS

You will receive \$375,000 as a prorated 2000 bonus in February 2001.

OTHER COMPENSATION

You will receive a cash payment of \$200,000 in lieu of continuation of life insurance benefits. Payment will be made as soon as administratively possible.

OPTIONS AND RIGHTS

Summarized below are the relevant provisions that apply to your long-term incentive awards, profit sharing and savings accounts, pension benefits, life insurance benefits and other benefits arrangements. In case of inconsistencies between this summary and the relevant plan, the terms of the plan will govern.

| Grant Date | Grant Price | Amount Remaining | Vesting* | Expiration Date* |
|--------------------------------|-------------|------------------|---|---|
| N/Q Stock Options: | | | | |
| 6/11/97 (Sign-on) | \$ 34.8125 | 1,000,000 | 480,000 (Now) 260,000 on 1/1/2001 260,000 on 1/1/2002 | 12/31/04 Options exercisable for balance of term |
| 6/11/97 (Sign-on) | \$ 34.8125 | 100,540 | 100,540 (Now) | 12/31/04 Options exercisable for balance of term |
| 12/31/97 (LEEP) | \$ 36.7032 | 400,512 | 264,335 (Now) 136,177 on 1/1/2001 | 12/31/05 Options exercisable for balance of term |
| 10/12/98 (LEEP) | \$ 46.8750 | 171,648 | 114,432 (Now) 57,216 on 1/1/2001 | 12/31/08 Options exercisable for balance of term |
| 12/7/98 (LEEP) | \$ 54.8594 | 163,480 | 81,740 (Now) 81,740 on 1/1/2001 | 2/26/09 Options exercisable for balance of term |
| 1/1/99 (Profit Sharing) | \$ 59.4375 | 1,374 | 458 (Now) 458 on 1/1/01 458 on 1/1/02 | 12/31/06 Options exercisable for balance of term |
| 9/9/99 (Bonus) | \$ 47.50 | 42,188 | 42,188 on 3/1/03 | 12/31/09 Options exercisable for balance of term |
| 10/11/99 (Retention) | \$ 25.3755 | 250,000 | 125,000 on 10/11/03 125,000 on 6/25/04 | 12/31/09 Options exercisable for balance of term |
| 2/7/00 (Retention) | \$ 21.7812 | 100,000 | 100,000 on 1/1/02 if meets targets, or 1/1/05 if not | 12/31/09 Options exercisable for balance of term |
| Total | | 2,229,742 | | |
| Incentive Stock Rights: | | | | |
| 6/11/97 (Sign on) | | 80,000 | 40,000 on 1/1/01 40,000 on 1/1/02 | |
| Total | | 80,000 | | |

Note: Subject only to the second and third paragraphs of this letter (relating to competition with the Company, disclosure of confidential business information or publicly making derogatory or disparaging statements about the Company), by reason of your separation from the Company, all of your options as set forth in the table above will continue to vest on the dates provided (subject to no other conditions) and will be exercisable until their expiration dates as set forth in such table.

PROFIT SHARING AND SAVINGS ACCOUNT

As you know, under relevant plan provisions, you have choices available regarding the continued investment of your account balances and the time and form of distribution. A calculation of your account balances will be completed at the end of your salary continuance period at which time you will have the opportunity to elect how and when the proceeds will be distributed.

RETIREMENT BENEFIT

You will be entitled to an annual retirement benefit of \$800,000 commencing as of the date hereof. The form of benefit is 100% joint and survivor meaning that your wife will continue to receive this benefit after your death.

MEDICAL, DENTAL AND OTHER BENEFITS

You will be entitled to retiree medical and dental coverage under the Mid-Career Hire Executive Retirement Program commencing the date hereof.

LIFE INSURANCE

Your Contributory Life Insurance coverage of \$3,000,000 will terminate on the date of this agreement. Upon termination of the Plan Agreement in accordance with the terms of the Contributory Life Insurance Plan, the Company will recover its cumulative premiums paid into the Contributory Life Insurance Plan, plus an amount for administrative expenses as stated in the Plan Agreement. At that time you will become sole owner of the policy along with any remaining cash value, with the option to continue the coverage at your own expense.

DEFERRED COMPENSATION PLAN

Your deferred compensation accounts will be paid out in accordance with the terms of the plan. You will receive the proceeds in early July. The balance of your accounts as of May 8, 2000 was \$13,022,591 which is subject to fluctuation based upon hypothetical investment results through the date of distribution.

OTHER ARRANGEMENTS

You will be paid for any accrued and unused vacation upon commencement of salary continuance. You will not accrue any further vacation during salary continuance.

Your company financial counseling program will be continued through the end of 2000.

Tax preparation will be extended through 2001 for the 2000 tax year.

The Executive Expense Allowance payment has been made in 2000. You will not be entitled to any future Executive Expense Allowance payments while on salary continuance.

You will be eligible for your 2000 physical under the Executive Physical program.

The company will provide you with an office and administrative support at First Stamford Place for 2 years, commencing May 15, 2000.

INDEMNITY

You will be entitled to be indemnified with respect to all periods of your service as a director or officer of the Company or any of its subsidiaries in accordance with 1) the provisions of Sections 721 through 725 of the Business Corporation Law of the State of New York and provisions of California Labor Code Section 2802 2) Section 2 of Article VIII of the by-laws of the Company as in effect on the date hereof and 3) the Company directors and officers liability insurance policies with Federal Insurance Company, National Union Fire Insurance Company of Pittsburgh P.A., Reliance Insurance Company, Chubb Atlantic Ltd., Gulf Insurance Company and A.C.E. Insurance, Ltd., including, without limitation, In re Xerox Securities Litigation, 3:99-CV-2374(AWT) pending in the United States District Court for the District of Connecticut.

RELEASE

This agreement shall not become effective until you execute and delivery to the Company the release in the form attached. This agreement supercedes any prior agreements between you and the Company with respect to your separation from the Company.

COOPERATION IN LITIGATION

You will cooperate fully with the Company and its counsel in any litigation that arises out of or is related to your service with the Company or any of its subsidiaries, or in which you are named as a party. That cooperation includes making yourself available for reasonable periods of time upon reasonable notice for consultation with the Company's counsel in any such litigation and to provide testimony before or during any trial.

DIRECTOR/OFFICER STATUS

You hereby withdraw your nomination for election as a Director of the Company at the Annual Meeting of Shareholders scheduled to be held on May 18, 2000, or any adjournment thereof, and hereby decline to serve as a Director.

Concurrently herewith you are executing your resignation as a Director and Officer of the Company and as a director or officer of any subsidiary or affiliate of the Company in which you serve in such capacity, effective on the date hereof.

Sincerely,

/s/ PAUL A. ALLAIRE

Paul A. Allaire

PAA/crl

AGREED AND ACCEPTED

/s/ G. RICHARD THOMAN

G. Richard Thoman

Xerox Corporation
Computation of Ratio of Earnings to Fixed Charges

The ratio of earnings to fixed charges, the ratio of earnings to combined fixed charges and preferred stock dividends are determined using the following applicable factors:

Earnings available for fixed charges are calculated first, by determining the sum of: (a) income (loss) from continuing operations before income taxes, (b) distributed equity income, (c) fixed charges, as defined below and (d) amortization of capitalized interest, if any. From this total, we subtract capitalized interest, if any.

Fixed charges are calculated as the sum of (a) interest costs (both expensed and capitalized), (b) amortization of debt expense and discount or premium relating to any indebtedness and (c) that portion of rental expense that is representative of the interest factor.

Preferred stock dividends used in the ratio of earnings to combined fixed charges and preferred stock dividends consist of the amount of pre-tax earnings required to cover dividends paid on our Series B convertible preferred stock and our Series C mandatory convertible preferred stock. The Series B dividends are tax deductible and, as such, are equivalent to the pre-tax earnings required to cover such dividends. The Series B convertible preferred stock was redeemed and converted to common stock as of May 27, 2004 and, as such, there were no dividends beyond such date.

| (in millions) | Year Ended December 31, | | | | |
|--|-------------------------|----------------|----------------|----------------|----------------|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Fixed charges: | | | | | |
| Interest expense | \$ 557 | \$ 708 | \$ 884 | \$ 896 | \$1,001 |
| Portion of rental expense which represents interest factor | 74 | 105 | 77 | 82 | 111 |
| Total Fixed charges | \$ 631 | \$ 813 | \$ 961 | \$ 978 | \$1,112 |
| Earnings available for fixed charges: | | | | | |
| Earnings | \$ 928 | \$1,116 | \$ 494 | \$ 158 | \$ 381 |
| Less: Undistributed equity in income of affiliated companies | (54) | (89) | (37) | (23) | (20) |
| Add: Fixed charges | 631 | 813 | 961 | 978 | 1,112 |
| Total Earnings available for fixed charges | \$1,505 | \$1,840 | \$1,418 | \$1,113 | \$1,473 |
| Ratio of earnings to fixed charges | 2.39 | 2.26 | 1.48 | 1.14 | 1.32 |

Xerox Corporation

Computation of Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends

| (in millions) | Year Ended December 31, | | | | |
|--|-------------------------|----------------|----------------|----------------|----------------|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Fixed charges: | | | | | |
| Interest expense | \$ 557 | \$ 708 | \$ 884 | \$ 896 | \$1,001 |
| Portion of rental expense which represents interest factor | 74 | 105 | 77 | 82 | 111 |
| Total Fixed charges before preferred stock dividends pre-tax income requirement | 631 | 813 | 961 | 978 | 1,112 |
| Preferred stock dividends pre-tax income requirement | 94 | 110 | 90 | 78 | 13 |
| Total Combined fixed charges and preferred stock dividends | \$ 725 | \$ 923 | \$1,051 | \$1,056 | \$1,125 |
| Earnings available for fixed charges: | | | | | |
| Earnings | \$ 928 | \$1,116 | \$ 494 | \$ 158 | \$ 381 |
| Less: Undistributed equity in income of affiliated companies | (54) | (89) | (37) | (23) | (20) |
| Add: Fixed charges before preferred stock dividends | 631 | 813 | 961 | 978 | 1,112 |
| Total Earnings available for fixed charges and preferred stock dividends | \$1,505 | \$1,840 | \$1,418 | \$1,113 | \$1,473 |
| Ratio of earnings to combined fixed charges and preferred stock dividends | 2.08 | 1.99 | 1.35 | 1.05 | 1.31 |

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

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

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

Executive Overview

We are a technology and services enterprise and a leader in the global document market, developing, manufacturing, marketing, servicing and financing the industry's broadest portfolio of document equipment, solutions and services. Our industry is undergoing a series of transformations from older technology light lens devices to digital systems, from black and white to color, and from paper documents to an increased reliance on electronic documents. We believe we are well positioned as these transformations play to our strengths and represent opportunities for future growth, since our research and development investments have been focused on digital and color offerings.

We operate in competitive markets and our customers demand improved solutions, such as the ability to print offset quality color documents on demand; improved product functionality, such as the ability to print, copy, fax and scan from a single device; and lower prices for the same functionality. Customers are also increasingly demanding document services such as consulting and assessments, managed services, imaging and hosting, and document intensive business process improvements.

We deliver advanced technology through focused investment in research and development and offset lower prices through continuous improvement of our cost base. The majority of our revenue is recurring revenue (supplies, service, paper, outsourcing and rentals), which we collectively refer to as post sale revenue. Post sale revenue is heavily dependent on the amount of equipment installed at customer locations and the utilization of those devices. As such, our critical success factors include hardware installations, which stabilize and grow our installed base of equipment at customer locations, page volume growth and higher revenue per page. Connected multifunction devices, new services and solutions are key drivers to increase equipment usage. The transition to color is the primary driver to improve revenue per page, as color documents typically require significantly more toner coverage per page than traditional black and white printing. Revenue per color page is approximately five times higher than revenue per black and white page.

Financial Overview

In 2005, we expanded earnings and made significant progress in positioning ourselves for revenue growth while significantly improving our overall financial condition and liquidity. Our continued focus on investment in the growing areas of digital production and office systems, particularly with respect to color products, contributed to equipment sales growth as the majority of our equipment sales were generated from products launched in the last two years. Total revenue was comparable to the prior year, as modest equipment sales growth was offset by declines in finance income. Post sale and other was comparable to the prior year. Color revenue was up 19% over the prior year reflecting our investments in this market.

We maintained our focus on cost management throughout 2005. While 2005 gross margins were slightly below 2004, we continued to more than offset lower prices with productivity improvements. Gross margins were impacted by a change in overall product mix reflecting a higher proportion of sales of products with lower gross margins. We reduced selling, administrative and general ("SAG") expenses as administrative and general expense efficiencies, and reductions in bad debt expense more than offset increased selling expenses. We

continued to invest in research and development, prioritizing our investments in the faster growing areas of the market. In addition, we reduced interest expense by decreasing debt by over \$2.8 billion during the year.

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

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 largely unchanged in 2005, 10% weaker in 2004 and 17% weaker in 2003. As a result, the foreign currency translation impact on revenue was negligible in 2005. For 2004 and 2003, foreign currency translation had a 3-percentage point and 5-percentage point favorable impact, respectively.

Our 2005 balance sheet strategy focused on reducing our total debt, optimizing operating cash flows and matching our remaining debt portfolio to support our customer financing operations. The successful implementation of this strategy in 2005 enabled us to significantly improve our liquidity and finish the year with a cash, cash equivalents and short-term investments balance of \$1.6 billion. Our prospective balance sheet strategy includes: returning our credit rating to investment grade; optimizing operating cash flows; achieving an optimal cost of capital; rebalancing secured and unsecured debt; and effectively deploying cash to deliver and maximize long-term shareholder value. In addition, our strategy includes maintaining our current leverage of financing assets (finance receivables and equipment on operating leases) and maintenance of a minimal level of non-financing debt.

Revenues for the three years ended December 31, 2005 were as follows:

| (in millions) | Year Ended December 31, | | | Percent Change | |
|---|-------------------------|-----------------|-----------------|----------------|------------|
| | 2005 | 2004 | 2003 | 2005 | 2004 |
| Equipment sales | \$ 4,519 | \$ 4,480 | \$ 4,250 | 1% | 5% |
| Post sale and other revenue | 10,307 | 10,308 | 10,454 | — | (1)% |
| Finance income | 875 | 934 | 997 | (6)% | (6)% |
| Total Revenues | \$15,701 | \$15,722 | \$15,701 | — | — |
| Total Color revenue included in total revenues | \$ 4,634 | \$ 3,903 | \$ 3,267 | 19% | 19% |

The following presentation reconciles the above information to the revenue classifications included in our Consolidated Statements of Income:

| (in millions) | Year Ended December 31, | | |
|---------------------------------------|-------------------------|-----------------|-----------------|
| | 2005 | 2004 | 2003 |
| Sales | \$ 7,400 | \$ 7,259 | \$ 6,970 |
| Less: Supplies, paper and other sales | (2,881) | (2,779) | (2,720) |
| Equipment Sales | \$ 4,519 | \$ 4,480 | \$ 4,250 |
| Service, outsourcing and rentals | \$ 7,426 | \$ 7,529 | \$ 7,734 |
| Add: Supplies, paper and other sales | 2,881 | 2,779 | 2,720 |
| Post sale and other revenue | \$10,307 | \$10,308 | \$10,454 |

Total 2005 revenues of \$15.7 billion were comparable to the prior year period. Currency impacts on total revenues were negligible for the year. Total 2005 revenues included the following:

- 1% growth in Equipment sales, including a negligible impact from currency, primarily reflecting revenue growth from color in Office and Production, low-end black and white office products as well as growth in DMO. These growth areas were partially offset by revenue declines in higher-end office black and white products, and black and white production products.
- Comparable Post sale and other revenues, including a negligible impact from currency, primarily reflecting revenue growth from digital products and in DMO which were partially offset by declines in light lens.
- 6% decline in Finance income including benefits from currency of 1-percentage points, which reflects lower finance receivables.

Total 2004 revenues of \$15.7 billion increased modestly as compared to 2003 including a 3-percentage point benefit from currency. Total 2004 revenues included the following:

- 5% growth in Equipment sales, reflecting the success of our color and digital light production products and a 3-percentage point benefit from currency.
- 1% decline in Post sale and other revenues due to declines in older light lens technology products and Developing Market Operations (“DMO”), driven by Latin America, were partially offset by growth in digital office and production color, as well as a 3-percentage point benefit from currency. The light lens and DMO declines reflect a reduction of equipment at customer locations and related page volume declines. As our equipment sales continue to increase, we expect the effects of post-sale declines will moderate and ultimately reverse over time.
- 6% decline in Finance income, including a 4-percentage point benefit from currency, which reflects a decrease in equipment lease originations over the past several years.

Net income and diluted earnings per share for the three years ended December 31, 2005 were as follows:

| (in millions, except share amounts) | Year Ended December 31, | | |
|---|-------------------------|---------|---------|
| | 2005 | 2004 | 2003 |
| Net income | \$ 978 | \$ 859 | \$ 360 |
| Preferred stock dividends | (58) | (73) | (71) |
| Income available to common shareholders | \$ 920 | \$ 786 | \$ 289 |
| Diluted earnings per share | \$ 0.94 | \$ 0.86 | \$ 0.36 |

2005 Net income of \$978 million, or 94 cents per diluted share, included the following:

- \$343 million after-tax benefit related to the finalization of the 1996-1998 IRS audit.
- \$84 million after-tax (\$115 million pre-tax) charge for litigation matters relating to the MPI arbitration panel decision and probable losses for other legal matters.
- \$58 million after-tax (\$93 million pre-tax) gain related to the sale of our entire equity interest in Integic Corporation (“Integic”).
- \$247 million after-tax (\$366 million pre-tax) restructuring charges.

2004 Net income of \$859 million, or 86 cents per diluted share, included the following:

- \$83 million after-tax (\$109 million pre-tax) gain related to the sale of substantially all of our investment in ContentGuard Holdings, Inc. (“ContentGuard”).
- \$38 million after-tax pension settlement benefit from Fuji Xerox.

- \$30 million after-tax (\$38 million pre-tax) gain from the sale of our investment in ScanSoft, Inc. (“ScanSoft”).
- \$57 million after-tax (\$86 million pre-tax) restructuring charges.

2003 Net income of \$360 million, or 36 cents per diluted share, included the following:

- \$146 million after-tax (\$239 million pre-tax) charge related to the court approved settlement of the Berger v. RIGP litigation.
- \$111 million after-tax (\$176 million pre-tax) restructuring charges.
- \$45 million after-tax (\$73 million pre-tax) loss on early extinguishment of debt and income tax benefits of \$35 million from the reversal of deferred tax asset valuation allowances.

Application of Critical Accounting Policies

In preparing our Consolidated Financial Statements and accounting for the underlying transactions and balances, we apply various accounting policies. We consider the policies discussed below as critical to understanding our Consolidated Financial Statements, as their application places the most significant demands on management’s judgment, since financial reporting results rely on estimates of the effects of matters that are inherently uncertain. Specific risks associated with these critical accounting policies are discussed throughout this MD&A where such policies affect our reported and expected financial results. For a detailed discussion of the application of these and other accounting policies, refer to Note 1 to the Consolidated Financial Statements.

Senior management has discussed the development and selection of the critical accounting policies, estimates and related disclosures, included herein, with the Audit Committee of the Board of Directors. Preparation of this annual report requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, as well as disclosure of contingent assets and liabilities. These estimates and assumptions also impact revenues and expenses during the reporting period. Although actual results may differ from those estimates, we believe the estimates are reasonable and appropriate. In instances where different estimates could reasonably have been used in the current period, we have disclosed the impact on our operations of these different estimates. In certain instances, such as with respect to revenue recognition for leases, because the accounting rules are prescriptive, it would not have been possible to have reasonably used different estimates in the current period. In these instances, use of sensitivity information would not be appropriate. Changes in assumptions and estimates are reflected in the period in which they occur. The impact of such changes could be material to our results of operations and financial condition in any quarterly or annual period.

Revenue Recognition Under Bundled Arrangements: We sell most of our products and services under bundled lease arrangements, which typically include equipment, service, supplies and financing components for which the customer pays a single negotiated monthly fixed price for all elements over the contractual lease term. These arrangements typically also include an incremental, variable component for page volumes in excess of contractual page volume minimums, which are often expressed in terms of price per page. Revenues under these arrangements are allocated considering the relative fair values of the lease and non-lease deliverables included in the bundled arrangement based upon the estimated relative fair values of each element. Lease deliverables include maintenance and executory costs, equipment and financing, while non-lease deliverables generally consist of the supplies and non-maintenance services. Our revenue allocation for the lease deliverables begins by allocating revenues to the maintenance and executory costs plus profit thereon. The remaining amounts are allocated to the equipment and financing elements. We perform extensive analyses of available verifiable objective evidence of equipment fair value based on cash selling prices during the applicable period. The cash selling prices are compared to the range of values included in our lease accounting systems. The range of cash selling prices must be reasonably consistent with the lease selling prices, taking into account residual values that accrue to our benefit, in order for us to determine that such lease prices are indicative of fair value. Our pricing interest rates, which are used in determining customer payments, are developed based upon a variety of factors including local prevailing rates in the marketplace and the customer’s credit history, industry and credit class.

Effective in 2004, our pricing rates are reassessed quarterly based on changes in local prevailing rates in the marketplace and are adjusted to the extent such rates vary by twenty-five basis points or more, cumulatively, from the last rate in effect. The pricing interest rates generally equal the implicit rates within the leases, as corroborated by our comparisons of cash to lease selling prices.

Revenue Recognition for Leases: Our accounting for leases involves specific determinations under applicable lease accounting standards, which often involve complex and prescriptive provisions. These provisions affect the timing of revenue recognition for our equipment. If the leases qualify as sales-type capital leases, equipment revenue is recognized upon delivery or installation of the equipment as sale revenue as opposed to ratably over the lease term. The critical elements that we consider with respect to our lease accounting are the determination of the economic life and the fair value of equipment, including the residual value. For purposes of determining the economic life, we consider the most objective measure to be the original contract term, since most equipment is returned by lessees at or near the end of the contracted term. The economic life of most of our products is five years since this represents the most frequent contractual lease term for our principal products and only a small percentage of our leases are for original terms longer than five years. There is no significant after-market for our used equipment. We believe five years is representative of the period during which the equipment is expected to be economically usable, with normal service, for the purpose for which it is intended. Residual values are established at lease inception using estimates of fair value at the end of the lease term and are established with due consideration to forecasted supply and demand for our various products, product retirement and future product launch plans, end of lease customer behavior, remanufacturing strategies, competition and technological changes.

Accounts and Finance Receivables Allowance for Doubtful Accounts and Credit Losses: We perform ongoing credit evaluations of our customers and adjust credit limits based upon customer payment history and current creditworthiness. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that have been identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience credit loss rates similar to those we have experienced in the past. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers. We recorded bad debt provisions of \$72 million, \$110 million, and \$224 million in selling, administrative and general expenses in our Consolidated Statements of Income for the years ended December 31, 2005, 2004 and 2003, respectively. The declining trend in our provision for doubtful accounts is primarily due to improvements in customer administration, receivables aging, write-off trends, collection practices and credit approval policies.

As discussed above, in preparing our Consolidated Financial Statements for the three years ended December 31, 2005, we estimated our provision for doubtful accounts based on historical experience and customer-specific collection issues. This methodology has been consistently applied for all periods presented. During the five year period ended December 31, 2005, our allowance for doubtful accounts ranged from 3.6% to 5.5% of gross receivables. Holding all other assumptions constant, a 1-percentage point increase or decrease in the allowance from the December 31, 2005 rate of 3.6% would change the 2005 provision by approximately \$100 million.

Historically, about half of the provision for doubtful accounts relates to our finance receivables portfolio. This provision is inherently more difficult to estimate than the provision for trade accounts receivable because the underlying lease portfolio has an average maturity, at any time, of approximately two to three years and contains past due billed amounts, as well as unbilled amounts. The estimated credit quality of any given customer and class of customer or geographic location can significantly change during the life of the portfolio. We consider all available information in our quarterly assessments of the adequacy of the provision for doubtful accounts.

Pension and Post-retirement Benefit Plan Assumptions: We sponsor pension plans in various forms in several countries covering substantially all employees who meet eligibility requirements. Post-retirement benefit plans cover primarily U.S. employees for retirement medical costs. Several statistical and other factors that attempt to anticipate future events are used in calculating the expense, liability and asset values related to our pension and post-retirement benefit plans. These factors include assumptions we make about the discount rate, expected return on plan assets, rate of increase in healthcare costs, the rate of future compensation increases and mortality, among others. For purposes of determining the expected return on plan assets, we utilize a calculated value approach in determining the value of the pension plan assets, as opposed to a fair market value approach. The primary difference between the two methods relates to a systematic recognition of changes in fair value over time (generally two years) versus immediate recognition of changes in fair value. Our expected rate of return on plan assets is then applied to the calculated asset value to determine the amount of the expected return on plan assets to be used in the determination of the net periodic pension cost. The calculated value approach reduces the volatility in net periodic pension cost that results from using the fair market value approach. The difference between the actual return on plan assets and the expected return on plan assets is added to, or subtracted from, any cumulative differences that arose in prior years. This amount is a component of the unrecognized net actuarial (gain) loss and is subject to amortization to net periodic pension cost over the average remaining service lives of the employees participating in the pension plan.

As a result of cumulative historical asset returns being lower than expected asset returns, as well as declining interest rates, 2006 net periodic pension cost will increase. The total unrecognized actuarial loss as of December 31, 2005 was \$1.9 billion, as compared to \$2.0 billion at December 31, 2004. The change from December 31, 2004 relates to improved asset returns as compared to expected returns, partially offset by a decline in the discount rate. The total unrecognized actuarial loss will be amortized in the future, subject to offsetting gains or losses that will change the future amortization amount. We have recently utilized a weighted average expected rate of return on plan assets of 8.0% for 2005 expense, 8.1% for 2004 expense and 8.3% for 2003 expense, on a worldwide basis. In estimating this rate, we considered the historical returns earned by the plan assets, the rates of return expected in the future and our investment strategy and asset mix with respect to the plans' funds. The weighted average expected rate of return on plan assets we will utilize to calculate our 2006 expense will be 7.8%.

Another significant assumption affecting our pension and post-retirement benefit obligations and the net periodic pension and other post-retirement benefit cost is the rate that we use to discount our future anticipated benefit obligations. The discount rate reflects the current rate at which the pension liabilities could be effectively settled considering the timing of expected payments for plan participants. In estimating this rate, we consider rates of return on high quality fixed-income investments included in various published bond indexes, adjusted to eliminate the effects of call provisions and differences in the timing and amounts of cash outflows related to the bonds. In the U.S. and the U.K., which comprise approximately 81% of our projected benefit obligations, we consider the Moody's Aa Corporate Bond Index and the International Index Company's iBoxx Sterling Corporates AA Cash Bond Index, respectively in the determination of the appropriate discount rate assumptions. The weighted average rate we will utilize to measure our pension obligation as of December 31, 2005 and calculate our 2006 expense will be 5.2%, which is a decrease from 5.6% used in determining 2005 expense. Primarily as a result of the reduction in the discount rate, our 2006 net periodic pension cost is expected to be \$32 million higher than 2005.

On a consolidated basis, we recognized net periodic pension cost of \$343 million, \$350 million, and \$364 million for the years ended December 31, 2005, 2004 and 2003, respectively. Pension cost is included in several income statement components based on the related underlying employee costs. Pension and post-retirement benefit plan assumptions are included in Note 14 to the Consolidated Financial Statements. Holding all other assumptions constant, a 0.25% increase or decrease in the discount rate would change the 2006 projected net periodic pension cost by approximately \$35 million. Likewise, a 0.25% increase or decrease in the expected return on plan assets would change the 2006 projected net periodic pension cost by approximately \$15 million.

Income Taxes and Tax Valuation Allowances: We record the estimated future tax effects of temporary differences between the tax bases of assets and liabilities and amounts reported in our Consolidated Balance

Sheets, as well as operating loss and tax credit carryforwards. We follow very specific and detailed guidelines in each tax jurisdiction regarding the recoverability of any tax assets recorded in our Consolidated Balance Sheets and provide necessary valuation allowances as required. We regularly review our deferred tax assets for recoverability considering historical profitability, projected future taxable income, the expected timing of the reversals of existing temporary differences and tax planning strategies. If we continue to operate at a loss in certain jurisdictions or are unable to generate sufficient future taxable income, or if there is a material change in the actual effective tax rates or time period within which the underlying temporary differences become taxable or deductible, we could be required to increase the valuation allowance against all or a significant portion of our deferred tax assets resulting in a substantial increase in our effective tax rate and a material adverse impact on our operating results. Conversely, if and when our operations in some jurisdictions were to become sufficiently profitable to recover previously reserved deferred tax assets, we would reduce all or a portion of the applicable valuation allowance in the period when such determination is made. This would result in an increase to reported earnings in such period. Adjustments to our valuation allowance, through (credits) charges to income tax expense, were \$(38) million, \$12 million, and \$(16) million for the years ended December 31, 2005, 2004 and 2003, respectively. There were other increases/(decreases) to our valuation allowance, including the effects of currency, of \$61 million, \$(21) million, and \$69 million for the years ended December 31, 2005, 2004 and 2003, respectively, that did not affect income tax expense in total as there was a corresponding adjustment to deferred tax assets or other comprehensive income. Gross deferred tax assets of \$3.6 billion and \$3.5 billion had valuation allowances of \$590 million and \$567 million at December 31, 2005 and 2004, respectively.

We are subject to ongoing tax examinations and assessments in various jurisdictions. Accordingly, we may incur additional tax expense based upon our assessment of the probable outcomes of such matters. In addition, when applicable, we adjust the previously recorded tax expense to reflect examination results. Our ongoing assessments of the probable outcomes of the examinations and related tax positions require judgment and can materially increase or decrease our effective tax rate as well as impact our operating results.

Legal Contingencies: We are involved in a variety of claims, lawsuits, investigations and proceedings concerning securities law, intellectual property law, environmental law, employment law and ERISA, as discussed in Note 16 to the Consolidated Financial Statements. We determine whether an estimated loss from a contingency should be accrued by assessing whether a loss is deemed probable and can be reasonably estimated. We assess our potential liability by analyzing our litigation and regulatory matters using available information. We develop our views on estimated losses in consultation with outside counsel handling our defense in these matters, which involves an analysis of potential results, assuming a combination of litigation and settlement strategies. Should developments in any of these matters cause a change in our determination as to an unfavorable outcome and result in the need to recognize a material accrual, or should any of these matters result in a final adverse judgment or be settled for significant amounts, they could have a material adverse effect on our results of operations, cash flows and financial position in the period or periods in which such change in determination, judgment or settlement occurs.

Summary of Results

Segment Revenues

As discussed in Note 2 to the Consolidated Financial Statements, operating segment financial information for 2004 and 2003 has been restated to reflect changes in operating segment structure made during 2005. In 2005, we implemented a new financial reporting system, which has enabled greater efficiencies in financial reporting and provides enhanced analytical capabilities including activity-based cost analysis on shared services and internal cost allocations. As a result of the implementation, we made changes to the allocation of certain segment costs and expenses. These changes included a reallocation of costs associated with corporate and certain shared service functions. These changes did not involve a change in the composition of our reportable segments and did not impact segment revenue. We have reclassified prior-period amounts to conform to the current period's presentation.

Our reportable segments are consistent with how we manage the business and view the markets we serve. Our reportable segments are Production, Office, DMO and Other. Our offerings include hardware, services, solutions and consumable supplies. The Production segment includes black and white products, which operate at speeds over 90 pages per minute (“ppm”) and color products which operate at speeds over 40 ppm, excluding 50 ppm products with an embedded controller. Products include the Xerox iGen3[®] digital color production press, Xerox Nuvera[™], DocuTech[®], DocuPrint[®], Xerox 4110[™] and DocuColor[®] families, as well as older technology light-lens products. These products are sold predominantly through direct sales channels in North America and Europe to Fortune 1000, graphic arts, government, education and other public sector customers. The Office segment includes black and white products that operate at speeds up to 90 ppm, and color devices up to 40 ppm, as well as, 50 ppm color devices with an embedded controller. Products include the suite of CopyCentre[®], WorkCentre[®], and WorkCentre Pro digital multifunction systems, DocuColor color multifunction products, color laser, solid ink and monochrome laser desktop printers, digital and light-lens copiers and facsimile products. These products are sold through direct and indirect sales channels in North America and Europe to global, national and mid-size commercial customers as well as government, education and other public sector customers. The DMO segment includes our operations in Latin America, Central and Eastern Europe, the Middle East, India, Eurasia, Russia and Africa. This segment includes sales of products that are typical to the aforementioned segments, however, management serves and evaluates these markets on an aggregate geographic basis, rather than on a product basis. The segment classified as Other includes several units, none of which met the thresholds for separate segment reporting. This group primarily includes Xerox Supplies Business Group (predominantly paper), Small Office/Home Office (“SOHO”), Wide Format Systems, Xerox Technology Enterprises and value-added services, royalty and license revenues. Paper sales were approximately 45% of Other segment revenues in 2005. Other segment profit (loss) includes the operating results from these entities, other less significant businesses, our equity income from Fuji Xerox, and certain costs which have not been allocated to the Production, Office and DMO segments, including non-financing interest as well as other items included in Other expenses, net.

Revenues by segment for the years ended 2005, 2004 and 2003 were as follows:

| (in millions) | Production | Office | DMO | Other | Total |
|-----------------------------|-----------------|----------------|----------------|----------------|-----------------|
| 2005 | | | | | |
| Equipment sales | \$ 1,368 | \$2,436 | \$ 558 | \$ 157 | \$ 4,519 |
| Post sale and other revenue | 2,830 | 4,670 | 1,245 | 1,562 | 10,307 |
| Finance income | 342 | 512 | 9 | 12 | 875 |
| Total Revenue | \$ 4,540 | \$7,618 | \$1,812 | \$1,731 | \$15,701 |
| 2004 | | | | | |
| Equipment sales | \$ 1,358 | \$2,431 | \$ 503 | \$ 188 | \$ 4,480 |
| Post sale and other revenue | 2,880 | 4,644 | 1,194 | 1,590 | 10,308 |
| Finance income | 352 | 552 | 10 | 20 | 934 |
| Total Revenue | \$ 4,590 | \$7,627 | \$1,707 | \$1,798 | \$15,722 |
| 2003 | | | | | |
| Equipment sales | \$ 1,188 | \$2,426 | \$ 466 | \$ 170 | \$ 4,250 |
| Post sale and other revenue | 2,943 | 4,622 | 1,285 | 1,604 | 10,454 |
| Finance income | 376 | 594 | 12 | 15 | 997 |
| Total Revenue | \$ 4,507 | \$7,642 | \$1,763 | \$1,789 | \$15,701 |

Equipment Sales

Equipment sales reflect the results of our technology investments and the associated product launches as approximately two-thirds of 2005 equipment sales were generated from products launched over the past two years. During 2005, we launched 49 new products including 6 products in the fourth quarter.

2005 Equipment sales of \$4.5 billion increased 1% from 2004 reflecting:

- Negligible impact from currency.
- Growth in lower-end office black and white devices, color printers, as well as office and production color systems, which more than offset declines in other monochrome office and monochrome production products.
- Growth in color equipment sales of \$306 million or 22%, from the prior comparable period. Color equipment sales represented 38% of total equipment sales versus 32% for the prior year comparable period.

2004 Equipment sales of \$4.5 billion increased 5% from 2003 reflecting:

- 3-percentage point benefit from currency.
- Market acceptance of our color and digital light production products.
- Continued equipment sales growth, reflecting the success of numerous products launched in the past two years, as the majority of 2004 equipment sales were generated from these products.
- Continued color equipment sales growth in 2004 representing approximately one-third of total equipment sales.

Production

2005 equipment sales increased 1% from 2004, primarily reflecting install growth with a negligible impact from currency, partially offset by price declines of approximately 5% and product mix. Production system install activity for 2005 included the following:

- 30% growth in installs of production color products largely driven by strong iGen3 and DocuColor 240, 250, 7000 and 8000 activity.
- 9% growth in installs of black and white production systems reflecting the success of the 4110 light production system, as well as growth in production publishing systems.

2004 equipment sales increased 14% from 2003, as improved product mix, installation growth and favorable currency of 4-percentage points more than offset price declines of approximately 3%. Production system install activity for 2004 included the following:

- Strong 2004 production color equipment install growth of 11% due to increased installations driven by the DocuColor 5252 and Xerox iGen3 digital color production press products.
- 2004 production monochrome equipment install growth of 7% driven by the success of the Xerox 2101 copier/printer and strong demand for the Xerox Nuvera 100 and 120 copier/printers, more than offset declines of 32% in production publishing, printing and older technology light lens products.

Office

2005 equipment sales were comparable to 2004, including a negligible impact from currency. Strong install growth was offset by price declines of approximately 7% and product mix, which reflected an increased proportion of lower-end equipment sales. Office product install activity for 2005 included the following:

- 22% install growth in black and white digital copiers and multifunction devices driven by strong sales of Segment 1 and 2 devices (11-30 ppm), which more than offset declines of Segment 3 to 5 devices (31-90 ppm).
- 51% install growth in office color multifunction systems driven in part by strong sales of the DocuColor 240/250, which was announced during the second quarter of 2005.
- 111% improvement in install activity for color printers.

2004 equipment sales were essentially unchanged from 2003, reflecting the following:

- Installation growth of approximately 20% and favorable currency of 3-percentage points were offset by moderating price declines of approximately 6% and the impact of product mix. Product mix reflected an increased proportion of low-end equipment due to very strong growth in office monochrome (“Segments 1 and 2”) of 30% as well as monochrome and color printers of 54%.
- Color printer growth of 74% primarily reflects the success of the solid ink Phaser® 8400, the first product launched from our new solid ink platform in January 2004, as well as other color printer introductions.

DMO

Equipment sales in DMO consist primarily of Segment 1 and 2 devices and office printers. Equipment sales in 2005 increased 11% from 2004, primarily reflecting strong growth in Eurasia and Central and Eastern Europe. Equipment sales in 2004 increased 8% from 2003, primarily reflecting growth in Russia and Central and Eastern Europe offset by declines in Latin America, primarily driven by Brazil, and shift in product mix to lower segments.

Other

2005 equipment sales declined 16% from 2004, driven by declines in value-added services. The decline in value-added services reflects the integration of a portion of our service contracts into our outsourcing business, the revenue from which is included in the Office and Production segments. Other 2004 equipment sales grew 11% from 2003, primarily due to growth in equipment sales associated with our value-added services business and a 2-percentage point currency benefit.

Post Sale and Other Revenue

Post sale revenue is largely a function of the equipment placed at customer locations, the volume of prints and copies that our customers make on that equipment and the mix of color pages, as well as associated services.

2005 post sale and other revenues of \$10.3 billion were comparable to the prior year period, with our growth areas (“digital office, digital production and value-added services”) collectively growing 5% and DMO growing 4%, more than offsetting a 40% decline in analog light lens products. Color post sale and other revenue grew 16% for 2005, and color sales represented 26% of post sale and other revenue in 2005 versus 22% in 2004. In 2005, approximately 7% of our pages were printed on color devices, which is up from 5% in 2004. Color pages generate around five times more revenue and gross profit dollars than black and white pages.

2004 post sale and other revenues of \$10.3 billion declined 1% from 2003, including a 4-percentage point benefit from currency. These declines reflect lower equipment populations, as post sale revenue is largely a function of the equipment placed at customer locations, the volume of prints and copies that our customers make on that equipment and the mix of color pages, as well as associated services. 2004 supplies, paper and other sales of \$2.8 billion (included within post sale and other revenue) increased 2% from 2003, primarily reflecting currency benefits which offset declines in supplies. Supplies sales declined due to our exit from the SOHO business in 2001. 2004 service, outsourcing and rental revenue of \$7.5 billion declined 3% from 2003, as declines in rental and facilities management revenues more than offset benefits from currency. Declines in rental revenues primarily reflect reduced equipment populations within DMO and declines in facilities management revenues reflect consolidations by our customers as well as our prioritization of profitable contracts.

Production: 2005 post sale and other revenue declined 2% from 2004, as declines in older light lens technology were only partially offset by revenue growth from digital products. Currency impact was negligible for 2005. 2004 post sale and other revenue declined 2% from 2003, as declines in monochrome products, driven primarily by lower page volumes, offset favorable mix from color page growth of approximately 40% as well as favorable currency.

Office: 2005 post sale and other revenue increased 1% from 2004, primarily reflecting a 1-percentage point benefit from currency and growth in digital black and white, color printing and color multifunctional products. These positive effects were partially offset by declines in older light lens technology. 2004 post sale and other revenue improved modestly from 2003 as favorable mix to color pages, digital page growth, and favorable currency were partially offset by declines in older technology light lens products.

DMO: 2005 post sale and other revenue grew 4% from 2004, reflecting growth in Eurasia and Central and Eastern Europe, more than offsetting declines in Brazil. 2004 post sale and other revenue declined 7% from 2003 primarily reflecting a decline in Latin America's rental equipment population. In response, we have continued our transition to indirect distribution channels that is intended to increase, over time, the sales of office devices and the associated supplies and service revenue.

Other: 2005 post sale and other revenue declined 2% from 2004, including a negligible impact from currency, as declines in SOHO and other revenues were partially offset by growth in value-added services. 2004 post sale and other revenue declined 1% from 2003, as declines in SOHO were essentially offset by currency benefits and growth in value-added services as well as other activity.

2006 Projected Revenues

We expect 2006 equipment sales will continue to grow, as we anticipate that new platforms and products launched during the past 2 years, and those planned in 2006, will enable us to further strengthen our market position. Excluding currency impacts, compared to 2005, we expect 2006 post sale and other revenue and financing income will grow following the transition to positive growth during the second half of 2005. Growth in post sale and other revenue and financing income will be driven by our success at increasing the amount of our equipment at customer locations and the volume of pages and mix of color pages generated on that equipment. Excluding currency impacts, we expect 2006 total revenues to increase approximately 3% from 2005 levels.

Segment Operating Profit

Segment operating profit and operating margin for the three years ended December 31, 2005 were as follows:

| <u>(in millions)</u> | <u>Production</u> | <u>Office</u> | <u>DMO</u> | <u>Other</u> | <u>Total</u> |
|----------------------|-------------------|---------------|------------|--------------|--------------|
| 2005 | | | | | |
| Operating Profit | \$ 427 | \$ 819 | \$ 64 | \$ 151 | \$ 1,461 |
| Operating Margin | 9.4% | 10.8% | 3.5% | 8.7% | 9.3% |
| 2004 | | | | | |
| Operating Profit | \$ 511 | \$ 779 | \$ 35 | \$ (125) | \$ 1,200 |
| Operating Margin | 11.1% | 10.2% | 2.1% | (7.0)% | 7.6% |
| 2003 | | | | | |
| Operating Profit | \$ 466 | \$ 790 | \$ 172 | \$ (440) | \$ 988 |
| Operating Margin | 10.3% | 10.3% | 9.8% | (24.6)% | 6.3% |

Production: 2005 operating profit declined \$84 million and operating margin declined 1.7-percentage points from 2004. The declines primarily reflect reduced gross margins impacted by mix, and higher selling expenses, which were partially offset by improvements in G&A and R,D&E efficiencies. 2004 operating profit increased \$45 million and operating margin increased 0.8-percentage points from 2003. These increases primarily reflect R&D efficiencies and lower bad debt expenses which were partially offset by lower gross margin.

Office: 2005 operating profit increased \$40 million and operating margin improved 0.6-percentage points from 2004. The improvements primarily reflect lower SAG, partially offset by lower gross margins impacted by mix and higher R,D&E. 2004 operating profit decreased \$11 million and operating margin declined 0.1-percentage points from 2003. The declines primarily reflect lower gross margins, partially offset by lower bad debt expense.

DMO: 2005 operating profit increased \$29 million from 2004 and operating margin improved 1.4-percentage points from 2004. These improvements primarily reflect increasing revenues and operating margin contributions from Eurasia and Central and Eastern Europe. 2004 operating profit declined \$137 million from 2003 primarily reflecting results in Latin America where the pace of revenue declines have exceeded cost and expense reductions.

Other: 2005 operating profit increased \$276 million as compared to 2004, principally due to:

- Reduced interest expense of \$157 million, primarily due to lower average debt balances.
- Higher interest income of \$63, which includes \$57 million associated with the finalization of the 1996-1998 IRS audit.
- An improvement in aggregate currency gains and losses of \$68 million.
- A gain on the sale of Integic of \$93 million.
- These items were partially offset by the absence of the \$38 million pension settlement gain from Fuji Xerox in 2004, as well as the absence of the \$38 million gain from the 2004 sale of our ownership interest in ScanSoft.

2004 operating loss improved by \$315 million as compared to 2003, principally due to:

- Reduced interest expense of \$127 million.
- An increase in equity income from Fuji Xerox of \$93 million.
- Gain on sale of our interest in ScanSoft of \$38 million.

Gross margins

Gross margins by revenue classification were as follows:

| (in millions) | Year Ended December 31, | | |
|----------------------------------|----------------------------|-------|-------|
| | 2005 | 2004 | 2003 |
| Total gross margin | 41.2% | 41.6% | 42.6% |
| Sales | 36.6% | 37.4% | 37.6% |
| Service, outsourcing and rentals | 43.3% | 43.0% | 44.3% |
| Finance income | 62.7% | 63.1% | 63.7% |

2005 **Gross margin** of 41.2% decreased 0.4-percentage points from 2004 reflecting a decline in product mix of 1.3-percentage points reflecting a higher proportion of sales in office printer and light production systems. Price declines of 1.5-percentage points were more than offset by cost improvements of 2.3-percentage points.

2004 **Gross margin** of 41.6% declined 1.0-percentage points from 2003. Approximately 0.8-percentage points of the decline is due to product mix impacts from a greater proportion of lower gross margin products in the Office and Production segments. Approximately 0.6-percentage points of the decline reflects the impact of DMO results. The decline in DMO results relates to Brazil's revenue, which has declined faster than declines in its cost levels and a shift in product mix to lower gross margin products in various DMO geographies. Productivity improvements essentially offset the impact of lower prices.

2005 **Sales gross margin** of 36.6% decreased 0.8-percentage points from 2004 driven by product mix declines of 1.5-percentage points. Price declines of 2.2-percentage points were more than offset by cost improvements of 2.4-percentage points. Product mix reflects a higher proportion of sales of products with lower gross margins, including office printers and light production systems, and a lower proportion of sales of products with higher gross margins such as higher end office black and white multifunction devices and high-end production black and white systems.

2004 Sales gross margin of 37.4% decreased 0.2-percentage points from 2003. Approximately 0.4-percentage points of the decline results from product mix and DMO results contributed 0.6-percentage points to the decline. Additionally, productivity improvements offset lower prices and other variances.

2005 **Service, outsourcing and rental margin** of 43.3% increased 0.3-percentage points driven by cost improvements of 2.6-percentage points, which more than offset by prices declines of 1.1-percentage points and product mix declines of 0.9-percentage points.

2004 Service, outsourcing, and rentals gross margin of 43.0% declined 1.3-percentage points from 2003. The majority of the decline is attributed to a change in product mix in the Office and Production segments as well as DMO results. Productivity and cost improvements offset lower prices for the year.

2005 **Finance income gross margin** of 62.7% declined 0.4-percentage points due to interest costs specific to equipment financing. Equipment financing interest is determined based on an estimated cost of funds, applied against an estimated level of debt required to support our finance receivables. The estimated cost of funds is primarily based on our secured borrowings rates. The estimated level of debt is based on an assumed 7 to 1 leverage ratio of debt/equity as compared to our average finance receivables. This methodology has been consistently applied for all periods presented.

2004 Finance income gross margin decreased 0.6-percentage points from 2003 due to interest costs specific to equipment financing.

Research, development and engineering (“R,D&E”) of \$943 million in 2005 was \$29 million higher than the prior year. We expect 2006 R, D&E spending to approximate 6% of total revenue in 2006.

Research and development (“R&D”) of \$755 million in 2005 decreased from the prior year by \$5 million. This period over period comparison reflects lower expenditures in the Production segment, which were partially offset by increased spending in the Office segment. The lower spending in the Production segment was as a result of recent product launches, and cost efficiencies that we captured from our platform development strategy. We invest in technological development, particularly in color, and believe our R&D spending is sufficient to remain technologically competitive. Our R&D is strategically coordinated with that of Fuji Xerox, which invested \$720 million and \$704 million in R&D in 2005 and 2004, respectively. 2004 R&D expense of \$760 million was \$108 million lower than the prior year, primarily due to improved efficiencies as we captured benefits from our platform development strategy as well as the commercial launch of the Xerox iGen3.

Sustaining engineering costs of \$188 million increased by \$34 million from the prior year, based on increases in year-over-year product launches. Refer to Note 1-“Basis of Presentation” and Note 19-Research, Development and Engineering in the Consolidated Financial Statements for additional information. On average, the reclassification of sustaining engineering costs increased gross margins by approximately 1% for the year ended 2005.

The following table illustrates the effects of our 2005 reclassification of our sustaining engineering costs from cost of sales to R,D&E:

| (in millions) | 2004 | | | | | 2005 | | | | |
|-------------------------------------|-------|-------|-------|-------|--------|-------|-------|-------|-------|--------|
| | Q1 | Q2 | Q3 | Q4 | YTD | Q1 | Q2 | Q3 | Q4 | YTD |
| Total Sustaining Engineering (“SE”) | \$ 30 | \$ 41 | \$ 45 | \$ 38 | \$ 154 | \$ 42 | \$ 54 | \$ 46 | \$ 46 | \$ 188 |
| Gross Margin %, with SE | 39.8% | 41.3% | 41.3% | 40.1% | 40.6% | 40.7% | 39.0% | 40.1% | 40.3% | 40.0% |
| Gross Margin %, without SE | 40.6% | 42.4% | 42.5% | 41.0% | 41.6% | 41.8% | 40.4% | 41.3% | 41.4% | 41.2% |
| R&D % revenue, without SE | 5.0% | 4.9% | 5.1% | 4.4% | 4.8% | 4.9% | 4.8% | 5.2% | 4.4% | 4.8% |
| R,D&E % revenue, with SE | 5.8% | 5.9% | 6.3% | 5.3% | 5.8% | 6.0% | 6.2% | 6.4% | 5.5% | 6.0% |

Selling, Administrative and General Expenses (“SAG”): SAG expense information was as follows (in millions):

| | Year Ended December 31, | | | Amount Change | |
|--------------------------------|-------------------------|---------|---------|---------------|---------|
| | 2005 | 2004 | 2003 | 2005 | 2004 |
| Total SAG expenses | \$4,110 | \$4,203 | \$4,249 | \$ (93) | \$ (46) |
| SAG as a percentage of revenue | 26.2% | 26.7% | 27.1% | (0.5)% | (0.4)% |

In 2005, SAG expenses decreased primarily as a result of the following:

- An \$86 million reduction in general and administrative (“G&A”) expenses due to continued expense management initiatives.
- A \$38 million decrease in bad debt expense.
- A partially offsetting increase in selling expenses of \$31 million from 2004 due to additional spending for advertising and marketing programs to support product launches and other selling expenses, as well as, special compensation payments related to the 2005 merit increase process. These increases in selling expenses were partially offset by the absence of \$28 million Olympic marketing expense that occurred in 2004.

In 2004, SAG expenses decreased primarily as a result of the following:

- A \$114 million decline in bad debt expense.
- Reductions in G&A due to efficiencies from continued expense management initiatives.
- An offsetting increase in selling expenses of \$52 million from 2003 reflecting increased spending in selling and marketing initiatives, as well as unfavorable currency impacts of \$141 million.

Bad debt expense included in SAG was \$72 million, \$110 million and \$224 million in 2005, 2004 and 2003, respectively. The 2005 reduction reflects improved collections performance, receivables aging and write-off trends. Bad debt expense as a percent of total revenue was 0.5%, 0.7% and 1.4% for 2005, 2004 and 2003, respectively.

For the three years ended December 31, 2005, 2004 and 2003 we recorded **restructuring charges** of \$366 million, \$86 million and \$176 million, respectively, primarily related to the headcount reductions of approximately 3,900, 1,900 and 2,000 employees, respectively, across all geographies and segments. The 2005 restructuring initiatives are focused on implementing a flexible workforce in our service operations, as well as creating cost efficiencies in our manufacturing and back office support operations. We expect prospective annual savings associated with the 2005 actions to be approximately \$290 million. The remaining restructuring reserve balance as of December 31, 2005 for all programs was \$236 million. In the next 12 months, we expect to spend approximately \$212 million of this reserve.

Worldwide employment of 55,200 as of December 31, 2005 declined approximately 2,900 from December 31, 2004, primarily reflecting reductions attributable to our restructuring programs and other attrition. Worldwide employment was approximately 58,100 and 61,100 at December 31, 2004 and 2003, respectively.

Gain on Affiliate’s Sale of Stock: In 2003, we recorded cumulative gains on an affiliate’s sale of stock of \$13 million reflecting our proportionate share of the increase in equity of ScanSoft Inc., an equity investment. The gain resulted from ScanSoft’s issuance of stock in connection with its acquisition of Speechworks, Inc. ScanSoft is a developer of digital imaging software that enables users to leverage the power of their scanners, digital cameras and other electronic devices. As discussed in Note 21 to the Consolidated Financial Statements, in April 2004 we completed the sale of our ownership interest in ScanSoft.

Other Expenses, Net: Other expenses, net for the three years ended December 31, 2005 consisted of the following:

| (in millions) | Year Ended December 31, | | | Amount Change | |
|---|-------------------------|--------------|--------------|----------------|----------------|
| | 2005 | 2004 | 2003 | 2005 | 2004 |
| Non-financing interest expense | \$ 231 | \$363 | \$522 | \$(132) | \$(159) |
| Interest income | (138) | (75) | (65) | (63) | (10) |
| (Gain) loss on sales of businesses and assets | (97) | (61) | 13 | (36) | (74) |
| Currency losses, net | 5 | 73 | 11 | (68) | 62 |
| Amortization of intangible assets | 38 | 37 | 36 | 1 | 1 |
| Legal matters | 115 | 9 | 242 | 106 | (233) |
| Minorities' interests in earnings of subsidiaries | 15 | 8 | 6 | 7 | 2 |
| All other expenses, net | 55 | 15 | 111 | 40 | (96) |
| | <u>\$ 224</u> | <u>\$369</u> | <u>\$876</u> | <u>\$(145)</u> | <u>\$(507)</u> |

Non-financing interest expense: In 2005 non-financing interest expense decreased due to lower average debt balances as a result of scheduled term debt repayments and medium-term note redemptions, as well as the full-year effect of the December 2004 Capital Trust II liability conversion. 2004 non-financing interest expense was \$159 million lower than 2003, primarily due to lower average debt balances as a result of the full year effect of the June 2003 recapitalization and other scheduled term debt repayments.

Interest income: Interest income is derived primarily from our invested cash and cash equivalent balances and interest resulting from periodic tax settlements. In 2005, interest income increased primarily due to:

- A \$57 million increase associated with the previously disclosed settlement of the 1996-1998 IRS audit (Refer to Note 15-Income and Other Taxes in the Consolidated Financial Statements).
- A \$23 million increase primarily reflecting higher rates of return from our money market funds.
- Partially offset by the absence of \$26 million of interest income related to a 2004 domestic tax refund.

In 2004, interest income increased primarily as a result of \$26 million related to a domestic tax refund claim in 2004, partially offset by the absence of \$13 million of interest income related to Brazilian tax credits in 2003.

(Gain) Loss on sales of businesses and assets: In 2005, gain on sales of businesses and assets primarily relate to the \$93 million gain in the first quarter on the sale of Integic. In 2004, gains on the sale of businesses and assets primarily reflect the \$38 million pre-tax gain from the sale of our ownership interest in ScanSoft, as well as, gains totaling \$14 million related to the sale of certain excess land and buildings in Europe and Mexico. The 2003 amount primarily included losses related to the sale of Xerox Engineering Systems subsidiaries in France and Germany, which were partially offset by a gain on the sale of our investment in Xerox South Africa.

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

In 2005, 2004 and 2003 currency losses totaled \$5 million, \$73 million and \$11 million respectively. The decrease in 2005 from 2004 was primarily due to the strengthening of the U.S. and Canadian Dollars against the Euro and the Yen in 2005, as compared to the weakening U.S. Dollar in 2004, and decreased costs of hedging foreign currency denominated assets and liabilities due to lower spot/forward premiums in 2005. The increase in currency losses in 2004 from 2003 was primarily due to the weakening U.S. dollar in 2004 and increased costs of hedging foreign currency denominated assets and liabilities due to higher spot/forward premiums in 2004.

Legal matters: In 2005, legal matters costs consisted of the following:

- \$102 million, including \$13 million for interest expense, related to the MPI arbitration panel ruling (Refer to Note 16—Contingencies in the Consolidated Financial Statements).
- \$13 million related to other legal matters, primarily reflecting charges for probable losses on cases that have not yet been resolved.

In 2004, legal matters costs consist of expenses associated with the resolution of legal and regulatory matters, none of which was individually material, partially offset by the adjustment of an estimate associated with a previously recorded litigation accrual.

In 2003, legal matters costs primarily consisted of a \$239 million provision for litigation relating to the court approved settlement of the Berger v. Retirement Income Guarantee Plan (“RIGP”) litigation. RIGP represents the primary U.S. pension plan for salaried employees. The settlement was paid from RIGP assets and was reflected in our 2004 actuarial valuation. The obligation related to this settlement was included in plan amendments in the change in the benefit obligation.

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

All other expenses, net: In 2005 all other expenses, net included the following individually significant items:

- \$15 million for losses sustained from Hurricane Katrina related to property damage and impaired receivables. We continue to reassess the estimate of our losses from the effects of Hurricane Katrina. Our current estimate as of December 31, 2005, of total assets at risk in the affected areas, primarily finance receivables from customers, was approximately \$20 million.
- \$26 million charge related to the European Union Waste Directive, including the associated adoption of FASB Staff Position No. 143-1, “Accounting for Electronic Equipment Waste Obligations”, which provided guidance on accounting for the European Union (EU) Directive on the disposal of electronic equipment. Refer to Note 1—Summary of Significant Accounting Policies in the Consolidated Financial Statements.

In 2003, all other expenses, net included a \$73 million loss on early extinguishment of debt reflecting the write off of the remaining unamortized fees associated with the 2002 Credit Facility.

Income tax (benefits) expenses were as follows (in millions):

| | Year Ended December 31, | | |
|--------------------------------|-------------------------|--------|--------|
| | 2005 | 2004 | 2003 |
| Pre-tax income | \$ 830 | \$ 965 | \$ 436 |
| Income tax (benefits) expenses | (5) | 340 | 134 |
| Effective tax rate | (0.6)% | 35.2% | 30.7% |

The 2005 effective tax rate of (0.6)% was lower than the U.S. statutory tax rate primarily due to:

- Tax benefits of \$253 million, associated with the finalization of the 1996-1998 IRS audit in the second quarter.
- Tax benefits of \$42 million primarily from the realization of foreign tax credits offset by the geographical mix of income and the related tax rates in those jurisdictions.
- Tax benefits of \$31 million from the reversal of a valuation allowance on deferred tax assets associated with foreign net operating loss carryforwards. This reversal followed a re-evaluation of their future realization resulting from a refinancing of a foreign operation.
- These impacts were partially offset by losses in certain jurisdictions where we are not providing tax benefits and continue to maintain deferred tax valuation allowances.

The 2004 effective tax rate of 35.2% was comparable to the U.S. statutory tax rate primarily reflecting:

- The impact of nondeductible expenses and \$20 million of unrecognized tax benefits primarily related to recurring losses in certain jurisdictions where we maintained deferred tax asset valuation allowances.
- Partially offset by tax benefits from other foreign adjustments, including earnings taxed at different rates, tax law changes of \$14 million and other items that are individually insignificant.

The 2003 effective tax rate of 30.7% was lower than the U.S. statutory tax rate primarily reflecting:

- Tax benefits of \$35 million resulting from the reversal of valuation allowances on deferred tax assets following a re-evaluation of their future realization due to improved financial performance, other foreign adjustments, including earnings taxed at different rates, the impact of Series B Convertible Preferred Stock dividends and state tax benefits.
- Partially offset by tax expense for audit and other tax return adjustments, as well as, \$19 million of unrecognized tax benefits primarily related to recurring losses in certain jurisdictions where we maintained deferred tax asset valuation allowances.

Our effective tax rate is based on recurring factors including the geographical mix of income before taxes and the related tax rates in those jurisdictions, as well as available foreign tax credits. In addition, our effective tax rate will change based on discrete or other nonrecurring events (such as audit settlements) that may not be predictable. We anticipate that our effective tax rate for 2006 will approximate 34.0%, excluding the effects of any discrete items.

Equity in Net Income of Unconsolidated Affiliates: Equity in net income of unconsolidated affiliates of \$98 million, principally related to our 25% share of Fuji Xerox income, decreased \$53 million in 2005 as compared to 2004 reflecting the following:

- A \$44 million decrease in our 25% share of Fuji Xerox's net income. The lower net income related to the absence of the \$38 million pension settlement gain in 2004. Refer to Note 7—Investments in Affiliates, at Equity in the Consolidated Financial Statements for condensed financial data of Fuji Xerox.
- The absence of \$7 million of equity income from Integic Corporation. In the first quarter of 2005, we sold our entire equity interest in Integic Corporation.

Equity in net income of unconsolidated affiliates increased \$93 million in 2004 as compared to 2003 reflecting:

- \$38 million related to our share of a pension settlement gain recorded by Fuji Xerox subsequent to a transfer of a portion of their pension obligation to the Japanese government in accordance with the Japan Welfare Pension Insurance Law.
- The remainder of the 2004 increase is primarily due to the improved operational performance of Fuji Xerox.

Income from Discontinued Operations: Income from discontinued operations, net of tax, for the years ended December 31, 2005 and 2004 was as follows (in millions):

| | 2005 | 2004 | 2003 |
|---|--------------|--------------|------------|
| Insurance Group Operations tax benefits | \$ 53 | \$— | \$— |
| Gain on sale of ContentGuard, net of income taxes of \$26 | — | 83 | — |
| Total | \$ 53 | \$ 83 | \$— |

As disclosed in Note 15—Income and Other Taxes, in June 2005 we received notice that our 1996-1998 Internal Revenue Service (“IRS”) audit was finalized. Of the total tax benefits realized, including the reversal of existing reserves, \$53 was attributed to our discontinued operations.

In the first quarter 2004, we sold all but 2% of our 75% ownership interest in ContentGuard Inc, (“ContentGuard”) to Microsoft Corporation and Time Warner Inc. for \$66 million in cash. The sale resulted in an after-tax gain of approximately \$83 million (\$109 million pre-tax) and reflects our recognition of cumulative operating losses. The revenues, operating results and net assets of ContentGuard were immaterial for all periods presented. ContentGuard, which was originally created out of research developed at the Xerox Palo Alto Research Center (“PARC”), licenses intellectual property and technologies related to digital rights management. During 2005, we sold our remaining interest in ContentGuard.

Recent Accounting Pronouncements: Refer to Note 1 of the Consolidated Financial Statements for a description of recent accounting pronouncements including the respective dates of adoption and effects on results of operations and financial condition.

Capital Resources and Liquidity

Cash Flow Analysis: The following summarizes our cash flows for each of the three years ended December 31, 2005, as reported in our Consolidated Statements of Cash Flows in the accompanying Consolidated Financial Statements:

| (in millions) | 2005 | 2004 | 2003 | 2005 Amount Change | 2004 Amount Change |
|--|-----------------|-----------------|-----------------|--------------------|--------------------|
| Net cash provided by operating activities | \$ 1,420 | \$ 1,750 | \$ 1,879 | \$ (330) | \$ (129) |
| Net cash (used in) provided by investing activities | (295) | 203 | 49 | (498) | 154 |
| Net cash used in financing activities | (2,962) | (1,293) | (2,470) | (1,669) | 1,177 |
| Effect of exchange rate changes on cash and cash equivalents | (59) | 81 | 132 | (140) | (51) |
| (Decrease) increase in cash and cash equivalents | (1,896) | 741 | (410) | (2,637) | 1,151 |
| Cash and cash equivalents at beginning of period | 3,218 | 2,477 | 2,887 | 741 | (410) |
| Cash and cash equivalents at end of period | \$ 1,322 | \$ 3,218 | \$ 2,477 | \$ (1,896) | \$ 741 |

Cash, cash equivalents and Short-term investments reported in our Consolidated Financial Statements were as follows:

| | 2005 | 2004 |
|--|-----------------|-----------------|
| Cash and cash equivalents | \$ 1,322 | \$ 3,218 |
| Short-term investments | 244 | — |
| Total Cash, cash equivalents and Short-term investments | \$ 1,566 | \$ 3,218 |

For the year ended December 31, 2005, **net cash provided by operating activities**, decreased \$330 million from 2004 primarily as a result of the following:

- \$258 million decrease due to modest growth in accounts receivable in 2005 compared to a decline in 2004.
- \$83 million decrease due to lower finance receivable run-off.
- \$124 million decrease due to higher inventory growth in 2005 compared to 2004 reflecting an increase in the number of new products.
- Partially offsetting these items were lower tax payments of \$96 million due to refunds from audit and other tax settlements, as well as, the timing of payments associated with restructuring.
- Partially offsetting lower pension contributions of \$21 million.

For the year ended December 31, 2004, net cash provided by operating activities decreased \$129 million from 2003 primarily as a result of the following:

- Lower finance receivable reductions of \$159 million reflecting the increase in equipment sale revenue in 2004.
- Higher cash usage related to inventory of \$100 million to support new products.
- Increased tax payments of \$46 million due to increased income.
- Lower cash generation from the early termination of interest rate swaps of \$62 million.
- Lower pension plan contributions of \$263 million partially offsetting the above cash outflows.

We expect 2006 operating cash flows to be at the high end of the range of \$1.2 billion to \$1.5 billion, as compared to \$1.4 billion in 2005. This expectation reflects cash generation from a decrease in finance receivables that offsets cash usage from an increase in equipment on operating leases, resulting in a neutral impact on net operating cash flow. Since finance receivables and on-lease equipment are expected to be leveraged at a 7:1 debt to equity ratio, if these items collectively use or provide cash the overall impact on our total cash flows should be minimal since our debt should also increase or decrease as appropriate to maintain our current leverage.

For the year ended December 31, 2005, **net cash from investing activities** decreased \$498 million from 2004 primarily as a result of the following:

- \$247 million from the net purchases of short-term investments which were intended to increase our return on available cash.
- Decrease of \$143 million due to a lower net reduction of escrow and other restricted investments due to the 2004 renegotiation of certain secured borrowing arrangements and scheduled releases from an escrow account of supporting interest payments on our prior liability to a trust issuing preferred securities.
- Decrease of \$86 million due to lower proceeds from divestitures and investments, net reflecting:
 - 2005 proceeds of \$105 million primarily consisting of \$96 million from the sale of our equity interest in Integic Corporation.
 - 2004 proceeds of \$191 million primarily consisting of \$66 million from the ContentGuard sale, \$79 million from the ScanSoft sale and \$36 million from a preferred stock investment.
- Decrease of \$48 million due to lower proceeds from the sale of excess land and buildings.
- Partially offsetting these items was a \$15 million decrease in capital and internal use software expenditures.

We expect 2006 capital expenditures including internal use software to approximate \$250 million.

For the year ended December 31, 2004, net cash from investing activities increased \$154 million from 2003 primarily as a result of the following:

- An increase of \$156 million in proceeds from the sale of businesses and investments, consisting of the \$191 million referred to above, as offset by \$35 million of proceeds from the 2003 divestitures of investments in South Africa, France and Germany.
- An increase of \$43 million of proceeds from the sale of certain excess land and buildings.
- Partially offsetting these items was a \$12 million decrease due to the acquisition of an additional interest in Xerox India in 2004, and a \$31 million decrease due to a lower net reduction of escrow and other restricted investments. 2003 investing cash flows included \$235 million related to our former reinsurance obligations with our discontinued operations.

For the year ended December 31, 2005, **net cash used in financing activities** increased \$1.7 billion from 2004 primarily as a result of the following:

- A \$1.5 billion reduction in proceeds from new secured financings, reflecting a rebalancing of our secured and unsecured debt portfolio.
- \$433 million cash usage for the acquisition of common stock under the authorized October 2005 share repurchase program.
- A partially offsetting \$235 million decrease in net payments on term and other debt reflecting lower debt maturity obligations.

For the year ended December 31, 2004, net cash used in financing activities decreased \$1.2 billion from 2003 primarily as a result of the following:

- A \$2.6 billion decrease in net payments of term and other debt.
- \$889 million in proceeds received on the issuance of mandatory redeemable preferred stock in 2003.
- A partially offsetting decrease of \$404 million in proceeds from the issuance of common stock and a decrease of \$114 million in net proceeds from secured financing.

Customer Financing Activities and Debt: We provide equipment financing to the majority of our customers. Because the finance leases allow our customers to pay for equipment over time rather than at the date of installation, we maintain a certain level of debt to support our investment in these customer finance leases.

During the last four years we had established a series of financing arrangements with a number of major financial institutions to provide secured funding for our customer leasing activities in several of the major countries in which we operate, specifically in Canada, France, the Netherlands, the U.K. and U.S. While terms and conditions vary somewhat between countries, in general these arrangements call for the financial counterparty to provide loans secured by the sales-type lease originations in the country for which it has been contracted to be the funding source. Most arrangements are transacted through bankruptcy remote special purpose entities and the transfers of receivables and equipment to these entities are generally intended to be true sales at law. Under these arrangements, secured debt matches the terms of the underlying finance receivables it supports, which eliminates certain significant refinancing, pricing and duration risks associated with our financing.

At December 31, 2005 and 2004, all of the lease receivables and related secured debt are consolidated in our financial statements because we are determined to be the primary beneficiary of the arrangements and frequently the counterparties have various types of recourse to us. The lease receivables sold represent the collateral for the related secured debt and are not available for general corporate purposes until the related debt is paid off. Most of the secured financing arrangements include over-collateralization of approximately 10% of the lease amounts sold. All of these arrangements are subject to usual and customary conditions of default including cross defaults. In the remote circumstance that an event of default occurs and remains uncured, in general, the counterparty can cease providing funding for new lease originations.

Information on restricted cash that is the result of these third party secured funding arrangements is included in Note 1—"Restricted Cash and Investments" to the Consolidated Financial Statements and disclosure of the amounts for new funding and debt repayments are included in the accompanying Consolidated Statement of Cash Flows.

We also have arrangements in certain countries—Germany, Italy, the Nordic Countries, Brazil and Mexico—in which third party financial institutions originate lease contracts directly with our customers. In these arrangements, we sell and transfer title to the equipment to these financial institutions and generally have no continuing ownership rights in the equipment subsequent to its sale.

In addition to these third party arrangements, we also support our customer finance leasing activities with cash generated from operations and through capital markets offerings.

Refer to Note 4—Receivables, Net in the Consolidated Financial Statements for further information regarding our third party secured funding arrangements as well as a comparison of finance receivables to our financing-related debt as of December 31, 2005 and 2004.

As of December 31, 2005 and 2004, debt secured by finance receivables was approximately 41% and 44% of total debt, respectively. Consistent with our objective to rebalance the ratio of secured and unsecured debt, we expect payments on secured loans will continue to exceed proceeds from new secured loans in 2006. The following represents our aggregate debt maturity schedule as of December 31, 2005:

| (in millions) | Unsecured Debt | Debt Secured by Finance Receivables | Other Secured Debt | Total Debt |
|---------------|-------------------|---|--------------------------|------------------------|
| 2006 | \$ 66 | \$ 1,058 | \$ 15 | \$1,139 ⁽¹⁾ |
| 2007 | 258 | 1,139 | 185 | 1,582 |
| 2008 | 28 | 643 | 307 | 978 |
| 2009 | 879 | 103 | 7 | 989 |
| 2010 | 688 | 36 | 3 | 727 |
| Thereafter | 1,826 | 3 | 34 | 1,863 |
| Total | \$ 3,745 | \$ 2,982 | \$ 551 | \$7,278 |

⁽¹⁾ Quarterly secured and unsecured total debt maturities (in millions) for 2006 are \$353, \$307, \$256 and \$223 for the first, second, third and fourth quarters, respectively.

The following table summarizes our secured and unsecured debt as of December 31, 2005 and 2004:

| (in millions) | December 31, 2005 | December 31, 2004 |
|-------------------------------------|----------------------|----------------------|
| Term Loan | \$ 300 | \$ 300 |
| Debt secured by finance receivables | 2,982 | 4,436 |
| Capital leases | 38 | 58 |
| Debt secured by other assets | 213 | 235 |
| Total Secured Debt | 3,533 | 5,029 |
| Senior Notes | 2,862 | 2,936 |
| Subordinated debt | 19 | 19 |
| Other Debt | 864 | 2,140 |
| Total Unsecured Debt | 3,745 | 5,095 |
| Total Debt | \$ 7,278 | \$ 10,124 |

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

With \$1.6 billion of cash, cash equivalents and short-term investments, as of December 31, 2005, borrowing capacity under our 2003 Credit Facility of approximately \$700 million and funding available through our secured funding programs, we believe our liquidity (including operating and other cash flows that we expect to generate) will be sufficient to meet operating cash flow requirements as they occur and to satisfy all scheduled debt maturities for at least the next twelve months. Our ability to maintain positive liquidity going forward depends on our ability to continue to generate cash from operations and access the financial markets, both of which are

subject to general economic, financial, competitive, legislative, regulatory and other market factors that are beyond our control. As of December 31, 2005, we had an active shelf registration statement with \$1.75 billion of capacity that enables us to access the market on an opportunistic basis and offer both debt and equity securities.

Credit Facility: The 2003 Credit Facility consists of a \$300 million term loan and a \$700 million revolving credit facility, which includes a \$200 million sub-facility for letters of credit. Xerox Corporation is the only borrower of the term loan. The revolving credit facility is available, without sub-limit, to Xerox Corporation and certain of its foreign subsidiaries, including Xerox Canada Capital Limited, Xerox Capital (Europe) plc and other qualified foreign subsidiaries (excluding Xerox Corporation, the "Overseas Borrowers"). The 2003 Credit Facility matures on September 30, 2008. As of December 31, 2005, the \$300 million term loan and \$15 million of letters of credit were outstanding and there were no outstanding borrowings under the revolving credit facility. Since inception of the 2003 Credit Facility in June 2003, there have been no borrowings under the revolving credit facility.

The term loan and the revolving loans each bear interest at LIBOR plus a spread that varies between 1.75% and 3.00% or, at our election, at a base rate plus a spread that depends on the then-current leverage ratio, as defined, in the 2003 Credit Facility. This rate was 6.22% at December 31, 2005.

The 2003 Credit Facility contains affirmative and negative covenants as well as financial maintenance covenants. Subject to certain exceptions, we cannot pay cash dividends on our common stock during the facility term, although we can pay cash dividends on our preferred stock provided there is then no event of default. In addition to other defaults customary for facilities of this type, defaults on other debt, or bankruptcy, of Xerox, or certain of our subsidiaries, and a change in control of Xerox, would constitute events of default. At December 31, 2005, we were in compliance with the covenants of the 2003 Credit Facility and we expect to remain in compliance for at least the next twelve months.

Share Repurchase Program: In October 2005, the board of directors authorized the repurchase of up to \$500 million of the company's common stock during a period of up to one year. In addition, during January 2006, the board of directors authorized an additional repurchase of \$500 million of the company's common stock to also occur during a period of up to one year. Refer to Note 18—Common Stock in the Consolidated Financial Statements for further information.

Other Financing Activity

Financing Business: We currently fund our customer financing activity through third-party funding arrangements, cash generated from operations, cash on hand, capital markets offerings and secured loans. In the United States, Canada, the Netherlands, the U.K., and France, we are currently funding a significant portion of our customer financing activity through secured borrowing arrangements with GE, De Lage Landen Bank ("DLL") and Merrill Lynch. At the end of the third quarter 2005, we repaid \$120 million of secured debt through a transaction with our DLL Joint Venture to purchase DLL's parent's 51% ownership interest in the Belgium and Spain leasing operations, which were previously sold to the joint venture in the fourth quarter of 2003. In connection with the purchase, the secured borrowings to DLL's parent in these operations were repaid and the related finance receivables are no longer encumbered. Other than the repayment of the secured debt, the effects from this transaction were immaterial. In October 2005, we renegotiated our Loan Agreement with GE resulting in a reduction in applicable interest rates and the elimination of the monthly borrowing requirement. The interest rate reduction is applicable to existing and new loans. Additionally in October 2005, we finalized renegotiation of our Loan Agreements with Merrill Lynch in France resulting in an increase in the size of the facility from €350 million to €420 million (\$414 to \$497), lower applicable interest rates and an extension for an additional 2 years at our option from the current expiration date of July 2007. Refer to Note 4 to the Consolidated Financial Statements for a more detailed discussion of our customer financing arrangements.

Loan Covenants and Compliance: At December 31, 2005, we were in full compliance with the covenants and other provisions of the 2003 Credit Facility, the senior notes and the Loan Agreement and expect to remain

in full compliance for at least the next twelve months. Any failure to be in compliance with any material provision or covenant of the 2003 Credit Facility or the senior notes could have a material adverse effect on our liquidity and operations. Failure to be in compliance with the covenants in the Loan Agreement, including the financial maintenance covenants incorporated from the 2003 Credit Facility, would result in an event of termination under the Loan Agreement and in such case GECC would not be required to make further loans to us. If GECC were to make no further loans to us and assuming a similar facility was not established and that we were unable to obtain replacement financing in the public debt markets, it could materially adversely affect our liquidity and our ability to fund our customers' purchases of our equipment and this could materially adversely affect our results of operations. We have the right at any time to prepay without penalty any loans outstanding under or terminate the 2003 Credit Facility.

Capital Markets Offerings and Other: In August 2004, we issued \$500 million aggregate principal amount of Senior Notes due 2011 at par value and, in September 2004, we issued an additional \$250 million aggregate principal amount Senior Notes due 2011 at 104.25% of par. These notes, which are discussed further in Note 11—Debt in the Consolidated Financial Statements, form a single series of debt. Interest on the Senior Notes accrues at the annual rate of 6.875% and, as a result of the premium we received on the second issuance of Senior Notes, have a weighted average effective interest rate of 6.6%. The weighted average effective interest rate associated with the Senior Notes reflects our improved liquidity and ability to access the capital markets on more favorable terms.

In December 2004, we completed the redemption of our liability to the Xerox trust issuing trust preferred securities. In lieu of cash redemption, holders of substantially all of the securities converted \$1.0 billion aggregate principal amount of securities into 113 million shares of our common stock. As a result of this conversion and redemption, there is no remaining outstanding principal. This redemption, which had no impact on diluted earnings per share, is discussed further in Note 12 to the Consolidated Financial Statements.

Credit Ratings: Our credit ratings as of December 31, 2005 were as follows:

| | <u>Senior Unsecured Debt</u> | <u>Outlook</u> | <u>Comments</u> |
|----------------------------------|----------------------------------|----------------|---|
| Moody's ^{(1), (2), (6)} | Ba2 | Positive | The Moody's rating was upgraded from B1 in August 2004. The outlook was upgraded to positive in September 2005. |
| S&P ^{(3), (4)} | BB- | Positive | The S&P rating on Senior Secured Debt is BB-. The outlook was upgraded to positive in April 2005. |
| Fitch ⁽⁵⁾ | BB+ | Positive | The Fitch rating was upgraded from BB in August 2005. |

⁽¹⁾ In December 2003, Moody's assigned to Xerox a first time SGL-1 rating. This rating was affirmed in August 2004.

⁽²⁾ In August 2004, Moody's upgraded the long-term senior unsecured debt rating of Xerox from B1 to Ba2, a two notch upgrade. The corporate rating was upgraded to Ba1.

⁽³⁾ In April 2005, S&P launched a short-term speculative-grade rating scale and assigned to Xerox a first time B-1 rating.

⁽⁴⁾ In April 2005, S&P upgraded the long-term senior unsecured debt rating of Xerox from B+ to BB-, a one notch upgrade. The corporate rating was affirmed as BB- and changed its Outlook from Stable to Positive.

⁽⁵⁾ In August 2005, Fitch upgraded the senior unsecured debt of Xerox from BB to BB+, and also upgraded the Trust Preferred securities from B+ to BB-, both one notch upgrades. The corporate rating Outlook was affirmed as Positive and affirmed the Secured Bank Facility at BBB-.

⁽⁶⁾ In September 2005, Moody's changed its Outlook from Stable to Positive.

Our credit ratings, which are periodically reviewed by major rating agencies, have substantially improved over the past two years. As described in the above table, Moody's and S&P have made positive rating upgrades during the 2005 annual period. In January 2006, S&P placed our rating on Credit-Watch Positive indicating a review of the credit with positive implications within the coming 30 days. Even though as of February 2006, our

current credit rating still remains below investment grade, we expect our management strategies will return the company to investment grade in the future.

Contractual Cash Obligations and Other Commercial Commitments and Contingencies: At December 31, 2005, we had the following contractual cash obligations and other commercial commitments and contingencies (in millions):

| | Year 1 | Years 2-3 | | Years 4-5 | | Thereafter |
|--|-----------------|-----------------|-----------------|-----------------|---------------|-----------------|
| | 2006 | 2007 | 2008 | 2009 | 2010 | |
| Long-term debt, including capital lease obligations ⁽¹⁾ | \$ 1,139 | \$ 1,582 | \$ 978 | \$ 989 | \$ 727 | \$ 1,863 |
| Minimum operating lease commitments ⁽²⁾ | 197 | 165 | 124 | 102 | 90 | 197 |
| Liabilities to subsidiary trusts issuing preferred securities ⁽³⁾ | 98 | — | — | — | — | 626 |
| Purchase Commitments | | | | | | |
| Flextronics ⁽⁴⁾ | 734 | — | — | — | — | — |
| EDS Contracts ⁽⁵⁾ | 299 | 290 | 282 | 138 | — | — |
| Other ⁽⁶⁾ | 39 | 34 | 31 | 1 | — | — |
| Total contractual cash obligations | \$ 2,506 | \$ 2,071 | \$ 1,415 | \$ 1,230 | \$ 817 | \$ 2,686 |

⁽¹⁾ Refer to Note 11 to our Consolidated Financial Statements for interest payments by us as well as for additional information related to long-term debt (amounts above include principal portion only).

⁽²⁾ Refer to Note 6 to our Consolidated Financial Statements for additional information related to minimum operating lease commitments.

⁽³⁾ Refer to Note 12 to our Consolidated Financial Statements for interest payments by us as well as for additional information related to liabilities to subsidiary trusts issuing preferred securities (amounts above include principal portion only).

⁽⁴⁾ Flextronics: In 2001, we outsourced certain manufacturing activities to Flextronics under a five-year agreement expiring on November 30, 2006, which we expect to extend for at least an additional three-year period in accordance with existing contractual terms.

⁽⁵⁾ EDS Contracts: We have an information management contract with Electronic Data Systems Corp. (“EDS”) to provide services to us for global mainframe system processing, application maintenance and support, desktop services and helpdesk support, voice and data network management, and server management through June 30, 2009. There are no minimum payments required under the contract. After July 1, 2006, we can terminate the current contract for convenience with six months notice, as defined in the contract, with no termination fee and with payment to EDS for costs incurred as of the termination date. Should we terminate the contract for convenience, we have an option to purchase the assets placed in service under the EDS contract.

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

Other Commercial Commitments and Contingencies

Pension and Other Post-Retirement Benefit Plans: We sponsor pension and other post-retirement benefit plans that require periodic cash contributions. Our 2005 cash fundings for these plans were \$388 million for pensions and \$112 million for other post-retirement plans. Our anticipated cash fundings for 2006 are \$106 million for pensions and \$130 million for other post-retirement plans. Cash contribution requirements for our domestic tax qualified pension plans are governed by the Employment Retirement Income Security Act (“ERISA”) and the Internal Revenue Code. Cash contribution requirements for our international plans are subject to the applicable regulations in each country. The expected 2006 pension contributions do not include contributions to the domestic tax qualified plans because these plans have already exceeded the ERISA minimum

funding requirements for the plans' 2005 plan year. However, once the January 1, 2006 actuarial valuations and projected results as of the end of the 2006 measurement year are available, the desirability of additional contributions will be assessed. Based on these results, we may voluntarily decide to contribute to these plans, even though no contribution is required. In prior years, after making this assessment, we decided to contribute \$230 and \$210 in April 2005 and April 2004, respectively, to our domestic tax qualified plans in order to make them 100 percent funded on a current liability basis under the ERISA funding rules. Our other post-retirement benefit plans are non-funded and are almost entirely related to domestic operations. Cash contributions are made each year to cover medical claims costs incurred in that year.

Fuji Xerox: We had product purchases from Fuji Xerox totaling \$1.5 billion, \$1.1 billion, and \$871 million in 2005, 2004 and 2003, respectively. Our purchase commitments with Fuji Xerox are in the normal course of business and typically have a lead time of three months. We anticipate that we will purchase approximately \$1.9 billion of products from Fuji Xerox in 2006. Related party transactions with Fuji Xerox are discussed in Note 7 to the Consolidated Financial Statements.

Brazil Tax and Labor Contingencies: At December 31, 2005, our Brazilian operations were involved in various litigation matters and have received or been levied with numerous governmental assessments related to indirect and other taxes as well as disputes associated with former employees and contract labor. The total amounts related to these unreserved contingencies, inclusive of any related interest, were approximately \$900 million. The tax matters, which comprise a significant portion of the total contingencies, principally relate to claims for taxes on the internal transfer of inventory, municipal service taxes on rentals and gross revenue taxes. We are disputing these tax and labor matters and intend to vigorously defend our position. Based on the opinion of legal counsel, we do not believe that the ultimate resolution of these matters will materially impact our results of operations, financial position or cash flows. In connection with these proceedings, customary local regulations may require us to make escrow cash deposits or post other security of up to half of the total amount in dispute. As of December 31, 2005 we have made escrow cash deposits of \$117 million for matters we are disputing and there are liens on certain of our Brazilian assets. Generally, any escrowed amounts would be refundable and any liens would be removed to the extent the matter is resolved in our favor. We routinely assess these matters as to probability of ultimately incurring a liability against our Brazilian operations and record our best estimate of the ultimate loss in situations where we assess the likelihood of an ultimate loss as probable of occurring.

Off-Balance Sheet Arrangements

Although we generally do not utilize off-balance sheet arrangements in our operations, we enter into operating leases in the normal course of business. The nature of these lease arrangements is discussed in Note 6 to the Consolidated Financial Statements. Additionally, we utilize special purpose entities ("SPEs") in conjunction with certain financing transactions. The SPEs utilized in conjunction with these transactions are consolidated in our financial statements in accordance with applicable accounting standards. These transactions, which are discussed further in Note 4 to the Consolidated Financial Statements, have been accounted for as secured borrowings with the debt and related assets remaining on our balance sheets. Although the obligations related to these transactions are included in our balance sheet, recourse is generally limited to the secured assets and no other assets of the Company.

Refer to Note 16—Contingencies for further information regarding our guarantees, indemnifications and warranty liabilities.

Financial Risk Management

We are exposed to market risk from foreign currency exchange rates and interest rates, which could affect operating results, financial position and cash flows. We manage our exposure to these market risks through our regular operating and financing activities and, when appropriate, through the use of derivative financial instruments. These derivative financial instruments are utilized to hedge economic exposures as well as reduce

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

Assuming a 10% appreciation or depreciation in foreign currency exchange rates from the quoted foreign currency exchange rates at December 31, 2005, the potential change in the fair value of foreign currency-denominated assets and liabilities in each entity would not be significant because all material currency asset and liability exposures were economically hedged as of December 31, 2005. A 10% appreciation or depreciation of the U.S. dollar against all currencies from the quoted foreign currency exchange rates at December 31, 2005 would have a \$582 million impact on our Cumulative translation adjustment portion of equity. The amount permanently invested in foreign subsidiaries and affiliates, primarily Xerox Limited, Fuji Xerox, Xerox Canada Inc. and Xerox do Brasil, and translated into dollars using the year-end exchange rates, was \$5.8 billion at December 31, 2005, net of foreign currency-denominated liabilities designated as a hedge of our net investment.

Interest Rate Risk Management: The consolidated weighted-average interest rates related to our debt and liabilities to subsidiary trusts issuing preferred securities for 2005, 2004 and 2003 approximated 6.0%, 5.8%, and 6.0%, respectively. Interest expense includes the impact of our interest rate derivatives.

Virtually all customer-financing assets earn fixed rates of interest. As discussed above, a significant portion of those assets has been pledged as collateral for secured financing arrangements and the interest rates on a significant portion of those loans are fixed.

As of December 31, 2005, approximately \$2.9 billion of our debt carried variable interest rates, including the effect of pay-variable interest rate swaps we are utilizing with the intent to reduce the effective interest rate on our debt.

The fair market values of our fixed-rate financial instruments are sensitive to changes in interest rates. At December 31, 2005, a 10% change in market interest rates would change the fair values of such financial instruments by approximately \$257 million.

Forward-Looking Statements

This Annual Report contains forward-looking statements and information relating to Xerox that are based on our beliefs, as well as assumptions made by and information currently available to us. The words “anticipate,” “believe,” “estimate,” “expect,” “intend,” “will,” “should” and similar expressions, as they relate to us, are intended to identify forward-looking statements. Actual results could differ materially from those projected in such forward-looking statements. Information concerning certain factors that could cause actual results to differ materially is included in our 2005 Annual Report on Form 10-K filed with the SEC. We do not intend to update these forward-looking statements.

XEROX CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

| (in millions, except per-share data) | Year ended December 31, | | |
|--|-------------------------|---------------|---------------|
| | 2005 | 2004 | 2003 |
| Revenues | | | |
| Sales | \$ 7,400 | \$ 7,259 | \$ 6,970 |
| Service, outsourcing and rentals | 7,426 | 7,529 | 7,734 |
| Finance income | 875 | 934 | 997 |
| | 15,701 | 15,722 | 15,701 |
| Costs and Expenses | | | |
| Cost of sales | 4,695 | 4,545 | 4,346 |
| Cost of service, outsourcing and rentals | 4,207 | 4,295 | 4,307 |
| Equipment financing interest | 326 | 345 | 362 |
| Research, development and engineering expenses | 943 | 914 | 962 |
| Selling, administrative and general expenses | 4,110 | 4,203 | 4,249 |
| Restructuring and asset impairment charges | 366 | 86 | 176 |
| Gain on affiliate's sale of stock | — | — | (13) |
| Other expenses, net | 224 | 369 | 876 |
| | 14,871 | 14,757 | 15,265 |
| Income from Continuing Operations before Income Taxes, Equity Income, Discontinued Operations and Cumulative Effect of Change in Accounting Principle | | | |
| | 830 | 965 | 436 |
| Income tax (benefits) expenses | (5) | 340 | 134 |
| Equity in net income of unconsolidated affiliates | 98 | 151 | 58 |
| | 933 | 776 | 360 |
| Income from Discontinued Operations, net of tax | | | |
| | 53 | 83 | — |
| Cumulative Effect of Change in Accounting Principle, net of tax | | | |
| | (8) | — | — |
| | 978 | 859 | 360 |
| Net Income | | | |
| Less: Preferred stock dividends, net | (58) | (73) | (71) |
| | \$ 920 | \$ 786 | \$ 289 |
| Basic Earnings per Share | | | |
| Income from Continuing Operations | \$ 0.91 | \$ 0.84 | \$ 0.38 |
| Basic Earnings per Share | \$ 0.96 | \$ 0.94 | \$ 0.38 |
| Diluted Earnings per Share | | | |
| Income from Continuing Operations | \$ 0.90 | \$ 0.78 | \$ 0.36 |
| Diluted Earnings per Share | \$ 0.94 | \$ 0.86 | \$ 0.36 |

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

XEROX CORPORATION
CONSOLIDATED BALANCE SHEETS

| (in millions, except share data in thousands) | December 31, | |
|--|------------------|------------------|
| | 2005 | 2004 |
| Assets | | |
| Cash and cash equivalents | \$ 1,322 | \$ 3,218 |
| Short-term investments | 244 | — |
| Total cash, cash equivalents and short-term investments | 1,566 | 3,218 |
| Accounts receivable, net | 2,037 | 2,076 |
| Billed portion of finance receivables, net | 296 | 377 |
| Finance receivables, net | 2,604 | 2,932 |
| Inventories | 1,201 | 1,143 |
| Other current assets | 1,032 | 1,182 |
| Total current assets | 8,736 | 10,928 |
| Finance receivables due after one year, net | 4,949 | 5,188 |
| Equipment on operating leases, net | 431 | 398 |
| Land, buildings and equipment, net | 1,627 | 1,759 |
| Investments in affiliates, at equity | 782 | 845 |
| Intangible assets, net | 289 | 324 |
| Goodwill | 1,671 | 1,848 |
| Deferred tax assets, long-term | 1,547 | 1,521 |
| Other long-term assets | 1,921 | 2,073 |
| Total Assets | \$ 21,953 | \$ 24,884 |
| Liabilities and Equity | | |
| Short-term debt and current portion of long-term debt | \$ 1,139 | \$ 3,074 |
| Accounts payable | 1,043 | 1,037 |
| Accrued compensation and benefits costs | 621 | 637 |
| Unearned income | 191 | 243 |
| Other current liabilities | 1,352 | 1,309 |
| Total current liabilities | 4,346 | 6,300 |
| Long-term debt | 6,139 | 7,050 |
| Liabilities to subsidiary trusts issuing preferred securities | 626 | 717 |
| Pension and other benefit liabilities | 1,151 | 1,189 |
| Post-retirement medical benefits | 1,188 | 1,180 |
| Other long-term liabilities | 1,295 | 1,315 |
| Total liabilities | 14,745 | 17,751 |
| Series C mandatory convertible preferred stock | 889 | 889 |
| Common stock, including additional paid-in-capital | 4,741 | 4,881 |
| Treasury stock, at cost | (203) | — |
| Retained earnings | 3,021 | 2,101 |
| Accumulated other comprehensive loss | (1,240) | (738) |
| Total Liabilities and Equity | \$ 21,953 | \$ 24,884 |
| Shares of common stock issued | 945,106 | 955,997 |
| Treasury stock | (13,917) | — |
| Shares of common stock outstanding | 931,189 | 955,997 |

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

XEROX CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

| (in millions) | Year ended December 31, | | |
|---|-------------------------|-----------------|-----------------|
| | 2005 | 2004 | 2003 |
| Cash Flows from Operating Activities | | | |
| Net income | \$ 978 | \$ 859 | \$ 360 |
| Adjustments required to reconcile net income to cash flows from operating activities: | | | |
| Depreciation and amortization | 637 | 686 | 748 |
| Provisions for receivables and inventory | 107 | 159 | 302 |
| Deferred tax (benefit) expense | (15) | 155 | (70) |
| Net gain on sales of businesses and assets | (97) | (61) | (1) |
| Undistributed equity in net income of unconsolidated affiliates | (54) | (89) | (37) |
| Loss on early extinguishment of debt | — | — | 73 |
| Income from discontinued operations | (53) | (83) | — |
| Restructuring and asset impairment charges | 366 | 86 | 176 |
| Cash payments for restructurings | (214) | (187) | (345) |
| Contributions to pension benefit plans | (388) | (409) | (672) |
| (Increase) decrease in inventories | (162) | (38) | 62 |
| Increase in equipment on operating leases | (248) | (234) | (166) |
| Decrease in finance receivables | 254 | 337 | 496 |
| (Increase) decrease in accounts receivable and billed portion of finance receivables | (34) | 224 | 164 |
| Decrease in other current and long-term assets | 164 | 109 | 105 |
| Increase in accounts payable and accrued compensation | 313 | 333 | 408 |
| Net change in income tax assets and liabilities | (211) | (68) | (3) |
| Net change in derivative assets and liabilities | 38 | (23) | 71 |
| Increase (decrease) in other current and long-term liabilities | 7 | (79) | (37) |
| Other, net | 32 | 73 | 245 |
| | <u>1,420</u> | <u>1,750</u> | <u>1,879</u> |
| Cash Flows from Investing Activities | | | |
| Purchases of short-term investments | (386) | — | — |
| Proceeds from sales of short-term investments | 139 | — | — |
| Cost of additions to land, buildings and equipment | (181) | (204) | (197) |
| Proceeds from sales of land, buildings and equipment | 5 | 53 | 10 |
| Cost of additions to internal use software | (56) | (48) | (53) |
| Proceeds from divestitures and investments, net | 105 | 191 | 35 |
| Acquisitions, net of cash acquired | (1) | (12) | — |
| Net change in escrow and other restricted investments | 80 | 223 | 254 |
| | <u>(295)</u> | <u>203</u> | <u>49</u> |
| Cash Flows from Financing Activities | | | |
| Cash proceeds from new secured financings | 557 | 2,061 | 2,450 |
| Debt payments on secured financings | (1,879) | (1,906) | (2,181) |
| Net cash payments on other debt | (1,187) | (1,422) | (4,044) |
| Proceeds from issuance of mandatory redeemable preferred stock | — | — | 889 |
| Preferred stock dividends | (58) | (83) | (57) |
| Proceeds from issuances of common stock | 40 | 73 | 477 |
| Payments to acquire treasury stock | (433) | — | — |
| Other | (2) | (16) | (4) |
| | <u>(2,962)</u> | <u>(1,293)</u> | <u>(2,470)</u> |
| Effect of exchange rate changes on cash and cash equivalents | (59) | 81 | 132 |
| (Decrease) increase in cash and cash equivalents | (1,896) | 741 | (410) |
| Cash and cash equivalents at beginning of year | 3,218 | 2,477 | 2,887 |
| Cash and cash equivalents at end of year | \$ 1,322 | \$ 3,218 | \$ 2,477 |

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

XEROX CORPORATION
CONSOLIDATED STATEMENTS OF COMMON SHAREHOLDERS' EQUITY

| (in millions, except share data in thousands) | Common Stock Shares | Common Stock Amount | Additional Paid-In-Capital | Treasury Stock Shares | Treasury Stock Amount | Retained Earnings | Accumulated Other Comprehensive Loss ⁽¹⁾ | Total |
|---|---------------------|---------------------|----------------------------|-----------------------|-----------------------|-------------------|---|----------------|
| Balance at December 31, 2002 | 738,273 | \$ 738 | \$ 2,001 | — | \$ — | \$ 1,025 | \$ (1,871) | \$1,893 |
| Net income | | | | | | 360 | | 360 |
| Translation adjustments | | | | | | | 547 | 547 |
| Minimum pension liability, net of tax | | | | | | | 42 | 42 |
| Unrealized gain on securities, net of tax | | | | | | | 17 | 17 |
| Unrealized gains on cash flow hedges, net of tax | | | | | | | 2 | 2 |
| Comprehensive income | | | | | | | | \$ 968 |
| Stock option and incentive plans, net | 9,530 | 9 | 41 | | | | | 50 |
| Common stock offering | 46,000 | 46 | 405 | | | | | 451 |
| Series B convertible preferred stock dividends (\$6.25 per share), net of tax | | | | | | (41) | | (41) |
| Series C mandatory convertible preferred stock dividends (\$3.23 per share) | | | | | | (30) | | (30) |
| Other | 81 | 1 | (2) | | | 1 | | — |
| Balance at December 31, 2003 | 793,884 | \$ 794 | \$ 2,445 | — | \$ — | \$ 1,315 | \$ (1,263) | \$3,291 |
| Net income | | | | | | 859 | | 859 |
| Translation adjustments | | | | | | | 453 | 453 |
| Minimum pension liability, net of tax | | | | | | | 86 | 86 |
| Unrealized gain on securities, net of tax | | | | | | | 2 | 2 |
| Realized gain on securities, net of tax | | | | | | | (18) | (18) |
| Unrealized gains on cash flow hedges, net of tax | | | | | | | 2 | 2 |
| Comprehensive income | | | | | | | | \$1,384 |
| Stock option and incentive plans, net | 11,433 | 11 | 111 | | | | | 122 |
| Series B convertible preferred stock conversion | 37,040 | 37 | 446 | | | | | 483 |
| Series B convertible preferred stock dividends (\$2.54 per share) | | | | | | (15) | | (15) |
| Series C mandatory convertible preferred stock dividends (\$6.25 per share) | | | | | | (58) | | (58) |
| Conversion of liability to subsidiary trust | 113,415 | 113 | 922 | | | | | 1,035 |
| Other | 225 | 1 | 1 | | | | | 2 |
| Balance at December 31, 2004 | 955,997 | \$ 956 | \$ 3,925 | — | \$ — | \$ 2,101 | \$ (738) | \$6,244 |
| Net income | | | | | | 978 | | 978 |
| Translation adjustments | | | | | | | (493) | (493) |
| Minimum pension liability, net of tax | | | | | | | (6) | (6) |
| Unrealized loss on securities, net of tax | | | | | | | (1) | (1) |
| Unrealized losses on cash flow hedges, net of tax | | | | | | | (2) | (2) |
| Comprehensive income | | | | | | | | \$ 476 |
| Stock option and incentive plans, net | 5,548 | 6 | 84 | | | | | 90 |
| Series C mandatory convertible preferred stock dividends (\$6.25 per share) | | | | | | (58) | | (58) |
| Payments to acquire treasury stock | | | | (30,502) | (433) | | | (433) |
| Cancellation of treasury stock | (16,585) | (17) | (213) | 16,585 | 230 | | | — |
| Other | 146 | | | | | | | — |
| Balance at December 31, 2005 | 945,106 | \$ 945 | \$ 3,796 | (13,917) | \$ (203) | \$ 3,021 | \$ (1,240) | \$6,319 |

⁽¹⁾ As of December 31, 2005, Accumulated other comprehensive loss is composed of cumulative translation adjustments of \$(1,017), cash flow hedging gains of \$1 and minimum pension liabilities of \$(224).

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in millions, except per-share data and unless otherwise indicated)

Note 1—Summary of Significant Accounting Policies

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

Description of Business and Basis of Presentation: We are a technology and services enterprise and a leader in the global document market, developing, manufacturing, marketing, servicing and financing a complete range of document equipment, solutions and services.

Certain reclassifications of prior year amounts have been made to conform to the current year presentation. Effective July 1, 2005, we reclassified sustaining engineering costs from cost of sales and cost of service, outsourcing and rentals to a new line item in our Consolidated Statements of Income entitled Research, development and engineering expenses (“R,D&E”). This presentation aligns our external reporting presentation to our internal management of these costs. The components of R,D&E for all years presented are disclosed in Note 19—Research, Development and Engineering.

Basis of Consolidation: The Consolidated Financial Statements include the accounts of Xerox Corporation and all of our controlled subsidiary companies. All significant intercompany accounts and transactions have been eliminated. Investments in business entities in which we do not have control, but we have the ability to exercise significant influence over operating and financial policies (generally 20% to 50% ownership), are accounted for using the equity method of accounting. Upon the sale of stock of a subsidiary, we recognize a gain or loss in our Consolidated Statements of Income equal to our proportionate share of the corresponding increase or decrease in that subsidiary’s equity. Operating results of acquired businesses are included in the Consolidated Statements of Income from the date of acquisition.

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

For convenience and ease of reference, we refer to the financial statement caption “Income from Continuing Operations before Income Taxes, Equity Income, Discontinued Operations and Cumulative Effect of Change in Accounting Principle” as “pre-tax income,” throughout the notes to the Consolidated Financial Statements.

Use of Estimates: The preparation of our Consolidated Financial Statements, in accordance with accounting principles generally accepted in the United States of America, requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities, as well as the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions are used for, but not limited to: (i) allocation of revenues and fair values in leases and other multiple element arrangements; (ii) accounting for residual values; (iii) economic lives of leased assets; (iv) allowance for doubtful accounts; (v) inventory valuation; (vi) restructuring and related charges; (vii) asset impairments; (viii) depreciable lives of assets; (ix) useful lives of intangible assets; (x) pension and post-retirement benefit plans; (xi) income tax reserves and valuation allowances and (xii) contingency and litigation reserves. Future events and their effects cannot be predicted with certainty; accordingly, our accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of our Consolidated Financial Statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. Actual results could differ from those estimates.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The following table summarizes certain significant charges that require management estimates:

| <u>(in millions)</u> | Year ended December 31, | | |
|--|----------------------------|-------|-------|
| | 2005 | 2004 | 2003 |
| Restructuring provisions and asset impairments | \$366 | \$ 86 | \$176 |
| Amortization of intangible assets | 42 | 38 | 36 |
| Provisions for receivables | 51 | 86 | 224 |
| Provisions for obsolete and excess inventory | 56 | 73 | 78 |
| Provisions for litigation and regulatory matters | 115 | 9 | 242 |
| Depreciation and obsolescence of equipment on operating leases | 205 | 210 | 271 |
| Depreciation of buildings and equipment | 280 | 305 | 299 |
| Amortization of capitalized software | 114 | 134 | 143 |
| Pension benefits—net periodic benefit cost | 343 | 350 | 364 |
| Other post-retirement benefits—net periodic benefit cost | 117 | 111 | 108 |
| Deferred tax asset valuation allowance provisions | (38) | 12 | (16) |

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

New Accounting Standards and Accounting Changes:

During the two years ended December 31, 2005, the Financial Accounting Standards Board (“FASB”) issued several pronouncements of significance to the Company which are discussed in detail below. In addition, the FASB issued several other pronouncements, including standards on inventory (SFAS No. 151 “Inventory Costs, an amendment of ARB 43, Chapter 4”), exchanges of nonmonetary assets (SFAS No. 153 “Exchanges of Nonmonetary Assets”), and accounting changes (SFAS No. 154 “Accounting Changes and Error Corrections”), which we either currently comply with or are not anticipating to have a significant impact on our future financial condition or results of operations.

In June 2005, the FASB issued Staff Position No. FAS 143-1, “Accounting for Electronic Equipment Waste Obligations” (“FSP 143-1”), which provided guidance on the accounting for obligations associated with the European Union (“EU”) Directive on Waste Electrical and Electronic Equipment (the “WEEE Directive”). FSP 143-1 provided guidance on how to account for the effects of the WEEE Directive with respect to historical waste and waste associated with products on the market on or before August 13, 2005. As of December 31, 2005, the WEEE Directive had been adopted into law by the EU member countries in which we have significant operations, with the exception of the United Kingdom. Accordingly, in 2005, we recorded an initial after-tax charge of \$18 (\$26 pre-tax) in Other expenses, net in the accompanying Consolidated Statement of Income representing the disposal obligation primarily related to our leased equipment population in service as of the date the EU member countries adopted the WEEE Directive. The adoption of the WEEE Directive by an EU member country created a legal disposal obligation and accordingly we are now required to accrue the cost of that obligation at the time the equipment is placed in service. We will be required to record a similar charge for the United Kingdom when it adopts the WEEE Directive, which is expected to be no more than \$10. The on-going quarterly expense resulting from compliance with the WEEE Directive associated with our leased equipment will generally be charged to cost of sales when equipment is placed in service and is not expected to have a material effect on our financial condition or results of operations.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

In March 2005, the FASB issued Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143" ("FIN 47"). FIN 47 requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated. A conditional asset retirement obligation is a legal obligation to perform an asset retirement activity in which the timing or method of settlement are conditional upon a future event that may or may not be within control of the entity. The adoption of FIN 47 in 2005 resulted in an after-tax charge of \$8 (\$12 pre-tax) and was recorded as a cumulative effect of change in accounting principle. This charge represents conditional asset retirement obligations associated with leased facilities where we are required to remove certain leasehold improvements and restore the facility to its original condition at lease termination. Previously, we recorded costs associated with this obligation upon lease termination when the costs were known. On a prospective basis, this accounting change requires recognition of these costs ratably over the lease term. We believe that the adoption of this interpretation will not have a material effect on our financial condition or results of operations. The pro forma effect of applying this guidance in all prior periods presented, as well as the effect on our Consolidated Balance Sheet, was not material.

Stock-Based Compensation: In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" ("FAS 123(R)"), an amendment of FAS No. 123, "Accounting for Stock-Based Compensation," which requires companies to recognize compensation expense using a fair-value based method for costs related to share-based payments, including stock options. As permitted by the SEC, the requirements of FAS 123(R) are effective for our fiscal year beginning January 1, 2006. Upon adoption, we will elect to apply the modified prospective transition method and therefore we will not restate the results of prior periods.

During May 2005, we approved the accelerated vesting of approximately 3.6 million unvested employee stock options granted in 2004, that would have been scheduled to vest January 1, 2007, to December 31, 2005. These accelerated options had a weighted average exercise price of \$13.71 as of the accelerated vesting date. The primary purpose of this accelerated vesting was to eliminate compensation expense we would recognize in our results of operations upon the adoption of FAS 123(R). The acceleration is expected to reduce our pre-tax stock option compensation expense in 2006 that otherwise would have been recognized by approximately \$31 or \$0.02 per diluted share and, accordingly, increase our 2005 pro forma expense disclosed below. After the effects of the accelerated vesting, the implementation of FAS 123(R) is expected to be immaterial. In addition, in 2005 in lieu of stock options, we began granting time- and performance-based restricted stock awards, which are already reflected as compensation expense in our results of operations. Therefore, the acceleration of vesting for substantially all previously awarded stock options effectively completes the transition to the new stock-based award program.

FAS 123(R) also requires that the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. While we can not estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in 2005 for such excess tax deductions was \$12.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Pending the effective date of FAS 123(R), we do not recognize compensation expense relating to employee stock options because the exercise price is equal to the market price at the date of grant. If we had elected to recognize compensation expense using a fair value approach, and therefore determined the compensation based on the value as determined by the modified Black-Scholes option pricing model, our pro forma income and income per share would have been as follows:

| <u>(in millions, except per share data)</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|---------------|---------------|---------------|
| Net income—as reported | \$ 978 | \$ 859 | \$ 360 |
| Add: Stock-based employee compensation expense included in reported net income, net of tax | 25 | 13 | 10 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax | (113) | (82) | (95) |
| Net income—pro forma | \$ 890 | \$ 790 | \$ 275 |
| Basic EPS—as reported | \$ 0.96 | \$ 0.94 | \$ 0.38 |
| Basic EPS—pro forma | 0.87 | 0.86 | 0.27 |
| Diluted EPS—as reported | \$ 0.94 | \$ 0.86 | \$ 0.36 |
| Diluted EPS—pro forma | 0.85 | 0.80 | 0.25 |

The pro forma periodic compensation expense amounts are not representative of future amounts as we began granting employees restricted stock awards with time- and performance-based restrictions in 2005 in lieu of stock options. As reflected in the pro forma amounts in the previous table, the weighted-average fair value of options granted in 2004 and 2003 was \$8.38 and \$5.39, respectively. The fair values were estimated on the date of grant using the following weighted average assumptions:

| | <u>2004</u> | <u>2003</u> |
|---------------------------------------|-------------|-------------|
| Risk-free interest rate | 3.2% | 3.3% |
| Expected life in years ⁽¹⁾ | 5.7 | 7.2 |
| Expected price volatility | 66.5% | 66.2% |
| Expected dividend yield | — | — |

⁽¹⁾ Options granted in 2004 expire eight years from date of grant, resulting in an expected life shorter than previous grants.

Refer to Note 18—Common Stock for additional disclosures regarding our stock compensation programs.

Summary of Accounting Policies:

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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

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

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

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

Revenue Recognition for Leases: Our accounting for leases involves specific determinations under SFAS No. 13, which often involve complex provisions and significant judgments. The two primary criteria of SFAS No. 13 which we use to classify transactions as sales-type or operating leases are (1) a review of the lease term to determine if it is equal to or greater than 75% of the economic life of the equipment and (2) a review of the present value of the minimum lease payments to determine if they are equal to or greater than 90% of the fair market value of the equipment at the inception of the lease. Our sales-type lease portfolios contain only normal credit and collection risks and have no important uncertainties with respect to future costs. Our leases in our Latin America operations have historically been recorded as operating leases given the cancellability of the contract or because the recoverability of the lease investment is deemed not to be predictable at lease inception.

The critical elements that we consider with respect to our lease accounting are the determination of the economic life and the fair value of equipment, including the residual value. For purposes of determining the economic life, we consider the most objective measure to be the original contract term, since most equipment is returned by lessees at or near the end of the contracted term. The economic life of most of our products is five years since this represents the most frequent contractual lease term for our principal products and only a small percentage of our leases have original terms longer than five years. There is no significant after-market for our used equipment. We believe that five years is representative of the period during which the equipment is expected to be economically usable, with normal service, for the purpose for which it is intended. We continually evaluate the economic life of both existing and newly introduced products for purposes of this determination. Residual values are established at lease inception using estimates of fair value at the end of the lease term. Our residual values are established with due consideration to forecasted supply and demand for our various products, product retirement and future product launch plans, end of lease customer behavior, remanufacturing strategies, competition and technological changes.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The vast majority of our leases that qualify as sales-type are non-cancelable and include cancellation penalties approximately equal to the full value of the lease receivables. A portion of our business involves sales to governmental units. Governmental units are those entities that have statutorily defined funding or annual budgets that are determined by their legislative bodies. Certain of our governmental contracts may have cancellation provisions or renewal clauses that are required by law, such as 1) those dependant on fiscal funding outside of a governmental unit's control, 2) those that can be cancelled if deemed in the best interest of the governmental unit's taxpayers or 3) those that must be renewed each fiscal year, given limitations that may exist on entering into multi-year contracts that are imposed by statute. In these circumstances, we carefully evaluate these contracts to assess whether cancellation is remote because of the existence of substantive economic penalties upon cancellation or whether the renewal is reasonably assured due to the existence of a bargain renewal option. The evaluation of a lease agreement with a renewal option includes an assessment as to whether the renewal is reasonably assured based on the intent of such governmental unit and pricing terms as compared to those of short-term leases at lease inception. We further ensure that the contract provisions described above are offered only in instances where required by law. Where such contract terms are not legally required, we consider the arrangement to be cancelable and account for it as an operating lease.

Aside from the initial lease of equipment to our customers, we may enter subsequent transactions with the same customer whereby we extend the term. We evaluate the classification of lease extensions of sales-type leases using the originally determined economic life for each product. There may be instances where we enter into lease extensions for periods that are within the original economic life of the equipment. These are accounted for as sales-type leases only when the extensions occur in the last three months of the lease term and they otherwise meet the appropriate criteria of SFAS No. 13. All other lease extensions of this type are accounted for as direct financing leases or operating leases, as appropriate.

Revenue Recognition Under Bundled Arrangements: We sell most of our products and services under bundled lease arrangements, which typically include equipment, service, supplies and financing components for which the customer pays a single negotiated fixed minimum monthly payment for all elements over the contractual lease term. These arrangements typically also include an incremental, variable component for page volumes in excess of contractual page volume minimums, which are often expressed in terms of price per page. The fixed minimum monthly payments are multiplied by the number of months in the contract term to arrive at the total fixed minimum payments that the customer is obligated to make ("fixed payments") over the lease term. The payments associated with page volumes in excess of the minimums are contingent on whether or not such minimums are exceeded ("contingent payments"). The minimum contractual committed page volumes are typically negotiated to equal the customer's estimated page volume at lease inception. In applying our lease accounting methodology, we only consider the fixed payments for purposes of allocating to the relative fair value elements of the contract. Contingent payments, if any, are inherently uncertain and therefore are recognized as revenue in the period when the customer exceeds the minimum copy volumes specified in the contract.

Revenues under bundled arrangements are allocated considering the relative fair values of the lease and non-lease deliverables included in the bundled arrangement based upon the estimated relative fair values of each element. Lease deliverables include maintenance and executory costs, equipment and financing, while non-lease deliverables generally consist of the supplies and non-maintenance services. Our revenue allocation for the lease deliverables begins by allocating revenues to the maintenance and executory costs plus profit thereon. The remaining amounts are allocated to the equipment and financing elements. We perform extensive analyses of available verifiable objective evidence of equipment fair value based on cash selling prices during the applicable period. The cash selling prices are compared to the range of values included in our lease accounting systems. The range of cash selling prices must be reasonably consistent with the lease selling prices, taking into account residual values that accrue to our benefit, in order for us to determine that such lease prices are indicative of fair value. Our pricing interest rates, which are used to determine customer lease payments, are developed based upon

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

a variety of factors including local prevailing rates in the marketplace and the customer's credit history, industry and credit class. Effective in 2004, our pricing rates are reassessed quarterly based on changes in local prevailing rates in the marketplace and are adjusted to the extent such rates vary by twenty-five basis points or more, cumulatively, from the last rate in effect. The pricing interest rates generally equal the implicit rates within the leases, as corroborated by our comparisons of cash to lease selling prices.

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

Restricted Cash and Investments: Several of our secured financing arrangements and derivative contracts, as well as other material contracts, require us to post cash collateral or maintain minimum cash balances in escrow. These cash amounts are reported in our Consolidated Balance Sheets, depending on when the cash will be contractually released. At December 31, 2005 and 2004, such restricted cash amounts were as follows (in millions):

| | December 31, | |
|---|--------------|--------------|
| | 2005 | 2004 |
| Escrow and cash collections related to secured borrowing arrangements | \$254 | \$372 |
| Collateral related to risk management arrangements | 43 | 61 |
| Other restricted cash | 149 | 97 |
| Total | \$446 | \$530 |

Of these amounts, \$270 and \$370 were included in Other current assets and \$176 and \$160 were included in Other long-term assets, as of December 31, 2005 and 2004, respectively.

Provisions for Losses on Uncollectible Receivables: The provisions for losses on uncollectible trade and finance receivables are determined principally on the basis of past collection experience applied to ongoing evaluations of our receivables and evaluations of the default risks of repayment. Allowances for doubtful accounts on accounts receivable balances were \$136 and \$183, as of December 31, 2005 and 2004, respectively. Allowances for doubtful accounts on finance receivables were \$229 and \$276 at December 31, 2005 and 2004, respectively.

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

Land, Buildings and Equipment and Equipment on Operating Leases: Land, buildings and equipment are recorded at cost. Buildings and equipment are depreciated over their estimated useful lives. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful life. Equipment on

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

operating leases is depreciated to estimated residual value over the lease term. Depreciation is computed using the straight-line method. Significant improvements are capitalized and maintenance and repairs are expensed. Refer to Notes 5 and 6 for further discussion.

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

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

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

Treasury Stock: We account for repurchased common stock under the cost method and include such treasury stock as a component of our Common shareholders' equity. Retirement of Treasury stock is recorded as a reduction of Common stock and Additional paid-in-capital.

Research and Development Expenses: Research and development costs are expensed as incurred.

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

Pension and Post-Retirement Benefit Obligations: We sponsor pension plans in various forms in several countries covering substantially all employees who meet eligibility requirements. Post-retirement benefit plans cover primarily U.S. employees for retirement medical costs. As permitted by existing accounting rules, we employ a delayed recognition feature in measuring the costs and obligations of pension and post-retirement benefit plans. This requires changes in the benefit obligations and changes in the value of assets set aside to meet those obligations to be recognized not as they occur, but systematically and gradually over subsequent periods.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

All changes are ultimately recognized, except to the extent they may be offset by subsequent changes. At any point, changes that have been identified and quantified await subsequent accounting recognition as net cost components and as liabilities or assets.

Several statistical and other factors that attempt to anticipate future events are used in calculating the expense, liability and asset values related to our pension and post-retirement benefit plans. These factors include assumptions we make about the discount rate, expected return on plan assets, rate of increase in healthcare costs, the rate of future compensation increases, and mortality, among others. Actual returns on plan assets are not immediately recognized in our income statement, due to the delayed recognition requirement. In calculating the expected return on the plan asset component of our net periodic pension cost, we apply our estimate of the long term rate of return to the plan assets that support our pension obligations, after deducting assets that are specifically allocated to Transitional Retirement Accounts (which are accounted for based on specific plan terms).

For purposes of determining the expected return on plan assets, we utilize a calculated value approach in determining the value of the pension plan assets, as opposed to a fair market value approach. The primary difference between the two methods relates to systematic recognition of changes in fair value over time (generally two years) versus immediate recognition of changes in fair value. Our expected rate of return on plan assets is then applied to the calculated asset value to determine the amount of the expected return on plan assets to be used in the determination of the net periodic pension cost. The calculated value approach reduces the volatility in net periodic pension cost that results from using the fair market value approach.

The difference between the actual return on plan assets and the expected return on plan assets is added to, or subtracted from, any cumulative differences that arose in prior years. This amount is a component of the unrecognized net actuarial (gain) loss and is subject to amortization to net periodic pension cost over the remaining service lives of the employees participating in the pension plan.

The discount rate is used to present value our future anticipated benefit obligations. In estimating our discount rate, we consider rates of return on high quality fixed-income investments included in various published bond indexes, adjusted to eliminate the effects of call provisions and differences in the timing and amounts of cash outflows related to the bonds, as well as, the expected timing of pension and other benefit payments. In the U.S. and the U.K., which comprise approximately 81% of our projected benefit obligation, we consider the Moody's Aa Corporate Bond Index and the International Index Company's iBoxx Sterling Corporates AA Cash Bond Index, respectively in the determination of the appropriate discount rate assumptions.

Foreign Currency Translation: The functional currency for most foreign operations is the local currency. Net assets are translated at current rates of exchange, and income, expense and cash flow items are translated at average exchange rates for the applicable period. The translation adjustments are recorded in Accumulated other comprehensive loss. The U.S. dollar is used as the functional currency for certain subsidiaries that conduct their business in U.S. dollars or operate in hyperinflationary economies. A combination of current and historical exchange rates is used in remeasuring the local currency transactions of these subsidiaries and the resulting exchange adjustments are included in income. Aggregate foreign currency losses were \$5, \$73 and \$11 in 2005, 2004 and 2003, respectively, and are included in Other expenses, net in the accompanying Consolidated Statements of Income.

Note 2—Segment Reporting

Our reportable segments are consistent with how we manage the business and view the markets we serve. Our reportable segments are Production, Office, Developing Markets Operations ("DMO") and Other. The

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Production and Office segments are centered around strategic product groups which share common technology, manufacturing and product platforms, as well as classes of customers. During 2005, we implemented a new financial reporting system which has enabled greater efficiencies in financial reporting and provides enhanced analytical capabilities including activity-based cost analysis on shared services and internal cost allocations. We have used the new financial reporting system to make changes in the allocation of certain segment costs and expenses, including a reallocation of costs associated with corporate and certain shared service functions. These changes did not involve a change in the composition of our reportable segments and did not impact segment revenue. We have reclassified prior-period amounts to conform to the current period's presentation. The following table illustrates the impact of these changes on annual segment operating profit for 2004 and 2003 (in millions):

| | Years Ended | |
|-------------------------|-------------|-------------|
| | 2004 | 2003 |
| Operating Profit | | |
| Production | \$123 | \$ 65 |
| Office | (19) | 48 |
| DMO | (8) | — |
| Other | (96) | (113) |
| Total | \$— | \$ — |

The Production segment includes black and white products which operate at speeds over 90 pages per minute (“ppm”) and color products which operate at speeds over 40 ppm, excluding 50 ppm products with an embedded controller. Products include the Xerox iGen3 digital color production press, Nuvera, DocuTech, DocuPrint, Xerox 2101 and DocuColor families, as well as older technology light-lens products. These products are sold predominantly through direct sales channels in North America and Europe to Fortune 1000, graphic arts, government, education and other public sector customers.

The Office segment includes black and white products which operate at speeds up to 90 ppm and color devices, up to 40 ppm, as well as, 50 ppm color devices with an embedded controller. Products include the suite of CopyCentre, WorkCentre, and WorkCentre Pro digital multifunction systems, DocuColor color multifunction products, color laser, solid ink color printers and multifunction devices, monochrome laser desktop printers, digital and light-lens copiers and facsimile products. These products are sold through direct and indirect sales channels in North America and Europe to global, national and mid-size commercial customers as well as government, education and other public sector customers.

The DMO segment includes our operations in Latin America, Central and Eastern Europe, the Middle East, India, Eurasia, Russia and Africa. This segment's sales consist of office and production including a large proportion of office devices and printers which operate at speeds of 11-30 ppm. Management serves and evaluates these markets on an aggregate geographic basis, rather than on a product basis.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Selected financial information for our operating segments for each of the years ended December 31, 2005, 2004 and 2003, respectively, was as follows (in millions):

| | <u>Production</u> | <u>Office</u> | <u>DMO</u> | <u>Other</u> | <u>Total</u> |
|---|-------------------|-----------------|-----------------|-----------------|------------------|
| 2005 ⁽¹⁾ | | | | | |
| Information about profit or loss: | | | | | |
| Revenues | \$ 4,198 | \$ 7,106 | \$ 1,803 | \$ 1,719 | \$ 14,826 |
| Finance income | 342 | 512 | 9 | 12 | 875 |
| Total segment revenues | \$ 4,540 | \$ 7,618 | \$ 1,812 | \$ 1,731 | \$ 15,701 |
| Interest expense ⁽²⁾ | \$ 121 | \$ 179 | \$ 8 | \$ 249 | \$ 557 |
| Segment profit (loss) ⁽³⁾ | 427 | 819 | 64 | 151 | 1,461 |
| Equity in net income of unconsolidated affiliates | — | — | 4 | 94 | 98 |
| 2004 ⁽¹⁾ | | | | | |
| Information about profit or loss: | | | | | |
| Revenues | \$ 4,238 | \$ 7,075 | \$ 1,697 | \$ 1,778 | \$ 14,788 |
| Finance income | 352 | 552 | 10 | 20 | 934 |
| Total segment revenues | \$ 4,590 | \$ 7,627 | \$ 1,707 | \$ 1,798 | \$ 15,722 |
| Interest expense ⁽²⁾ | \$ 114 | \$ 176 | \$ 12 | \$ 406 | \$ 708 |
| Segment profit (loss) ⁽³⁾ | 511 | 779 | 35 | (125) | 1,200 |
| Equity in net income of unconsolidated affiliates | — | — | 3 | 148 | 151 |
| 2003 ⁽¹⁾ | | | | | |
| Information about profit or loss: | | | | | |
| Revenues | \$ 4,131 | \$ 7,048 | \$ 1,751 | \$ 1,774 | \$ 14,704 |
| Finance income | 376 | 594 | 12 | 15 | 997 |
| Total segment revenues | \$ 4,507 | \$ 7,642 | \$ 1,763 | \$ 1,789 | \$ 15,701 |
| Interest expense ⁽²⁾ | \$ 120 | \$ 197 | \$ 34 | \$ 533 | \$ 884 |
| Segment profit (loss) ⁽³⁾ | 466 | 790 | 172 | (440) | 988 |
| Equity in net income of unconsolidated affiliates | — | 1 | 6 | 51 | 58 |

- ⁽¹⁾ Asset information on a segment basis is not disclosed as this information is not separately identified and internally reported to our chief executive officer.
- ⁽²⁾ Interest expense includes equipment financing interest as well as non-financing interest, which is a component of Other expenses, net.
- ⁽³⁾ Depreciation and amortization expense is recorded in cost of sales, research, development and engineering expenses and selling, administrative and general expenses and is included in the segment profit (loss) above. This information is neither identified nor internally reported to our chief executive officer. The separate identification of this information for purposes of segment disclosure is impracticable, as it is not readily available and the cost to develop it would be excessive.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The following is a reconciliation of segment profit to pre-tax income (in millions):

| | Years ended December 31, | | |
|---|--------------------------|----------|--------|
| | 2005 | 2004 | 2003 |
| Total segment profit | \$ 1,461 | \$ 1,200 | \$ 988 |
| Unallocated items: | | | |
| Restructuring and asset impairment charges | (366) | (86) | (176) |
| Provisions for certain litigation matters ⁽¹⁾ | (114) | — | (239) |
| Initial provision for WEEE Directive (“FSP 143-1”) ⁽²⁾ | (26) | — | — |
| Losses from Hurricane Katrina | (15) | — | — |
| 2002 credit facility fee write-off | — | — | (73) |
| Other expenses, net | (12) | 2 | (6) |
| Allocated item: | | | |
| Equity in net income of unconsolidated affiliates | (98) | (151) | (58) |
| Pre-tax income | \$ 830 | \$ 965 | \$ 436 |

⁽¹⁾ 2005 provision for litigation includes \$102 related to MPI arbitration panel ruling, including \$13 million for interest expense, and \$12 million related to other legal matters. Refer to Note 16—Contingencies for further discussion. The 2003 provision for litigation includes the \$239 charge related to the court approved settlement of the Berger v. RIGP litigation discussed in Note 14—Employee Benefit Plans.

⁽²⁾ See Note 1—“New Accounting Standards and Accounting Changes” for discussion of this charge.

Geographic area data was as follows:

| (in millions) | Revenues | | | Long-Lived Assets ⁽¹⁾ | | |
|---------------|-----------|-----------|-----------|----------------------------------|----------|----------|
| | 2005 | 2004 | 2003 | 2005 | 2004 | 2003 |
| United States | \$ 8,388 | \$ 8,346 | \$ 8,547 | \$ 1,386 | \$ 1,427 | \$ 1,477 |
| Europe | 5,226 | 5,281 | 4,863 | 500 | 585 | 616 |
| Other Areas | 2,087 | 2,095 | 2,291 | 386 | 434 | 460 |
| Total | \$ 15,701 | \$ 15,722 | \$ 15,701 | \$ 2,272 | \$ 2,446 | \$ 2,553 |

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

Note 3—Short-Term Investments

As of December 31, 2005, we held \$244 in marketable securities that are classified within Short-term investments in our Consolidated Balance Sheets. These securities are considered available-for-sale and are carried at fair value based on quoted market prices. Unrealized gains and losses, net of taxes, are recorded within Accumulated other comprehensive loss, a component of Common shareholders’ equity. The purchases of Short-term investments for the year ending December 31, 2005 were \$386, including \$2 of premiums which are amortized as an offset to Interest income over the remaining term of the investments. The cost of securities sold is based on the specific identification method. Proceeds from sales of Short-term investments for the year ended December 31, 2005 were \$139. No gains or losses were realized on these sales.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The following table summarizes the fair market values and unrealized losses of our Short-term investments as of December 31, 2005 (in millions):

| Description of Securities | Maturities Less Than 12 Months | | Maturities 12 Months or Greater | | Total | |
|-------------------------------------|--------------------------------------|----------------------|---------------------------------------|----------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate bonds | \$ 93 | \$ — | \$ 51 | \$ 1 | \$144 | \$ 1 |
| Auction rate municipal bonds | — | — | 45 | — | 45 | — |
| US government agency securities | 13 | — | 19 | — | 32 | — |
| Total Debt Securities | \$106 | \$ — | \$115 | \$ 1 | \$221 | \$ 1 |
| Auction rate preferred securities | | | | | 23 | — |
| Total Short-term investments | | | | | \$244 | \$ 1 |

The contractual maturities of the available-for-sale debt securities at December 31, 2005 are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay and creditors may have the right to call obligations. These securities are classified within current assets because they are highly liquid, traded in active markets and are available for use, if needed, for current operations.

| (in millions) | Fair Value |
|-------------------------------------|---------------|
| Debt Securities: | |
| Due in 1 year or less | \$ 106 |
| Due after 1 year through 5 years | 70 |
| Due after 5 years through 10 years | — |
| Due after 10 years | 45 |
| Total Debt Securities | \$ 221 |
| Auction rate preferred securities | 23 |
| Total Short-term investments | \$ 244 |

On an ongoing basis, we evaluate our investments to determine if a decline in fair value is other-than-temporary. In this determination, we consider the duration that, and extent to which, market value is below original cost, our intent and ability to hold to recovery and the financial health of the issuer.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 4—Receivables, Net

Finance Receivables: Finance receivables result from installment arrangements and sales-type leases arising from the marketing of our equipment. These receivables are typically collateralized by a security interest in the underlying assets. Finance receivables, net at December 31, 2005 and 2004 were as follows (in millions):

| | 2005 | 2004 |
|--|----------|----------|
| Gross receivables | \$ 9,449 | \$10,267 |
| Unearned income | (1,458) | (1,619) |
| Unguaranteed residual values | 87 | 125 |
| Allowance for doubtful accounts | (229) | (276) |
| Finance receivables, net | 7,849 | 8,497 |
| Less: Billed portion of finance receivables, net | (296) | (377) |
| Current portion of finance receivables not billed, net | (2,604) | (2,932) |
| Amounts due after one year, net | \$ 4,949 | \$ 5,188 |

Contractual maturities of our gross finance receivables subsequent to December 31, 2005 were as follows (including those already billed of \$296):

| 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|---------|----------|----------|----------|--------|------------|----------|
| \$3,633 | \$ 2,590 | \$ 1,812 | \$ 1,004 | \$ 371 | \$ 39 | \$ 9,449 |

Secured Funding Arrangements

GE Secured Borrowings: We have an agreement in the U.S. (the “Loan Agreement”) under which GE Vendor Financial Services, a subsidiary of GE, is our primary third-party equipment financing provider, through the funding of loans secured by new lease originations. The maximum potential level of borrowing under the Loan Agreement is a function of the size of the portfolio of finance receivables generated by us that meet GE’s funding requirements and cannot exceed \$5 billion in any event. In October 2005, we renegotiated the Loan Agreement resulting in a reduction in applicable interest rates and the elimination of the monthly borrowing requirement. The interest rate reduction is applicable to existing and new loans.

Under this agreement, GE funds a significant portion of new U.S. lease originations at over-collateralization rates, which vary over time, but are expected to approximate 10% at the inception of each funding. The secured loans are subject to interest rates calculated at each loan funding at yield rates consistent with average rates for similar market based transactions as well as our current debt ratings. Refer to Note 11 for further information on interest rates. New lease originations, including the bundled service and supply elements, are transferred to a wholly-owned consolidated subsidiary which receives funding from GE. The funds received under this agreement are recorded as secured borrowings and together with the associated lease receivables are included in our Consolidated Balance Sheet. We and GE intend the transfers of the lease contracts to be “true sales at law” and that the wholly-owned consolidated subsidiary be bankruptcy remote and have received opinions to that effect from outside legal counsel. As a result, the transferred receivables are not available to satisfy any of our other obligations. GE’s funding commitment is not subject to our credit ratings. There are no credit rating defaults that could impair future funding under this agreement. This agreement contains cross default provisions related to certain financial covenants contained in the 2003 Credit Facility and other significant debt facilities. Any cross default would impair our ability to receive subsequent funding until the default was cured or waived but does not accelerate previous borrowings except in the case of bankruptcy. However, in the event of a default, we could be replaced as the maintenance service provider for the associated equipment under lease.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

We have similar long-term lease funding arrangements with GE in both the U.K. and Canada. These agreements contain similar terms and conditions as those contained in the U.S. Loan Agreement with respect to funding conditions and covenants. The final funding date for all facilities is currently December 2010.

France Secured Borrowings: In July 2003, we securitized \$443 of receivables in France using a three-year public secured financing arrangement. The funds received in connection with this agreement were recorded as secured borrowings. In September 2005, we repaid the remaining balance associated with this arrangement of \$47 million. We also have an on-going warehouse financing facility in France with Merrill Lynch to fund new lease originations. In October 2005, we amended this agreement resulting in an increase in the size of the facility from €350 million to €420 million (\$414 to \$497 as of December 31, 2005), lower applicable interest rates and an extension for an additional 2 years at our option from the current expiration date of July 2007.

The DLL Secured Borrowings: In 2002, we formed a joint venture with De Lage Landen Bank (“the DLL Joint Venture”) which became our primary equipment financing provider for new lease originations in the Netherlands through fundings from De Lage Landen Bank. In 2003, the DLL Joint Venture was expanded to include the leasing operations in Belgium and Spain. Our DLL Joint venture is consolidated as we are deemed to be the primary beneficiary of the joint venture’s financial results (Refer to Note 1—“Basis of Consolidation”). In September 2005, we completed a transaction with our DLL Joint Venture to purchase De Lage Landen Bank’s 51% ownership interest in the Belgium and Spain leasing operations. In connection with the purchase, the secured borrowings from De Lage Landen Bank to these operations of \$120 were repaid and the related finance receivables are no longer encumbered. Other than the repayment of the secured debt, the effects from this transaction were immaterial.

The following table shows finance receivables and related secured debt as of December 31, 2005 and 2004:

| (in millions) | Facility Amount | Maximum Facility Amount ⁽¹⁾ | December 31, 2005 | | December 31, 2004 | |
|--|---------------------------------|--|---------------------|----------------|---------------------|----------------|
| | | | Finance Receivables | Secured Debt | Finance Receivables | Secured Debt |
| Finance Receivables Encumbered by Loans : | | | | | | |
| GE secured loans: | | | | | | |
| GE Loans—U.S. | \$5 billion | \$8 billion | \$ 1,888 | \$1,701 | \$ 2,711 | \$2,486 |
| GE Loans—U.K. | £400 million (U.S. \$690) | £600 million (U.S. \$1.0 billion) | 637 | 581 | 771 | 685 |
| GE Loans—Canada | Cdn. \$850 million (U.S. \$730) | Cdn. \$2 billion (U.S. \$1.7 billion) | 258 | 174 | 486 | 426 |
| Total GE encumbered finance receivables, net | | | 2,783 | 2,456 | 3,968 | 3,597 |
| Merrill Lynch Loan—France | €420 million (U.S. \$497) | €420 million (U.S. \$497) | 430 | 342 | 368 | 287 |
| Asset-backed notes—France | N/A | N/A | — | — | 225 | 148 |
| DLL—Netherlands | N/A | N/A | 216 | 184 | 436 | 404 |
| Total encumbered finance receivables, net | | | 3,429 | \$2,982 | 4,997 | \$4,436 |
| Unencumbered finance receivables, net | | | 4,420 | | 3,500 | |
| Total Finance receivables, net ⁽²⁾ | | | \$ 7,849 | | \$ 8,497 | |

⁽¹⁾ Subject to mutual agreement by the parties.

⁽²⁾ Includes (i) billed portion of finance receivables, net (ii) finance receivables, net and (iii) finance receivables due after one year, net as included in the Consolidated Balance Sheets as of December 31, 2005 and 2004.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

As of December 31, 2005, \$3,429 of Finance receivables, net are held as collateral in various entities, as security for the borrowings noted above. Total outstanding debt secured by these receivables at December 31, 2005 was \$2,982. The entities are consolidated in our financial statements. Although the transferred assets are included in our total assets, the assets of the entities are not available to satisfy any of our other obligations. We also have arrangements in Germany, Italy, the Nordic countries, Brazil and Mexico in which third party financial institutions originate lease contracts directly with our customers. In these transactions, we sell and transfer title of the equipment to these financial institutions and have no continuing ownership rights in the leased equipment subsequent to its sale.

Accounts Receivable Funding Arrangement: In 2004, we completed a transaction with GE for a three-year \$400 revolving credit facility secured by our U.S. accounts receivable. This arrangement is being accounted for as a secured borrowing within our Consolidated Balance Sheets. Secured accounts receivables and related debt associated with this arrangement as of December 31, 2005 and 2004 were as follows (in millions):

| | <u>2005</u> | <u>2004</u> |
|----------------------------------|-------------|-------------|
| Secured accounts receivable, net | \$ 313 | \$ 354 |
| Secured debt | \$ 178 | \$ 200 |

Note 5—Inventories and Equipment on Operating Leases, Net

Inventories at December 31, 2005 and 2004 were as follows (in millions):

| | <u>2005</u> | <u>2004</u> |
|--------------------------|-----------------|-----------------|
| Finished goods | \$ 956 | \$ 895 |
| Work-in-process | 99 | 65 |
| Raw materials | 146 | 183 |
| Total Inventories | \$ 1,201 | \$ 1,143 |

Equipment on operating leases and similar arrangements consists of our equipment rented to customers and depreciated to estimated salvage value at the end of the lease term. The transfer of equipment from our inventories to equipment subject to an operating lease is presented in our Consolidated Statements of Cash Flows in the operating activities section as a non-cash adjustment. We recorded \$56, \$73 and \$78 in inventory write-down charges for the years ended December 31, 2005, 2004 and 2003, respectively. Equipment on operating leases and the related accumulated depreciation at December 31, 2005 and 2004 were as follows (in millions):

| | <u>2005</u> | <u>2004</u> |
|---|---------------|---------------|
| Equipment on operating leases | \$ 1,262 | \$ 1,649 |
| Less: Accumulated depreciation | (831) | (1,251) |
| Equipment on operating leases, net | \$ 431 | \$ 398 |

Depreciable lives generally vary from three to four years consistent with our planned and historical usage of the equipment subject to operating leases. Depreciation and obsolescence expense was \$205, \$210 and \$271 for the years ended December 31, 2005, 2004 and 2003, respectively. Our equipment operating lease terms vary, generally from 12 to 36 months. Scheduled minimum future rental revenues on operating leases with original terms of one year or longer are (in millions):

| <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>Thereafter</u> |
|-------------|-------------|-------------|-------------|-------------|-------------------|
| \$386 | \$212 | \$130 | \$60 | \$27 | \$ 4 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Total contingent rentals on operating leases, consisting principally of usage charges in excess of minimum contracted amounts, for the years ended December 31, 2005, 2004 and 2003 amounted to \$136, \$137 and \$235, respectively.

Note 6—Land, Buildings and Equipment, Net

Land, buildings and equipment, net at December 31, 2005 and 2004 were as follows (in millions):

| | <u>Estimated Useful Lives (Years)</u> | <u>2005</u> | <u>2004</u> |
|------------------------------------|---|-------------|-------------|
| Land | | \$ 51 | \$ 53 |
| Buildings and building equipment | 25 to 50 | 1,163 | 1,167 |
| Leasehold improvements | Varies | 326 | 313 |
| Plant machinery | 5 to 12 | 1,637 | 1,667 |
| Office furniture and equipment | 3 to 15 | 967 | 1,072 |
| Other | 4 to 20 | 76 | 74 |
| Construction in progress | | 83 | 96 |
| | | <hr/> | <hr/> |
| Subtotal | | 4,303 | 4,442 |
| Less: Accumulated depreciation | | (2,676) | (2,683) |
| | | <hr/> | <hr/> |
| Land, buildings and equipment, net | | \$ 1,627 | \$ 1,759 |
| | | <hr/> | <hr/> |

Depreciation expense was \$280, \$305 and \$299 for the years ended December 31, 2005, 2004 and 2003, respectively. We lease certain land, buildings and equipment, substantially all of which are accounted for as operating leases. Total rent expense under operating leases for the years ended December 31, 2005, 2004 and 2003 amounted to \$267, \$316, and \$287, respectively. Future minimum operating lease commitments that have remaining non-cancelable lease terms in excess of one year at December 31, 2005 were as follows:

| | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> | <u>Thereafter</u> |
|--|-------------|-------------|-------------|-------------|-------------|-------------------|
| | \$197 | \$165 | \$124 | \$102 | \$90 | \$ 197 |

In certain circumstances, we sublease space not currently required in operations. Future minimum sublease income under leases with non-cancelable terms in excess of one year amounted to \$14 at December 31, 2005.

We have an information technology contract with Electronic Data Systems Corp. (“EDS”) through June 30, 2009. Services to be provided under this contract include support of global mainframe system processing, application maintenance, desktop and helpdesk support, voice and data network management and server management. There are no minimum payments due EDS under the contract. Payments to EDS, which are primarily recorded in selling, administrative and general expenses, were \$305, \$328 and \$340 for the years ended December 31, 2005, 2004 and 2003, respectively.

In December 2003, STHQ Realty LLC was formed to finance the acquisition of the Company’s headquarters in Stamford, Connecticut. While the assets and liabilities of this special purpose entity are included in the Company’s Consolidated Financial Statements, STHQ Realty LLC is a bankruptcy remote separate legal entity. As a result, its assets of \$42 at December 31, 2005, are not available to satisfy the debts and other obligations of the Company.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 7—Investments in Affiliates, at Equity

Investments in corporate joint ventures and other companies in which we generally have a 20% to 50% ownership interest at December 31, 2005 and 2004 were as follows (in millions):

| | 2005 | 2004 |
|--|--------------|--------------|
| Fuji Xerox ⁽¹⁾ | \$725 | \$772 |
| Investment in subsidiary trusts issuing preferred securities | 42 | 39 |
| Other investments | 15 | 34 |
| Investments in affiliates, at equity | \$782 | \$845 |

⁽¹⁾ Fuji Xerox is headquartered in Tokyo and operates in Japan, China, Australia, New Zealand and other areas of the Pacific Rim. Our investment in Fuji Xerox of \$725 at December 31, 2005, differs from our implied 25% interest in the underlying net assets, or \$811, due primarily to our deferral of gains resulting from sales of assets by us to Fuji Xerox, partially offset by goodwill related to the Fuji Xerox investment established at the time we acquired our remaining 20% of Xerox Limited from The Rank Group plc. Such gains would only be recognized if Fuji Xerox sold a portion of the assets we previously sold to it or if we were to sell a portion of our current ownership interest in Fuji Xerox.

Our equity in net income of our unconsolidated affiliates for the three years ended December 31, 2005 was as follows:

| | 2005 | 2004 | 2003 |
|-------------------|-------------|--------------|-------------|
| Fuji Xerox | \$90 | \$134 | \$41 |
| Other investments | 8 | 17 | 17 |
| Total | \$98 | \$151 | \$58 |

Equity in net income of Fuji Xerox is affected by certain adjustments to reflect the deferral of profit associated with intercompany sales. These adjustments may result in recorded equity income that is different than that implied by our 25% ownership interest.

Equity income for 2004 included \$38 related to our share of a pension settlement gain recorded by Fuji Xerox subsequent to a transfer of a portion of their pension obligation to the Japanese government, in accordance with the Japan Welfare Pension Insurance Law.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Condensed financial data of Fuji Xerox for the three calendar years ended December 31, 2005 was as follows (in millions):

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|-----------------|-----------------|-----------------|
| Summary of Operations: | | | |
| Revenues | \$ 10,009 | \$ 9,450 | \$ 8,430 |
| Costs and expenses | 9,406 | 8,595 | 8,011 |
| Income before income taxes | 603 | 855 | 419 |
| Income taxes | 215 | 331 | 194 |
| Minorities' interests | 8 | 18 | 34 |
| Net income | <u>\$ 380</u> | <u>\$ 506</u> | <u>\$ 191</u> |
| Balance Sheet Data: | | | |
| <i>Assets:</i> | | | |
| Current assets | \$ 3,454 | \$ 3,613 | \$ 3,273 |
| Long-term assets | 4,168 | 4,606 | 4,766 |
| Total Assets | <u>\$ 7,622</u> | <u>\$ 8,219</u> | <u>\$ 8,039</u> |
| <i>Liabilities and Shareholders' Equity:</i> | | | |
| Current liabilities | \$ 2,991 | \$ 2,757 | \$ 2,594 |
| Long-term debt | 434 | 616 | 443 |
| Other long-term liabilities | 936 | 1,383 | 2,391 |
| Minorities' interests in equity of subsidiaries | 17 | 104 | 118 |
| Shareholders' equity | 3,244 | 3,359 | 2,493 |
| Total Liabilities and Shareholders' Equity | <u>\$ 7,622</u> | <u>\$ 8,219</u> | <u>\$ 8,039</u> |

In 2005, 2004 and 2003, we received dividends of \$38, \$50 and \$20, respectively, which were reflected as a reduction in our investment. Additionally, we have a technology agreement with Fuji Xerox whereby we receive royalty payments for their use of our Xerox brand trademark, as well as, rights to access their patent portfolio in exchange for access to our patent portfolio. In 2005, 2004 and 2003, we earned royalty revenues under this agreement of \$123, \$119 and \$110, respectively, which are included in Service, outsourcing and rental revenues in the Consolidated Statements of Income. We also have arrangements with Fuji Xerox whereby we purchase inventory from and sell inventory to Fuji Xerox. Pricing of the transactions under these arrangements is based upon negotiations conducted at arm's length. Certain of these inventory purchases and sales are the result of mutual research and development arrangements. Our purchase commitments with Fuji Xerox are in the normal course of business and typically have a lead time of three months. Purchases from and sales to Fuji Xerox for the three years ended December 31, 2005 were as follows (in millions):

| | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|-----------|-------------|-------------|-------------|
| Sales | \$ 163 | \$ 166 | \$ 149 |
| Purchases | 1,517 | 1,135 | 871 |

In addition to the payments described above, in 2005, 2004 and 2003, we paid Fuji Xerox \$28, \$27 and \$33, respectively, and Fuji Xerox paid us \$9 in each of the three years ended 2005, respectively, for unique research and development. As of December 31, 2005 and 2004, amounts due to Fuji Xerox were \$157 and \$155, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 8—Goodwill and Intangible Assets, Net

Goodwill:

The carrying amount of goodwill was \$1,671, \$1,848 and \$1,722, for the three years ended December 31, 2005. The only changes in goodwill for each of the three-years ended December 31, 2005 related to foreign currency translation adjustments of \$(177), \$132 and \$158, respectively, as well as a \$6 other charge that was incurred in the Other segment in 2004. The following table presents the carrying amount of goodwill, by operating segment, as of December 31, 2005 and 2004, respectively:

| | <u>Production</u> | <u>Office</u> | <u>DMO</u> | <u>Other</u> | <u>Total</u> |
|---------------------------------|-------------------|---------------|------------|--------------|--------------|
| Balance as of December 31, 2005 | \$ 745 | \$807 | \$— | \$119 | \$1,671 |
| Balance as of December 31, 2004 | 848 | 881 | — | 119 | 1,848 |

Intangible Assets, Net:

Intangible assets primarily relate to the Office operating segment. Intangible assets were comprised of the following as of December 31, 2005 and 2004 (in millions):

| | <u>Weighted Average Amortization Period</u> | <u>As of December 31, 2005:</u> | | | <u>As of December 31, 2004:</u> | | |
|-------------------------|---|--------------------------------------|-------------------------------------|-----------------------|--------------------------------------|-------------------------------------|-----------------------|
| | | <u>Gross Carrying Amount</u> | <u>Accumulated Amortization</u> | <u>Net Amount</u> | <u>Gross Carrying Amount</u> | <u>Accumulated Amortization</u> | <u>Net Amount</u> |
| Installed customer base | 17 years | \$ 226 | \$ 72 | \$ 154 | \$ 218 | \$ 58 | \$ 160 |
| Distribution network | 25 years | 123 | 30 | 93 | 123 | 25 | 98 |
| Existing technology | 7 years | 105 | 89 | 16 | 105 | 74 | 31 |
| Licensed technology | 7 years | 28 | 5 | 23 | 28 | 1 | 27 |
| Trademarks | 7 years | 23 | 20 | 3 | 23 | 15 | 8 |
| | | <u>\$ 505</u> | <u>\$ 216</u> | <u>\$ 289</u> | <u>\$ 497</u> | <u>\$ 173</u> | <u>\$ 324</u> |

Amortization expense related to intangible assets was \$42, \$38, and \$36 for the years ended December 31, 2005, 2004 and 2003, respectively, and is expected to approximate \$40 in 2006 and approximate \$22 annually from 2007 through 2010. Amortization expense is primarily recorded in Other expenses, net, with the exception of amortization expense associated with licensed technology, which is recorded in Cost of sales and Cost of service, outsourcing and rentals, as appropriate.

Note 9—Restructuring Programs

We have engaged in a series of restructuring programs related to downsizing our employee base, exiting certain activities, outsourcing certain internal functions and engaging in other actions designed to reduce our cost structure and improve productivity. Management continues to evaluate our business and, therefore, there may be supplemental provisions for new plan initiatives as well as changes in estimates to amounts previously recorded, as payments are made or actions are completed. Asset impairment charges were also incurred in connection with these restructuring actions for those assets made obsolete as a result of these programs.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The restructuring and asset impairment charges in the Consolidated Statements of Income totaled \$366, \$86 and \$176 in 2005, 2004 and 2003, respectively. Detailed information related to restructuring program activity during the three years ended December 31, 2005 is outlined below (in millions).

| Restructuring Activity | Ongoing Programs | | | | | Total |
|---|-----------------------------|------------------------------------|----------------------------------|---------------|--------------------------------|---------------|
| | Severance and Related Costs | Lease Cancellation and Other Costs | Asset Impairments ⁽¹⁾ | Total | Legacy Programs ⁽²⁾ | |
| Ending Balance December 31, 2002 | \$ 241 | \$ 45 | \$ — | \$ 286 | \$ 137 | \$ 423 |
| Restructuring Provision | 186 | 7 | — | 193 | 12 | 205 |
| Reversals of prior accruals | (15) | (1) | — | (16) | (13) | (29) |
| Net current year charges ⁽³⁾ | 171 | 6 | — | 177 | (1) | 176 |
| Charges against reserve and currency | (269) | (15) | — | (284) | (94) | (378) |
| Ending Balance December 31, 2003 | \$ 143 | \$ 36 | \$ — | \$ 179 | \$ 42 | \$ 221 |
| Restructuring Provision | 95 | 8 | 1 | 104 | 2 | 106 |
| Reversals of prior accruals | (11) | — | — | (11) | (9) | (20) |
| Net current year charges ⁽³⁾ | 84 | 8 | 1 | 93 | (7) | 86 |
| Charges against reserve and currency | (157) | (21) | (1) | (179) | (11) | (190) |
| Ending Balance December 31, 2004 | \$ 70 | \$ 23 | \$ — | \$ 93 | \$ 24 | \$ 117 |
| Restructuring Provision | 371 | 12 | 15 | 398 | 1 | 399 |
| Reversals of prior accruals | (21) | (6) | — | (27) | (6) | (33) |
| Net current year charges ⁽³⁾ | 350 | 6 | 15 | 371 | (5) | 366 |
| Charges against reserve and currency ⁽⁴⁾ | (203) | (10) | (15) | (228) | (19) | (247) |
| Ending Balance December 31, 2005 | \$ 217 | \$ 19 | \$ — | \$ 236 | \$ — | \$ 236 |

⁽¹⁾ 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. Accordingly, no reserve is ever maintained for asset impairments.

⁽²⁾ Legacy Programs, includes the runoff activity of several predecessor restructuring programs which were initiated between 2000 and 2001.

⁽³⁾ Represents amount recognized within the Consolidated Statements of Income for the years shown.

⁽⁴⁾ Charges in 2005 associated with Legacy Programs include the reclassification of \$9 to Other current and non-current liabilities reflecting the close out of these programs due to the immateriality of the remaining liability. The remaining liability primarily relates to our exit from facilities in Europe and the U.S., which are currently leased through 2009.

Additional details about our restructuring programs are as follows:

Reconciliation to Statements of Cash Flows

| | Years ended December 31, | | |
|---|-----------------------------|----------------|----------------|
| | 2005 | 2004 | 2003 |
| Charges to reserve, all programs | \$(247) | \$(190) | \$(378) |
| Pension curtailment, special termination benefits and settlements | — | 8 | 33 |
| Asset Impairments | 15 | 1 | 1 |
| Effects of foreign currency and other non-cash | 18 | (6) | (1) |
| Cash payments for restructurings | \$(214) | \$(187) | \$(345) |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Restructuring—Ongoing Programs: Beginning in the fourth quarter of 2002, we initiated a series of ongoing restructuring initiatives designed to leverage cost savings resulting from realized productivity improvements, realign and lower our overall cost structure and outsource certain internal functions. These initiatives primarily include severance actions and impact all major geographies and segments. During 2003, we provided \$177 for ongoing restructuring programs, net of reversals of \$16 related to changes in estimates for severance costs from previously recorded actions. The provision consisted of net charges of \$138 primarily related to the elimination of approximately 2,000 positions worldwide, \$33 for pension settlements and post-retirement medical benefit curtailments and \$6 for lease terminations. During 2004, we provided an additional \$93 for ongoing restructuring programs, net of reversals of \$11 related to changes in estimates for severance costs from previously recorded actions. The additional provision consisted of a net charge of \$76 related to the elimination of approximately 1,900 positions primarily in North America and Latin America, \$8 for pension settlements, \$8 for lease terminations and \$1 for asset impairments. During 2005, we provided an additional \$371 for ongoing restructuring programs, net of reversals of \$27 primarily related to changes in estimates in severance costs from previously recorded actions. The additional provision in 2005 consisted of a net charge of \$350 for severance costs, primarily related to the elimination of approximately 3,900 positions worldwide, a net charge of \$6 for lease terminations and \$15 for asset impairments. The initiatives in 2005 are focused on cost reductions in service, manufacturing and back office support operations primarily within the Office and Production segments. We expect to spend the majority of the restructuring balance as of December 31, 2005 in 2006.

The following tables summarize the total amount of costs expected to be incurred in connection with these restructuring programs and the cumulative amount incurred as of December 31, 2005:

Segment Reporting:

| (in millions) | Cumulative amount incurred as of December 31, 2004 | Net amount incurred for the year ended December 31, 2005 | Cumulative amount incurred as of December 31, 2005 | Total expected to be incurred * |
|-------------------------|--|--|--|---------------------------------|
| Production | \$ 255 | \$ 150 | \$ 405 | \$ 407 |
| Office | 198 | 175 | 373 | 374 |
| DMO | 97 | 22 | 119 | 123 |
| Other | 122 | 24 | 146 | 150 |
| Total Provisions | \$ 672 | \$ 371 | \$ 1,043 | \$ 1,054 |

* The total amount of \$1,054 represents the cumulative amount incurred through December 31, 2005 plus additional expected restructuring charges of approximately \$11 related to initiatives identified to date that have not yet been recognized in the Consolidated Financial Statements as well as expected interest accretion on the reserve.

Major Cost Reporting:

| (in millions) | Cumulative amount incurred as of December 31, 2004 | Amount incurred for the year ended December 31, 2005 | Cumulative amount incurred as of December 31, 2005 | Total expected to be incurred * |
|------------------------------------|--|--|--|---------------------------------|
| Severance and related costs | \$ 567 | \$ 350 | \$ 917 | \$ 922 |
| Lease cancellation and other costs | 59 | 6 | 65 | 70 |
| Asset impairments | 46 | 15 | 61 | 62 |
| Total Provisions | \$ 672 | \$ 371 | \$ 1,043 | \$ 1,054 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 10—Supplementary Financial Information

The components of other current assets and other current liabilities at December 31, 2005 and 2004 were as follows (in millions):

| | 2005 | 2004 |
|--|----------------|----------------|
| Other current assets | | |
| Deferred taxes | \$ 290 | \$ 289 |
| Restricted cash | 270 | 370 |
| Prepaid expenses | 133 | 142 |
| Financial derivative instruments | 28 | 125 |
| Other | 311 | 256 |
| Total Other current assets | \$1,032 | \$1,182 |
| Other current liabilities | | |
| Income taxes payable | \$ 84 | \$ 183 |
| Other taxes payable | 199 | 234 |
| Interest payable | 102 | 113 |
| Restructuring reserves | 212 | 93 |
| Financial derivative instruments | 12 | 46 |
| Product warranties | 20 | 22 |
| Liability to Xerox Capital LLC | 98 | — |
| Other | 625 | 618 |
| Total Other current liabilities | \$1,352 | \$1,309 |

The components of other long-term assets and other long-term liabilities at December 31, 2005 and 2004 were as follows (in millions):

| | 2005 | 2004 |
|---|----------------|----------------|
| Other long-term assets | | |
| Prepaid pension costs | \$ 829 | \$ 891 |
| Net investment in discontinued operations | 420 | 440 |
| Internal use software, net | 198 | 255 |
| Restricted cash | 176 | 160 |
| Financial derivative instruments | — | 19 |
| Debt issuance costs, net | 52 | 64 |
| Other | 246 | 244 |
| Total Other long-term assets | \$1,921 | \$2,073 |
| Other long-term liabilities | | |
| Deferred and other tax liabilities | \$ 771 | \$ 862 |
| Minorities' interests in equity of subsidiaries | 90 | 80 |
| Financial derivative instruments | 45 | 43 |
| Product warranties | 1 | 1 |
| Other | 388 | 329 |
| Total Other long-term liabilities | \$1,295 | \$1,315 |

Net investment in discontinued operations: Our net investment in discontinued operations is primarily related to the disengagement from our former insurance holding company, Talegen Holdings, Inc. ("Talegen"),

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

and consists of our net investment in Ridge Reinsurance Limited (“Ridge Re”) and a performance-based instrument relating to the 1997 sale of The Resolution Group (“TRG”).

Ridge Re: We provide aggregate excess of loss reinsurance coverage (the Reinsurance Agreement) to one of the former Talegen units, TRG, through Ridge Re, a wholly-owned subsidiary. The coverage limit for this remaining Reinsurance Agreement is \$578. We have guaranteed that Ridge Re will meet all its financial obligations under the remaining Reinsurance Agreement. Ridge Re maintains an investment portfolio in a trust that is required to provide security with respect to aggregate excess of loss reinsurance obligations under the remaining Reinsurance Agreement. At December 31, 2005 and 2004, the balance of the investments in the trust, consisting of U.S. government, government agency and high quality corporate bonds, was \$504 and \$544, respectively. Our remaining net investment in Ridge Re was \$83 and \$82 at December 31, 2005 and 2004, respectively. Based on Ridge Re’s current projections of investment returns and reinsurance payment obligations, we expect to fully recover our remaining investment. The projected reinsurance payments are based on actuarial estimates. We continue to evaluate potential strategies to transfer our obligations under the remaining reinsurance agreement, as well as the investments in the trust, to another insurance company in an effort to completely exit from this business.

Performance-Based Instrument: In connection with the 1997 sale of TRG, we received a \$462 performance-based instrument as partial consideration. Cash distributions are paid on the instrument, based on 72.5% of TRG’s available cash flow as defined in the sale agreement. For the years ended December 31, 2005 and 2004, we received cash distributions of \$20 and \$22, respectively. The recovery of this instrument is dependent upon the sufficiency of TRG’s available cash flows. Such cash flows are supported by TRG’s ultimate parent via a subscription agreement whereby the parent has agreed to purchase from TRG an established number of shares of this instrument each year through 2017. Based on current cash flow projections, we expect to fully recover the \$345 remaining balance of this instrument.

Liability to Xerox Capital LLC: Refer to Note 12 for further information.

Internal Use Software: Capitalized direct costs associated with developing, purchasing or otherwise acquiring software for internal use are amortized on a straight-line basis over the expected useful life of the software, beginning when the software is implemented. Useful lives of the software generally vary from 3 to 5 years. Amortization expense, including applicable impairment charges, was \$92, \$107, and \$116 for the years ended December 31, 2005, 2004 and 2003, respectively.

Note 11—Debt

Short-term borrowings at December 31, 2005 and 2004 were as follows (in millions):

| | 2005 | 2004 |
|--------------------------------------|-------------------|-------------------|
| | <u> </u> | <u> </u> |
| Current maturities of long-term debt | \$1,099 | \$3,038 |
| Notes payable | 40 | 36 |
| | <u> </u> | <u> </u> |
| Total | \$1,139 | \$3,074 |
| | <u> </u> | <u> </u> |

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Long-term debt, including debt secured by finance receivables at December 31, 2005 and 2004 was as follows (in millions):

| | <u>Weighted Average Interest Rates at December 31, 2005</u> | <u>2005</u> | <u>2004</u> |
|--|---|-----------------|-----------------|
| U.S. Operations | | | |
| Xerox Corporation | | | |
| Notes due 2006 ⁽¹⁾ | — % | \$ — | \$ 15 |
| Notes due 2007 ⁽¹⁾ | — | — | 25 |
| Notes due 2008 | 1.31 | 27 | 27 |
| Senior Notes due 2009 ⁽²⁾ | 9.75 | 620 | 627 |
| Euro Senior Notes due 2009 | 9.75 | 260 | 297 |
| Senior Notes due 2010 ⁽²⁾ | 7.13 | 688 | 704 |
| Notes due 2011 | 7.01 | 50 | 50 |
| Senior Notes due 2011 ⁽²⁾ | 6.88 | 752 | 758 |
| Senior Notes due 2013 ⁽²⁾ | 7.63 | 542 | 550 |
| Convertible Notes due 2014 | 9.00 | 19 | 19 |
| Notes due 2016 | 7.20 | 251 | 252 |
| 2003 Credit Facility due 2008 | 6.22 | 300 | 300 |
| Subtotal | | \$ 3,509 | \$ 3,624 |
| Xerox Credit Corporation | | | |
| Yen notes due 2005 | — | — | 970 |
| Yen notes due 2007 | 2.00 | 255 | 292 |
| Notes due 2008 ⁽¹⁾ | — | — | 25 |
| Notes due 2012 ⁽¹⁾ | 7.07 | 75 | 125 |
| Notes due 2013 | 6.50 | 60 | 59 |
| Notes due 2014 | 6.06 | 50 | 50 |
| Notes due 2018 | 7.00 | 25 | 25 |
| Subtotal | | 465 | 1,546 |
| Other U.S. Operations | | | |
| Borrowings secured by finance receivables ⁽³⁾ | 4.78 | 1,701 | 2,486 |
| Borrowings secured by other assets | 5.67 | 220 | 257 |
| Subtotal | | \$ 1,921 | \$ 2,743 |
| Total U.S. Operations | | \$ 5,895 | \$ 7,913 |
| International Operations | | | |
| Xerox Capital (Europe) plc: | | | |
| Japanese yen due 2005 | — | — | 97 |
| U.S. dollars due 2008 ⁽¹⁾ | — | — | 25 |
| Subtotal | | — | 122 |
| Other International Operations | | | |
| Pound Sterling secured borrowings due 2007-2008 ⁽³⁾ | 6.06 | 581 | 685 |
| Euro secured borrowings due 2005-2010 ⁽³⁾ | 3.73 | 526 | 839 |
| Canadian dollars secured borrowings due 2005-2007 ⁽³⁾ | 5.49 | 174 | 426 |
| Other debt due 2005-2010 | 5.86 | 62 | 103 |
| Subtotal | | 1,343 | 2,053 |
| Total International Operations | | 1,343 | 2,175 |
| Subtotal | | 7,238 | 10,088 |
| Less current maturities | | (1,099) | (3,038) |
| Total Long-term debt | | \$ 6,139 | \$ 7,050 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

- (1) Certain debt, instruments totaling \$140, were redeemed in 2005 prior to their scheduled maturities.
- (2) As of December 31, 2005, these senior notes were guaranteed by our wholly-owned subsidiary Xerox International Joint Marketing, Inc.
- (3) Refer to Note 4—Receivables, Net, for further discussion of borrowings secured by finance receivables, net.

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

| 2006 | 2007 | 2008 | 2009 | 2010 | Thereafter | Total |
|---------|---------|-------|-------|-------|------------|---------|
| \$1,099 | \$1,582 | \$978 | \$989 | \$727 | \$1,863 | \$7,238 |

Credit Facility: In June 2003, we entered into the 2003 Credit Facility. The 2003 Credit Facility consists of a fully drawn \$300 term loan and a \$700 revolving credit facility that includes a \$200 letter of credit sub-facility. This facility expires on September 30, 2008. As of December 31, 2005, the \$300 term loan and \$15 of letters of credit were outstanding and there were no outstanding borrowings under the revolving credit facility. Since inception of the 2003 Credit Facility in June 2003, there have been no borrowings under the revolving credit facility. Xerox is the only borrower of the term loan.

Subject to certain limits described in the following paragraph, the obligations under the 2003 Credit Facility are secured by liens on substantially all the assets of Xerox and each of our U.S. subsidiaries that have a consolidated net worth from time to time of \$100 or more (the "Material Subsidiaries"), excluding Xerox Credit Corporation ("XCC") and certain other finance subsidiaries, and are guaranteed by certain Material Subsidiaries. At December 31, 2005, Xerox is the only borrower under the 2003 Credit Facility.

Under the terms of certain of our outstanding public bond indentures, the amount of obligations under the 2003 Credit Facility that can be (1) secured by assets (the "Restricted Assets") of (a) Xerox and (b) our non-financing subsidiaries that have a consolidated net worth of at least \$100, without (2) triggering a requirement to also secure those indentures, is limited to the excess of (x) 20% of our consolidated net worth (as defined in the public bond indentures) over (y) the outstanding amount of certain other debt that is secured by the Restricted Assets. Accordingly, the amount of 2003 Credit Facility debt secured by the Restricted Assets will vary from time to time with changes in our consolidated net worth. The amount of security provided under this formula accrues ratably to the benefit of both the term loan and revolving loans under the 2003 Credit Facility.

The term loan and the revolving loans bear interest at LIBOR plus a spread that varies between 1.75% and 3.00% or, at our election, at a base rate plus a spread that depends on the then-current Leverage Ratio, as defined, in the 2003 Credit Facility. The interest rate on the debt as of December 31, 2005 was 6.22%.

The 2003 Credit Facility contains affirmative and negative covenants as well as financial maintenance covenants. Subject to certain exceptions, we cannot pay cash dividends on our common stock during the facility term, although we can pay cash dividends on our preferred stock, provided there is then no event of default. Among defaults customary for facilities of this type, defaults on our other debt, bankruptcy of certain of our legal entities, or a change in control of Xerox Corporation, would all constitute events of default. At December 31, 2005, we were in compliance with the covenants of the 2003 Credit Facility and we expect to remain in compliance for at least the next twelve months.

The senior notes also contain negative covenants (but no financial maintenance covenants) similar to those contained in the 2003 Credit Facility. However, they generally provide us with more flexibility than the 2003 Credit Facility covenants, except that payment of cash dividends on the Series C Mandatory Convertible Preferred Stock is subject to the conditions that there is then no default under the senior notes, that the fixed charge coverage ratio (as defined) is greater than 2.25 to 1.00, and that the amount of the cash dividend does not

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

exceed the then amount available under the restricted payments basket (as defined). The senior notes are guaranteed by our wholly-owned subsidiary Xerox International Joint Marketing, Inc.

Debt repayments and maturities: During 2005, we repaid \$140 of public unsecured debt prior to its scheduled maturity in addition to \$1,020 in scheduled public debt maturities.

Guarantees: At December 31, 2005, we have guaranteed \$17 of indebtedness of our foreign subsidiaries. This debt is included in our Consolidated Balance Sheet as of such date. In addition, as of December 31, 2005, \$32 of letters of credit have been issued in connection with insurance guarantees.

Interest: Interest paid on our short-term debt, long-term debt and liabilities to subsidiary trusts issuing preferred securities amounted to \$555, \$710 and \$867 for the years ended December 31, 2005, 2004 and 2003, respectively.

Interest expense and interest income for the three years ended December 31, 2005 was as follows (in millions):

| | Year Ended December 31, | | |
|---------------------------------|-------------------------|---------|---------|
| | 2005 | 2004 | 2003 |
| Interest expense ⁽¹⁾ | \$ 557 | \$ 708 | \$ 884 |
| Interest income ⁽²⁾ | (1,013) | (1,009) | (1,062) |

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

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

Equipment financing interest is determined based on an estimated cost of funds applied against an estimated level of debt required to support our financed receivables. The estimated cost of funds is primarily based on our secured borrowing rates. The estimated level of debt is based on an assumed 7 to 1 leverage ratio of debt/equity as compared to our average finance receivables. This methodology has been consistently applied for all periods presented.

A summary of the Net cash payments on other debt as shown on the Consolidated Statements of Cash Flows for the three years ended December 31, 2005 follows (in millions):

| | 2005 | 2004 | 2003 |
|--|------------------|------------------|------------------|
| Cash proceeds (payments) on notes payable, net | \$ 4 | \$ (6) | \$ 22 |
| Net cash proceeds from issuance of long-term debt ⁽¹⁾ | 50 | 974 | 1,580 |
| Cash payments on long-term debt | (1,241) | (2,390) | (5,646) |
| Total Net cash payments on other debt | \$(1,187) | \$(1,422) | \$(4,044) |

⁽¹⁾ Includes payment of debt issuance costs.

Note 12—Liability to Subsidiary Trusts Issuing Preferred Securities

The Liability to Subsidiary Trusts Issuing Preferred Securities included in our Consolidated Balance Sheets reflects the obligations to our subsidiaries that have issued preferred securities. These subsidiaries are not

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

consolidated in our financial statements because we are not the primary beneficiary of the trusts. As of December 31, 2005 and 2004, the components of our liabilities to the trusts were as follows (in millions):

| | 2005 | 2004 |
|----------------------------------|--------------|--------------|
| Trust I | \$626 | \$629 |
| Xerox Capital LLC ⁽¹⁾ | 98 | 88 |
| Total | \$724 | \$717 |

⁽¹⁾ Classified in Other current liabilities in the December 31, 2005 Consolidated Balance Sheet.

Trust I: In 1997, Xerox Capital Trust I (“Trust I”) issued 650 thousand of 8.0% preferred securities (the “Preferred Securities”) to investors for \$644 (\$650 liquidation value) and 20,103 shares of common securities to us for \$20. With the proceeds from these securities, Trust I purchased \$670 principal amount of 8.0% Junior Subordinated Debentures due 2027 of the Company (“the Debentures”). The Debentures represent all of the assets of Trust I. On a consolidated basis, we received net proceeds of \$637 which was net of fees and discounts of \$13. Interest expense, together with the amortization of debt issuance costs and discounts, amounted to \$54, \$54 and \$52 in 2005, 2004 and 2003, respectively. We have guaranteed (the “Guarantee”), on a subordinated basis, distributions and other payments due on the Preferred Securities. The Guarantee and our obligations under the Debentures and in the indenture pursuant to which the Debentures were issued and our obligations under the Amended and Restated Declaration of Trust governing the trust, taken together, provide a full and unconditional guarantee of amounts due on the Preferred Securities. The Preferred Securities accrue and pay cash distributions semiannually at a rate of 8% per year of the stated liquidation amount of one thousand dollars per Preferred Security. The Preferred Securities are mandatorily redeemable upon the maturity of the Debentures on February 1, 2027, or earlier to the extent of any redemption by us of any Debentures. The redemption price in either such case will be one thousand dollars per share plus accrued and unpaid distributions to the date fixed for redemption.

Xerox Capital LLC: In 1996, Xerox Capital LLC, issued 2 million deferred preferred shares for Canadian (Cdn.) \$50 (\$42) to investors and all of its common shares to us. The total proceeds of Cdn. \$63 (\$52) were loaned to us. The deferred preferred shares are mandatorily redeemable on February 28, 2006 for Cdn. \$90 (equivalent to \$77 at December 31, 2005). Our liability to the subsidiary trust at December 31, 2005 of \$98 includes the redeemable amount of deferred preferred shares of \$77 as well as our liability to the deconsolidated trust of \$21. This liability has been reclassified on the December 31, 2005 Consolidated Balance Sheet from a long-term liability to current liabilities due to the redemption date of February 28, 2006.

Note 13—Financial Instruments

We are exposed to market risk from changes in foreign currency exchange rates and interest rates, which could affect operating results, financial position and cash flows. We manage our exposure to these market risks through our regular operating and financing activities and, when appropriate, through the use of derivative financial instruments. These derivative financial instruments are utilized to hedge economic exposures as well as reduce earnings and cash flow volatility resulting from shifts in market rates. As permitted, certain of these derivative contracts have been designated for hedge accounting treatment under SFAS No. 133. However, for certain of these instruments we do not apply hedge accounting treatment and, accordingly, our results of operations are exposed to some level of volatility. The level of volatility will vary with the type and amount of derivative hedges outstanding, as well as fluctuations in the currency and interest rate market during the period.

We enter into limited types of derivative contracts, including interest rate and cross currency interest rate swap agreements, foreign currency spot, forward and swap contracts and purchased foreign currency options to

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

manage interest rate and foreign currency exposures. Our primary foreign currency market exposures include the Japanese yen, Euro, British pound sterling, Canadian dollar and Brazilian real. The fair market values of all our derivative contracts change with fluctuations in interest rates and/or currency rates and are designed so that any changes in their values are offset by changes in the values of the underlying exposures. Derivative financial instruments are held solely as risk management tools and not for trading or speculative purposes.

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

Some of our derivative and other material contracts at December 31, 2005 require us to post cash collateral or maintain minimum cash balances in escrow. These cash amounts are reported in our Consolidated Balance Sheets within Other current assets or Other long-term assets, depending on when the cash will be contractually released, as presented in Note 1 to the Consolidated Financial Statements.

Interest Rate Risk Management: We use interest rate swap agreements to manage our interest rate exposure and to achieve a desired proportion of variable and fixed rate debt. These derivatives may be designated as fair value hedges or cash flow hedges depending on the nature of the risk being hedged. Virtually all customer-financing assets earn fixed rates of interest and a significant portion of those assets have been matched to secured borrowings through third party funding arrangements which generally bear fixed rates of interest. These borrowings are secured by customer-financing assets and are designed to mature as we collect principal payments on the financing assets which secure them. The interest rates on a significant portion of those loans are fixed. As a result, these funding arrangements create natural match funding of the financing assets to the related debt.

At December 31, 2005 and 2004, we had outstanding single currency interest rate swap agreements with aggregate notional amounts of \$2.1 billion and \$2.8 billion, respectively. The net liability fair values at December 31, 2005 and 2004 were \$40 and \$37, respectively.

Fair Value Hedges: As of December 31, 2005 and 2004, pay variable/receive fixed interest rate swaps with notional amounts of \$1.8 billion and \$2.4 billion were designated and accounted for as fair value hedges. The swaps were structured to hedge the fair value of related debt by converting them from fixed rate instruments to variable rate instruments. No ineffective portion was recorded to earnings during 2005 or 2004. The following is a summary of our fair value hedges at December 31, 2005:

| <u>Debt Instrument</u> | <u>Year first Designated</u> | <u>Notional Amount</u> | <u>Net Liability Fair Value</u> | <u>Weighted-average Interest Rate paid</u> | <u>Interest Rate received</u> | <u>Basis</u> | <u>Maturity</u> |
|------------------------------|------------------------------|------------------------|---------------------------------|--|-------------------------------|--------------|-----------------|
| Senior Notes due 2010 | 2003/2005 | \$ 550 | \$ (9) | 7.39% | 7.13% | Libor | 2010 |
| Senior Notes due 2013 | 2003 | 250 | (3) | 7.40% | 7.63% | Libor | 2013 |
| Notes due 2016 | 2004 | 250 | (3) | 7.17% | 7.20% | Libor | 2016 |
| Senior Notes due 2011 | 2004 | 250 | (6) | 7.26% | 6.88% | Libor | 2011 |
| Liability to Capital Trust I | 2005 | 450 | (18) | 6.34% | 8.00% | Libor | 2027 |
| Total | | \$1,750 | \$ (39) | | | | |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Cash Flow Hedges: During 2005, pay fixed/receive variable interest rate swaps with notional amounts of £200 million (\$345) and a net liability fair value of \$(1), associated with the Xerox Finance Limited GE Capital borrowing were designated and accounted for as cash flow hedges. The swaps were structured to hedge the LIBOR interest rate of the debt by converting it from a variable rate instrument to a fixed rate instrument. No ineffective portion was recorded to earnings during 2005.

Terminated Swaps: During 2005, we terminated interest rate swaps with a notional value of \$1.3 billion and a net fair liability value of \$29 which had previously been designated as fair value hedges of certain indebtedness. The fair value adjustment to these debt instruments will be amortized to interest expense over the remaining term of the notes. During 2004, we terminated interest rate swaps with a notional value of \$1.1 billion and a net fair asset value of \$68. Interest rate swaps with a notional value of \$600 and a net fair asset value of \$55 had previously been designated as fair value hedges against the senior notes due 2009. In 2005 and 2004, the amortization of these fair value adjustments reduced interest expense by \$11 and \$9, respectively. The remaining derivatives terminated in 2005 and 2004 had not been previously designated as hedges and accordingly those terminations had no impact on earnings as they were being marked to market through earnings each period.

Foreign Exchange Risk Management: We may use certain derivative instruments to manage the exposures associated with the foreign currency exchange risks discussed below.

Issuance of foreign currency denominated debt

- We enter into cross-currency interest rate swap agreements to swap the proceeds and related interest payments with a counterparty. In return, we receive and effectively denominate the debt in local functional currencies.
- We utilize forward exchange contracts to hedge the currency exposure for interest payments on foreign currency denominated debt.
- These derivatives may be designated as fair value hedges or cash flow hedges depending on the nature of the risk being hedged.

Foreign currency denominated assets and liabilities

- We generally utilize forward foreign exchange contracts and purchased option contracts to hedge these exposures.
- Changes in the value of these currency derivatives are recorded in earnings together with the offsetting foreign exchange gains and losses on the underlying assets and liabilities.

Purchases of foreign-sourced inventory

- We generally utilize forward foreign exchange contracts and purchased option contracts to hedge these anticipated transactions. These contracts generally mature in six months or less.
- Although these contracts are intended to economically hedge foreign currency risks to the extent possible, the differences between the contract terms of our derivatives and the underlying forecasted exposures reduce our ability to obtain hedge accounting. Accordingly, changes in value for these derivatives are recorded directly through earnings.

During 2005, 2004, and 2003, we recorded net currency losses of \$5, \$73 and \$11, respectively. Net currency losses primarily result from the mark-to-market of foreign exchange contracts utilized to hedge foreign

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

currency denominated assets and liabilities, the re-measurement of foreign currency-denominated assets and liabilities and the mark-to-market impact of economic hedges of anticipated transactions for which we do not apply cash flow hedge accounting treatment.

At December 31, 2005, we had outstanding forward exchange and purchased option contracts with gross notional values of \$2,927. The following is a summary of the primary hedging positions and corresponding fair values held as of December 31, 2005:

| <u>Currency Hedged (Buy/Sell) (in millions)</u> | <u>Gross Notional Value</u> | <u>Fair Value Asset (Liability)</u> |
|---|-------------------------------------|---|
| U.S. Dollar/Euro | \$ 634 | \$ 10 |
| Japanese Yen/U.S. Dollar | 467 | 2 |
| Euro/U.S. Dollar | 225 | (2) |
| Canadian Dollar/Euro | 205 | (1) |
| Euro/U.K. Pound Sterling | 199 | 2 |
| Canadian Dollar/U.S. Dollar | 166 | — |
| Swedish Kronor/Euro | 147 | 1 |
| U.S. Dollar/U.K. Pound Sterling | 129 | 3 |
| U.S. Dollar/Canadian Dollar | 118 | — |
| Euro/Canadian Dollar | 98 | 1 |
| U.K. Pound Sterling/Euro | 93 | (1) |
| Swiss Franc/Euro | 93 | (1) |
| All Other | 353 | 2 |
| Total | \$2,927 | \$ 16 |

At December 31, 2005 and 2004, we had outstanding cross-currency interest rate swap agreements with aggregate notional amounts of \$127 and \$597, respectively. The net (liability) asset fair values at December 31, 2005 and 2004 were \$(5) and \$44, respectively. There was only one contract outstanding at December 31, 2005 and Japanese Yen was the currency hedged.

Cash Flow Hedges: As of December 31, 2005, cross currency swaps with a notional amount of \$127 were used to hedge the currency exposure for interest payments and principal on half of our Japanese Yen denominated debt of ¥30 billion (\$255). In addition, forward currency contracts were used to hedge the currency exposure for interest payments on the remaining debt. These combined strategies converted the hedged cash flows to U.S. dollar denominated payments and qualified for cash flow hedge accounting.

During 2004, certain forward contracts were used to hedge the interest payments on Euro denominated debt of \$377. The derivatives were designated and accounted for as cash flow hedges.

No amount of ineffectiveness was recorded in the Consolidated Statements of Income during 2005 or 2004 for our designated cash flow hedges and all components of each derivative's gain or loss was included in the assessment of hedge effectiveness.

Accumulated Other Comprehensive Loss ("AOCL"): During 2005, a \$32 after-tax decrease in the fair value of cash flow hedges was recorded in AOCL while an after-tax amount of \$30 was transferred to earnings as a result of scheduled payments and receipts on our cash flow hedges. This resulted in an ending gain position relating to the cash flow hedges in AOCL of \$1 as of December 31, 2005.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

During 2004, a \$16 after-tax increase in the fair value of cash flow hedges was recorded in AOCL while an after-tax amount of \$(14) was transferred to earnings as a result of scheduled payments and receipts on our cash flow hedges. This resulted in an ending gain position relating to the cash flow hedges in AOCL of \$3 as of December 31, 2004.

Fair Value of Financial Instruments: The estimated fair values of our financial instruments at December 31, 2005 and 2004 were as follows:

| (in millions) | 2005 | | 2004 | |
|--|-----------------|------------|-----------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Cash and cash equivalents | \$ 1,322 | \$1,322 | \$ 3,218 | \$3,218 |
| Short-term investments | 244 | 244 | — | — |
| Accounts receivable, net | 2,037 | 2,037 | 2,076 | 2,076 |
| Short-term debt | 1,139 | 1,134 | 3,074 | 3,093 |
| Long-term debt | 6,139 | 6,312 | 7,050 | 7,442 |
| Short-term liabilities to trusts issuing preferred securities ⁽¹⁾ | 98 | 96 | — | — |
| Long-term liabilities to trusts issuing preferred securities | 626 | 642 | 717 | 738 |

⁽¹⁾ Recognized as a component of Other current liabilities within the Consolidated Balance Sheets.

The fair value amounts for Cash and cash equivalents and Accounts receivable, net approximate carrying amounts due to the short maturities of these instruments. The fair value of Short and Long-term debt, as well as Liabilities to subsidiary trusts issuing preferred securities, was estimated based on quoted market prices for publicly traded securities or on the current rates offered to us for debt of similar maturities. The difference between the fair value and the carrying value represents the theoretical net premium or discount we would pay or receive to retire all debt at such date.

Note 14—Employee Benefit Plans

We sponsor numerous pension and other post-retirement benefit plans, primarily retiree health, in our U.S. and international operations. September 30 is the measurement date for most of our European plans and December 31 is the measurement date for all of our other post-retirement benefit plans, including all of our domestic plans. Information regarding our benefit plans is presented below (in millions):

| | Pension Benefits | | Other Benefits | |
|-------------------------------------|------------------|----------|----------------|---------|
| | 2005 | 2004 | 2005 | 2004 |
| Change in Benefit Obligation | | | | |
| Benefit obligation, January 1 | \$10,028 | \$ 8,971 | \$1,662 | \$1,579 |
| Service cost | 234 | 222 | 19 | 22 |
| Interest cost | 581 | 660 | 90 | 89 |
| Plan participants' contributions | 11 | 14 | 15 | 18 |
| Plan amendments | 30 | 232 | 44 | — |
| Actuarial loss (gain) | 527 | 272 | (54) | 70 |
| Currency exchange rate changes | (486) | 356 | 4 | 6 |
| Curtailments | (5) | (2) | — | — |
| Special termination benefits | — | 2 | — | — |
| Benefits paid/settlements | (618) | (699) | (127) | (122) |
| Benefit obligation, December 31 | \$10,302 | \$10,028 | \$1,653 | \$1,662 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

| | Pension Benefits | | Other Benefits | |
|--|------------------|-----------|----------------|-----------|
| | 2005 | 2004 | 2005 | 2004 |
| Change in Plan Assets | | | | |
| Fair value of plan assets, January 1 | \$ 8,110 | \$ 7,301 | \$ — | \$ — |
| Actual return on plan assets | 933 | 772 | — | — |
| Employer contribution | 388 | 409 | 112 | 104 |
| Plan participants' contributions | 11 | 14 | 15 | 18 |
| Currency exchange rate changes | (418) | 311 | — | — |
| Transfers/divestitures | 38 | 2 | — | — |
| Benefits paid/settlements | (618) | (699) | (127) | (122) |
| Fair value of plan assets, December 31 | \$ 8,444 | \$ 8,110 | \$ — | \$ — |
| Funded status (including under-funded and non-funded plans) | \$(1,858) | \$(1,918) | \$(1,653) | \$(1,662) |
| Unamortized transition (assets) obligations | 3 | (1) | — | — |
| Unrecognized prior service cost | (28) | (23) | (45) | (112) |
| Unrecognized net actuarial loss | 1,918 | 1,993 | 410 | 494 |
| Net amount recognized | \$ 35 | \$ 51 | \$(1,288) | \$(1,280) |
| Amounts recognized in the Consolidated Balance Sheets consist of: | | | | |
| Prepaid benefit cost | \$ 833 | \$ 897 | \$ — | \$ — |
| Accrued benefit liability | (1,081) | (1,092) | (1,288) | (1,280) |
| Intangible asset | 9 | 4 | — | — |
| Minimum pension liability included in AOCL | 274 | 242 | — | — |
| Net amount recognized | \$ 35 | \$ 51 | \$(1,288) | \$(1,280) |

| | Pension Benefits | | Other Benefits | |
|---|------------------|---------|----------------|------|
| | 2005 | 2004 | 2005 | 2004 |
| Change in minimum liability included in AOCL | \$ 32 | \$ (20) | | |

Information for benefit plans that are under-funded or non-funded on a Projected Benefit Obligation basis is presented below (in millions):

| | Pension Benefits | | Other Benefits | |
|--|------------------|---------|----------------|---------|
| | 2005 | 2004 | 2005 | 2004 |
| Aggregate projected benefit obligation | \$10,240 | \$9,959 | \$1,653 | \$1,662 |
| Aggregate fair value of plan assets | 8,364 | 8,019 | — | — |

The accumulated benefit obligation for all defined benefit pension plans was \$9,248 and \$8,966 at December 31, 2005 and 2004, respectively.

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

| | 2005 | 2004 |
|--|---------|---------|
| Aggregate projected benefit obligation | \$6,601 | \$6,464 |
| Aggregate accumulated benefit obligation | 5,826 | 5,727 |
| Aggregate fair value of plan assets | 4,845 | 4,668 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Our domestic retirement defined benefit plans provide employees a benefit, depending on eligibility, at the greater of (i) the benefit calculated under a highest average pay and years of service formula, (ii) the benefit calculated under a formula that provides for the accumulation of salary and interest credits during an employee's work life, or (iii) the individual account balance from the Company's prior defined contribution plan (Transitional Retirement Account or TRA).

| | Pension Benefits | | | Other Benefits | | |
|--|------------------|---------------|---------------|----------------|---------------|---------------|
| | 2005 | 2004 | 2003 | 2005 | 2004 | 2003 |
| Components of Net Periodic Benefit Cost (in millions) | | | | | | |
| Defined benefit plans | | | | | | |
| Service cost | \$ 234 | \$ 222 | \$ 197 | \$ 20 | \$ 22 | \$ 26 |
| Interest cost ⁽¹⁾ | 581 | 660 | 934 | 90 | 89 | 91 |
| Expected return on plan assets ⁽²⁾ | (622) | (678) | (940) | — | — | — |
| Recognized net actuarial loss | 98 | 104 | 53 | 31 | 24 | 13 |
| Amortization of prior service cost | (3) | (1) | — | (24) | (24) | (18) |
| Recognized net transition (asset) obligation | 1 | (1) | — | — | — | — |
| Recognized curtailment/settlement loss (gain) | 54 | 44 | 120 | — | — | (4) |
| Net periodic benefit cost | 343 | 350 | 364 | 117 | 111 | 108 |
| Special termination benefits | — | 2 | — | — | — | — |
| Defined contribution plans | 71 | 69 | 62 | — | — | — |
| Total | \$ 414 | \$ 421 | \$ 426 | \$ 117 | \$ 111 | \$ 108 |

⁽¹⁾ Interest cost includes interest expense on non-TRA obligations of \$328, \$312, and \$273 and interest expense directly allocated to TRA participant accounts of \$253, \$348, and \$661 for the years ended December 31, 2005, 2004 and 2003, respectively.

⁽²⁾ Expected return on plan assets includes expected investment income on non-TRA assets of \$369, \$330, and \$279 and actual investment income on TRA assets of \$253, \$348, and \$661 for the years ended December 31, 2005, 2004 and 2003, respectively.

Settlement/curtailment losses and special termination benefits were incurred as a result of our restructuring programs in all periods presented. Refer to Note 9 for that portion included in restructuring charges for each of the three years ended December 31, 2005.

Pension plan assets consist of both defined benefit plan assets and assets legally restricted to the TRA accounts. The combined investment results for these plans, along with the results for our other defined benefit plans, are shown above in the actual return on plan assets caption. To the extent that investment results relate to TRA, such results are charged directly to these accounts as a component of interest cost.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Plan Assets

Current Allocation and Investment Targets: As of the 2005 and 2004 measurement dates, the global pension plan assets were \$8.4 billion and \$8.1 billion, respectively. These assets were invested among several asset classes. The amount and percentage of assets invested in each asset class as of each of these dates is shown below:

| (in millions) | Asset Value | | Percentage of Total Assets | |
|----------------------------------|----------------|----------------|----------------------------|-------------|
| | 2005 | 2004 | 2005 | 2004 |
| Asset Category | | | | |
| Equity securities ⁽¹⁾ | \$4,830 | \$4,753 | 57% | 58% |
| Debt securities ⁽¹⁾ | 2,723 | 2,592 | 32 | 32 |
| Real estate | 504 | 464 | 6 | 6 |
| Other | 387 | 301 | 5 | 4 |
| Total | \$8,444 | \$8,110 | 100% | 100% |

⁽¹⁾ None of the investments include debt or equity securities of Xerox Corporation.

Investment Strategy: The target asset allocations for our worldwide plans for 2005 were 54% invested in equities, 39% invested in fixed income, 6% invested in real estate and 1% invested in Other. The target asset allocations for our worldwide plans for 2004 were 59% invested in equities, 34% invested in fixed income, 6% invested in real estate and 1% invested in Other. The pension assets outside of the U.S. as of the 2005 and 2004 measurement dates were \$4.3 billion and \$4.1 billion, respectively.

The target asset allocations for the U.S. pension plan include 64% invested in equities, 30% in fixed income, 5% in real estate and 1% in other investments. Cash investments are sufficient to handle expected cash requirements for benefit payments and will vary throughout the year. The expected long-term rate of return on the U.S. pension assets is 8.75%.

We employ a total return investment approach whereby a mix of equities and fixed income investments are used to maximize the long-term return of plan assets for a prudent level of risk. The intent of this strategy is to minimize plan expenses by exceeding the interest growth in long-term plan liabilities. Risk tolerance is established through careful consideration of plan liabilities, plan funded status, and corporate financial condition. This consideration involves the use of long-term measures that address both return and risk. The investment portfolio contains a diversified blend of equity and fixed income investments. Furthermore, equity investments are diversified across U.S and non-U.S. stocks as well as growth, value, and small and large capitalizations. Other assets such as real estate, private equity, and hedge funds are used to improve portfolio diversification. Derivatives may be used to hedge market exposure in an efficient and timely manner; however, derivatives may not be used to leverage the portfolio beyond the market value of the underlying investments. Investment risks and returns are measured and monitored on an ongoing basis through annual liability measurements and quarterly investment portfolio reviews.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Contributions: We expect to contribute \$106 to our worldwide pension plans and \$130 to our other post retirement benefit plans in 2006. The 2006 expected pension plan contributions do not include any planned contribution for the domestic tax qualified plans because there are no required contributions to these plans for the 2006 fiscal year. However, once the January 1, 2006 actuarial valuations and projected results as of the end of the 2006 measurement year are available, the desirability of additional contributions will be assessed. Based on these results, we may voluntarily decide to contribute to these plans, even though no contribution is required. In prior years, after making this assessment, we decided to contribute \$230 and \$210 in April 2005 and April 2004, respectively, to our domestic tax qualified plans in order to make them 100% funded on a current liability basis under the ERISA funding rules.

Estimated Future Benefit Payments: The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in millions):

| | <u>Pension Benefits</u> | <u>Other Benefits</u> |
|-----------------|-------------------------|-----------------------|
| 2006 | \$ 731 | \$ 130 |
| 2007 | 580 | 133 |
| 2008 | 531 | 135 |
| 2009 | 591 | 134 |
| 2010 | 667 | 129 |
| Years 2011-2015 | 3,437 | 640 |

Assumptions

| | <u>Pension Benefits</u> | | | <u>Other Benefits</u> | | |
|---|-------------------------|-------------|-------------|-----------------------|-------------|-------------|
| | <u>2005</u> | <u>2004</u> | <u>2003</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> |
| Weighted-average assumptions used to determine benefit obligations at the plan measurement dates | | | | | | |
| Discount rate | 5.2% | 5.6% | 5.8% | 5.6% | 5.8% | 6.0% |
| Rate of compensation increase | 3.9 | 4.0 | 3.9 | — (1) | — (1) | — (1) |

(1) Rate of compensation increase is not applicable to our other benefits as compensation levels do not impact earned benefits.

| | <u>Pension Benefits</u> | | | | <u>Other Benefits</u> | | | |
|---|-------------------------|-------------|-------------|-------------|-----------------------|-------------|-------------|-------------|
| | <u>2006</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> | <u>2006</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> |
| Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31 | | | | | | | | |
| Discount rate | 5.2% | 5.6% | 5.8% | 6.2% | 5.6% | 5.8% | 6.0% | 6.5% |
| Expected return on plan assets | 7.8 | 8.0 | 8.1 | 8.3 | — (1) | — (1) | — (1) | — (1) |
| Rate of compensation increase | 3.9 | 4.0 | 3.9 | 3.9 | — (2) | — (2) | — (2) | — (2) |

(1) Expected return on plan assets is not applicable to our other benefits as these plans are unfunded.

(2) Rate of compensation increase is not applicable to our other benefits as compensation levels do not impact earned benefits.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Assumed health care cost trend rates at December 31

| | 2005 | 2004 |
|---|-------|-------|
| Health care cost trend rate assumed for next year | 10.9% | 11.9% |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | 5.2% | 5.2% |
| Year that the rate reaches the ultimate trend rate | 2011 | 2011 |

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

| | One- percentage- point increase | One- percentage- point decrease |
|--|--|--|
| Effect on total service and interest cost components | \$ 5 | \$ (4) |
| Effect on post-retirement benefit obligation | 73 | (64) |

Berger Litigation: Our Retirement Income Guarantee Plan (“RIGP”) represents the primary U.S. pension plan for salaried employees. In 2003, we recorded a \$239 provision for litigation relating to the court approved settlement of the Berger v. RIGP litigation. The settlement is being paid from RIGP assets and has been reflected in our 2005 and 2004 actuarial valuations. The obligation related to this settlement has been included in plan amendments in the change in the benefit obligation noted above.

Employee Stock Ownership Plan (“ESOP”) Benefits: In 1989, we established an ESOP and sold to it 10 million shares of our Series B Convertible Preferred Stock (the “Convertible Preferred”) for a purchase price of \$785. Each Convertible Preferred share was convertible into 6 shares of our common stock. The Convertible Preferred had a \$1 par value and a guaranteed minimum value of \$78.25 per share and accrued annual dividends of \$6.25 per share, which were cumulative if earned. In May 2004, all 6.2 million of our Convertible Preferred shares were redeemed for 37 million common shares in accordance with the original conversion provisions of the Convertible Preferred shares. The redemption was accounted for through a transfer of \$483 from preferred stock to common stock and additional paid-in-capital. Dividends were paid through the redemption date. The redemption had no impact on net income or diluted earnings per share (“EPS”) as such shares were previously included in our EPS computation in accordance with the “if converted” methodology.

Information relating to the ESOP trust for each of the two years ended December 31, 2004 was as follows (in millions):

| | 2004 | 2003 |
|---|-------|------|
| Dividends declared on Convertible Preferred Stock | \$ 15 | \$41 |
| Cash contribution to the ESOP | — | 14 |
| Compensation expense | — | 8 |

Note 15—Income and Other Taxes

Income (loss) before income taxes for the three years ended December 31, 2005 were as follows (in millions):

| | 2005 | 2004 | 2003 |
|----------------------------|-------|-------|---------|
| Domestic income (loss) | \$386 | \$426 | \$(299) |
| Foreign income | 444 | 539 | 735 |
| Income before income taxes | \$830 | \$965 | \$ 436 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Provisions (benefits) for income taxes for the three years ended December 31, 2005 were as follows (in millions):

| | 2005 | 2004 | 2003 |
|----------------------|---------------|--------------|---------------|
| Federal income taxes | | | |
| Current | \$(94) | \$ 26 | \$ 77 |
| Deferred | (59) | 114 | (132) |
| Foreign income taxes | | | |
| Current | 95 | 178 | 144 |
| Deferred | 37 | 21 | 72 |
| State income taxes | | | |
| Current | 9 | (19) | (17) |
| Deferred | 7 | 20 | (10) |
| Total | \$ (5) | \$340 | \$ 134 |

A reconciliation of the U.S. federal statutory income tax rate to the consolidated effective income tax rate for the three years ended December 31, 2005 was as follows:

| | 2005 | 2004 | 2003 |
|--|---------------|--------------|--------------|
| U.S. federal statutory income tax rate | 35.0% | 35.0% | 35.0% |
| Nondeductible expenses | 3.4 | 3.4 | 5.0 |
| Effect of tax law changes | 0.3 | (1.5) | 1.0 |
| Change in valuation allowance for deferred tax assets | (4.6) | 1.3 | (3.8) |
| State taxes, net of federal benefit | 1.6 | 1.3 | (2.7) |
| Audit and other tax return adjustments | (25.5) | 0.7 | 7.6 |
| Tax-exempt income | (0.7) | (0.7) | (1.0) |
| Dividends on Series B convertible preferred stock | — | (0.6) | (3.1) |
| Other foreign, including earnings taxed at different rates | (10.3) | (2.4) | (7.0) |
| Other | 0.2 | (1.3) | (0.3) |
| Effective income tax rate | (0.6)% | 35.2% | 30.7% |

On a consolidated basis, we paid a total of \$186, \$253, and \$207 in income taxes to federal, foreign and state jurisdictions in 2005, 2004 and 2003, respectively.

Total income tax expense (benefit) for the three years ended December 31, 2005 was allocated as follows (in millions):

| | 2005 | 2004 | 2003 |
|--|---------------|--------------|--------------|
| Income taxes on income | \$ (5) | \$340 | \$134 |
| Common shareholders' equity ⁽¹⁾ | (43) | (20) | 123 |
| Total | \$(48) | \$320 | \$257 |

⁽¹⁾ For tax effects of items in accumulated other comprehensive loss and tax benefits related to stock option and incentive plans.

IRS Audit Resolution: In June 2005, the 1996-1998 IRS audit was finalized. As a result, we recorded an aggregate second quarter 2005 net income benefit of \$343. \$260 of this benefit, which includes an after-tax

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

benefit of \$33 for interest (\$54 pre-tax benefit), is the result of a change in tax law that allowed us to recognize a benefit for \$1.2 billion of capital losses associated with the disposition of our insurance group operations in those years. The claim of additional losses and related tax benefits required review by the U.S. Joint Committee on Taxation, which was completed in June 2005. The benefit did not result in a significant cash refund, but increased tax credit carryforwards and reduced taxes otherwise due. While these benefits originated from our discontinued operations, tax accounting rules require the classification of benefits resulting from a change in tax law to be classified within the continuing operations tax provision.

The \$343 benefit also includes after-tax benefits of \$83 related to the favorable resolution of certain other tax matters. Of this amount, \$53 is related to our discontinued operations and is reported within Income from discontinued operations in the Consolidated Statements of Income.

The following is a summary of the aggregate (benefit) recorded and where classified in the Consolidated Statements of Income for the year ended December 31, 2005 (in millions):

| | <u>Tax Law Change</u> | <u>Resolution of Tax Matters</u> | <u>Aggregate Benefits</u> |
|---|---------------------------|--------------------------------------|-------------------------------|
| Other expenses, net | \$ (54) | \$ (3) | \$ (57) |
| Income tax (benefits) expenses | (206) | (27) | (233) |
| Income from discontinued operations, net of tax | — | (53) | (53) |
| Net income | \$ (260) | \$ (83) | \$ (343) |

Deferred Income Taxes

In substantially all instances, deferred income taxes have not been provided on the undistributed earnings of foreign subsidiaries and other foreign investments carried at equity. The amount of such earnings included in consolidated retained earnings at December 31, 2005 was approximately \$6.5 billion. These earnings have been indefinitely reinvested and we currently do not plan to initiate any action that would precipitate the payment of income taxes thereon. It is not practicable to estimate the amount of additional tax that might be payable on the foreign earnings. Our March 31, 2001 sale of half of our ownership interest in Fuji Xerox, resulted in our investment no longer qualifying as a foreign corporate joint venture. Accordingly, deferred taxes are required to be provided on the undistributed earnings of Fuji Xerox, arising subsequent to such date, as we no longer have the ability to ensure indefinite reinvestment.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The tax effects of temporary differences that give rise to significant portions of the deferred taxes at December 31, 2005 and 2004 were as follows (in millions):

| | 2005 | 2004 |
|--|-----------------|-----------------|
| Tax effect of future tax deductions | | |
| Research and development | \$ 1,173 | \$ 1,281 |
| Post-retirement medical benefits | 478 | 499 |
| Depreciation | 271 | 247 |
| Net operating losses | 480 | 450 |
| Other operating reserves | 307 | 333 |
| Tax credit carryforwards | 346 | 289 |
| Deferred compensation | 185 | 198 |
| Allowance for doubtful accounts | 118 | 149 |
| Restructuring reserves | 69 | 43 |
| Other | 166 | 40 |
| | <u>3,593</u> | <u>3,529</u> |
| Valuation allowance | (590) | (567) |
| Total deferred tax assets | <u>\$ 3,003</u> | <u>\$ 2,962</u> |
| Tax effect of future taxable income | | |
| Unearned income and installment sales | \$(1,303) | \$(1,293) |
| Other | (42) | (79) |
| Total deferred tax liabilities | <u>(1,345)</u> | <u>(1,372)</u> |
| Total deferred taxes, net | <u>\$ 1,658</u> | <u>\$ 1,590</u> |

The above amounts are classified as current or long-term in the Consolidated Balance Sheets in accordance with the asset or liability to which they relate or, when applicable, based on the expected timing of the reversal. Current deferred tax assets at December 31, 2005 and 2004 amounted to \$290 and \$289, respectively.

The deferred tax assets for the respective periods were assessed for recoverability and, where applicable, a valuation allowance was recorded to reduce the total deferred tax asset to an amount that will, more likely than not, be realized in the future. The valuation allowance for deferred tax assets as of January 1, 2004 was \$577. The net change in the total valuation allowance for the years ended December 31, 2005 and 2004 was an increase of \$23 and a decrease of \$10, respectively. The valuation allowance relates primarily to certain net operating loss carryforwards, tax credit carryforwards and deductible temporary differences for which we have concluded it is more likely than not that these items will not be realized in the ordinary course of operations.

Although realization is not assured, we have concluded that it is more likely than not that the deferred tax assets for which a valuation allowance was determined to be unnecessary will be realized in the ordinary course of operations based on the available positive and negative evidence, including scheduling of deferred tax liabilities and projected income from operating activities. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if actual future income or income tax rates are lower than estimated, or if there are differences in the timing or amount of future reversals of existing taxable or deductible temporary differences.

At December 31, 2005, we had tax credit carryforwards of \$346 available to offset future income taxes, of which \$247 are available to carryforward indefinitely while the remaining \$99 will begin to expire, if not utilized, in 2006. We also had net operating loss carryforwards for income tax purposes of \$225 that will expire in 2006 through 2024, if not utilized, and \$2.2 billion available to offset future taxable income indefinitely.

Note 16—Contingencies

Guarantees, Indemnifications and Warranty Liabilities: Guarantees and claims arise during the ordinary course of business from relationships with suppliers, customers and nonconsolidated affiliates when the Company undertakes an obligation to guarantee the performance of others if specified triggering events occur. Nonperformance under a contract could trigger an obligation of the Company. These potential claims include actions based upon alleged exposures to products, real estate, intellectual property such as patents, environmental matters, and other indemnifications. The ultimate effect on future financial results is not subject to reasonable estimation because considerable uncertainty exists as to the final outcome of these claims. However, while the ultimate liabilities resulting from such claims may be significant to results of operations in the period recognized, management does not anticipate they will have a material adverse effect on the Company's consolidated financial position or liquidity. As of December 31, 2005, we have accrued our estimate of liability incurred under our indemnification arrangements and guarantees.

Indemnifications provided as part of contracts and agreements: We are a party to the following types of agreements pursuant to which we may be obligated to indemnify the other party with respect to certain matters:

- Contracts that we entered into for the sale or purchase of businesses or real estate assets, under which we customarily agree to hold the other party harmless against losses arising from a breach of representations and covenants, including obligations to pay rent. Typically, these relate to such matters as adequate title to assets sold, intellectual property rights, specified environmental matters and certain income taxes arising prior to the date of acquisition.
- Guarantees on behalf of our subsidiaries with respect to real estate leases. These lease guarantees may remain in effect subsequent to the sale of the subsidiary.
- Agreements to indemnify various service providers, trustees and bank agents from any third party claims related to their performance on our behalf, with the exception of claims that result from third-party's own willful misconduct or gross negligence.
- Guarantees of our performance in certain sales-contracts to our customers and indirectly the performance of third parties with whom we have subcontracted for their services. This includes indemnifications to customers for losses that may be sustained as a result of the use of our equipment at a customer's location.

In each of these circumstances, our payment is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow us to challenge the other party's claims. In the case of lease guarantees, we may contest the liabilities asserted under the lease. Further, our obligations under these agreements and guarantees may be limited in terms of time and/or amount, and in some instances, we may have recourse against third parties for certain payments we made.

Patent indemnifications: In most sales transactions to resellers of our products, we indemnify against possible claims of patent infringement caused by our products or solutions. These indemnifications usually do not include limits on the claims, provided the claim is made pursuant to the procedures required in the sales contract.

Indemnification of Officers and Directors: Our corporate by-laws require that, except to the extent expressly prohibited by law, we must indemnify Xerox Corporation's officers and directors against judgments, fines, penalties and amounts paid in settlement, including legal fees and all appeals, incurred in connection with civil or criminal action or proceedings, as it relates to their services to Xerox Corporation and our subsidiaries. Although the by-laws provide no limit on the amount of indemnification, we may have recourse against our insurance

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carriers for certain payments made by us. However, certain indemnification payments may not be covered under our directors' and officers' insurance coverage. In addition, we indemnify certain fiduciaries of our employee benefit plans for liabilities incurred in their service as fiduciary whether or not they are officers of the Company.

Product Warranty Liabilities: In connection with our normal sales of equipment, including those under sales-type leases, we generally do not issue product warranties. Our arrangements typically involve a separate full service maintenance agreement with the customer. The agreements generally extend over a period equivalent to the lease term or the expected useful life under a cash sale. The service agreements involve the payment of fees in return for our performance of repairs and maintenance. As a consequence, we do not have any significant product warranty obligations including any obligations under customer satisfaction programs. In a few circumstances, particularly in certain cash sales, we may issue a limited product warranty if negotiated by the customer. We also issue warranties for certain of our lower-end products in the Office segment, where full service maintenance agreements are not available. In these instances, we record warranty obligations at the time of the sale. Aggregate product warranty liability expenses for the three years ended as of December 31, 2005 were \$45, \$45 and \$47, respectively. Total product warranty liabilities as of December 31, 2005 and 2004 were \$21 and \$23, respectively.

Tax related contingencies

Brazil Tax and Labor Contingencies: At December 31, 2005, our Brazilian operations were involved in various litigation matters and have received or been levied with numerous governmental assessments related to indirect and other taxes as well as disputes associated with former employees and contract labor. The total amounts related to these unreserved contingencies, inclusive of any related interest, were approximately \$900. The tax matters, which comprise a significant portion of the total contingencies, principally relate to claims for taxes on the internal transfer of inventory, municipal service taxes on rentals and gross revenue taxes. We are disputing these tax and labor matters and intend to vigorously defend our position. Based on the opinion of legal counsel, we do not believe that the ultimate resolution of these matters will materially impact our results of operations, financial position or cash flows. In connection with these proceedings, customary local regulations may require us to make escrow cash deposits or post other security of up to half of the total amount in dispute. As of December 31, 2005 we have made escrow cash deposits of \$117 for matters we are disputing and there are liens on certain of our Brazilian assets. Generally, any escrowed amounts would be refundable and any liens would be removed to the extent the matter is resolved in our favor. We routinely assess these matters as to probability of ultimately incurring a liability against our Brazilian operations and record our best estimate of the ultimate loss in situations where we assess the likelihood of an ultimate loss as probable of occurring.

General Tax Contingencies: We are subject to ongoing tax examinations and assessments in various jurisdictions. Accordingly, we may record incremental tax expense based upon the probable outcomes of such matters. In addition, when applicable, we adjust the previously recorded tax expense to reflect examination results. Our ongoing assessments of the probable outcomes of the examinations and related tax positions require judgment and can materially increase or decrease our effective tax rate, as well as impact our operating results.

Legal Matters

As more fully discussed below, we are involved in a variety of claims, lawsuits, investigations and proceedings concerning securities law, intellectual property law, environmental law, employment law and the Employee Retirement Income Security Act ("ERISA"). We determine whether an estimated loss from a contingency should be accrued by assessing whether a loss is deemed probable and can be reasonably estimated. We assess our potential liability by analyzing our litigation and regulatory matters using available information. We develop our views on estimated losses in consultation with outside counsel handling our defense in these

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matters, which involves an analysis of potential results, assuming a combination of litigation and settlement strategies. Should developments in any of these matters cause a change in our determination as to an unfavorable outcome and result in the need to recognize a material accrual, or should any of these matters result in a final adverse judgment or be settled for significant amounts, they could have a material adverse effect on our results of operations, cash flows and financial position in the period or periods in which such change in determination, judgment or settlement occurs.

Litigation Against the Company:

In re Xerox Corporation Securities Litigation: A consolidated securities law action (consisting of 17 cases) is pending in the United States District Court for the District of Connecticut. Defendants are the Company, Barry Romeril, Paul Allaire and G. Richard Thoman. The consolidated action purports to be a class action on behalf of the named plaintiffs and all other purchasers of common stock of the Company during the period between October 22, 1998 through October 7, 1999 (“Class Period”). The amended consolidated complaint in the action alleges that in violation of Section 10(b) and/or 20(a) of the Securities Exchange Act of 1934, as amended (“1934 Act”), and SEC Rule 10b-5 thereunder, each of the defendants is liable as a participant in a fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of the Company’s common stock during the Class Period by disseminating materially false and misleading statements and/or concealing material facts relating to the defendants’ alleged failure to disclose the material negative impact that the April 1998 restructuring had on the Company’s operations and revenues. The amended complaint further alleges that the alleged scheme: (i) deceived the investing public regarding the economic capabilities, sales proficiencies, growth, operations and the intrinsic value of the Company’s common stock; (ii) allowed several corporate insiders, such as the named individual defendants, to sell shares of privately held common stock of the Company while in possession of materially adverse, non-public information; and (iii) caused the individual plaintiffs and the other members of the purported class to purchase common stock of the Company at inflated prices. The amended consolidated complaint seeks unspecified compensatory damages in favor of the plaintiffs and the other members of the purported class against all defendants, jointly and severally, for all damages sustained as a result of defendants’ alleged wrongdoing, including interest thereon, together with reasonable costs and expenses incurred in the action, including counsel fees and expert fees. On September 28, 2001, the court denied the defendants’ motion for dismissal of the complaint. On November 5, 2001, the defendants answered the complaint. On or about January 7, 2003, the plaintiffs filed a motion for class certification. Xerox and the individual defendants filed their opposition to that motion on June 28, 2005. The motion has been fully briefed, but has not been argued before the court. The court has not issued a ruling. On or about November 8, 2004, the International Brotherhood of Electrical Workers Welfare Fund of Local Union No. 164 (“IBEW”) filed a motion to intervene as a named plaintiff and class representative. That motion has been fully briefed, but has not been argued before the court. The court has not issued a ruling. Separately, on June 8, 2005, IBEW and Robert W. Roten moved to substitute as lead plaintiffs and proposed class representatives. That motion has been fully briefed, but has not been argued before the court. The court has not issued a ruling. The parties are currently engaged in discovery. The individual defendants and we deny any wrongdoing and are vigorously defending the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Carlson v. Xerox Corporation, et al.: A consolidated securities law action (consisting of 21 cases) is pending in the United States District Court for the District of Connecticut against the Company, KPMG and Paul A. Allaire, G. Richard Thoman, Anne M. Mulcahy, Barry D. Romeril, Gregory Tayler and Philip Fishbach. On September 11, 2002, the court entered an endorsement order granting plaintiffs’ motion to file a third consolidated amended complaint. The defendants’ motion to dismiss the second consolidated amended complaint was denied, as moot. According to the third consolidated amended complaint, plaintiffs purport to bring this case as a class action on behalf of an expanded class consisting of all persons and/or entities who purchased Xerox

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common stock and/or bonds during the period between February 17, 1998 through June 28, 2002 and who were purportedly damaged thereby (“Class”). The third consolidated amended complaint sets forth two claims: one alleging that each of the Company, KPMG, and the individual defendants violated Section 10(b) of the 1934 Act and SEC Rule 10b-5 thereunder; the other alleging that the individual defendants are also allegedly liable as “controlling persons” of the Company pursuant to Section 20(a) of the 1934 Act. Plaintiffs claim that the defendants participated in a fraudulent scheme that operated as a fraud and deceit on purchasers of the Company’s common stock and bonds by disseminating materially false and misleading statements and/or concealing material adverse facts relating to various of the Company’s accounting and reporting practices and financial condition. The plaintiffs further allege that this scheme deceived the investing public regarding the true state of the Company’s financial condition and caused the plaintiffs and other members of the alleged Class to purchase the Company’s common stock and bonds at artificially inflated prices, and prompted a SEC investigation that led to the April 11, 2002 settlement which, among other things, required the Company to pay a \$10 penalty and restate its financials for the years 1997-2000 (including restatement of financials previously corrected in an earlier restatement which plaintiffs contend was improper). The third consolidated amended complaint seeks unspecified compensatory damages in favor of the plaintiffs and the other Class members against all defendants, jointly and severally, including interest thereon, together with reasonable costs and expenses, including counsel fees and expert fees. On December 2, 2002, the Company and the individual defendants filed a motion to dismiss the complaint. On July 13, 2005, the court denied the motion. On October 31, 2005, the defendants answered the complaint. On January 19, 2006, plaintiffs filed a motion for class ratification. That motion has not been fully briefed or argued before the court. The parties are engaged in discovery. The individual defendants and we deny any wrongdoing and are vigorously defending the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Florida State Board of Administration, et al. v. Xerox Corporation, et al.: A securities law action brought by four institutional investors, namely the Florida State Board of Administration, the Teachers’ Retirement System of Louisiana, Franklin Mutual Advisers and PPM America, Inc., is pending in the United States District Court for the District of Connecticut against the Company, Paul Allaire, G. Richard Thoman, Barry Romeril, Anne Mulcahy, Philip Fishbach, Gregory Tayler and KPMG. The plaintiffs bring this action individually on their own behalves. In an amended complaint filed on October 3, 2002, one or more of the plaintiffs allege that each of the Company, the individual defendants and KPMG violated Sections 10(b) and 18 of the 1934 Act, SEC Rule 10b-5 thereunder, the Florida Securities Investors Protection Act, Fl. Stat. ss. 517.301, and the Louisiana Securities Act, R.S. 51:712(A). The plaintiffs further claim that the individual defendants are each liable as “controlling persons” of the Company pursuant to Section 20 of the 1934 Act and that each of the defendants is liable for common law fraud and negligent misrepresentation. The complaint generally alleges that the defendants participated in a scheme and course of conduct that deceived the investing public by disseminating materially false and misleading statements and/or concealing material adverse facts relating to the Company’s financial condition and accounting and reporting practices. The plaintiffs contend that in relying on false and misleading statements allegedly made by the defendants, at various times from 1997 through 2000 they bought shares of the Company’s common stock at artificially inflated prices. As a result, they allegedly suffered aggregated cash losses in excess of \$200. The plaintiffs further contend that the alleged fraudulent scheme prompted a SEC investigation that led to the April 11, 2002 settlement which, among other things, required the Company to pay a \$10 penalty and restate its financials for the years 1997-2000 including restatement of financials previously corrected in an earlier restatement which plaintiffs contend was false and misleading. The plaintiffs seek, among other things, unspecified compensatory damages against the Company, the individual defendants and KPMG, jointly and severally, including prejudgment interest thereon, together with the costs and disbursements of the action, including their actual attorneys’ and experts’ fees. On December 2, 2002, the Company and the individual defendants filed a motion to dismiss all claims in the complaint that are in common with the claims in the

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Carlson action. On July 13, 2005, the court denied the motion. On December 9, 2005, the defendants moved to dismiss claims based on issues uniquely related to plaintiffs. Plaintiffs filed their opposition to that motion on January 31, 2006. That motion has not been fully briefed or argued before the court. The parties are engaged in discovery. The individual defendants and we deny any wrongdoing and are vigorously defending the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

In Re Xerox Corp. ERISA Litigation: On July 1, 2002, a class action complaint captioned Patti v. Xerox Corp. et al. was filed in the United States District Court for the District of Connecticut (Hartford) alleging violations of the ERISA. Three additional class actions (Hopkins, Uebele and Saba) were subsequently filed in the same court making substantially similar claims. On October 16, 2002, the four actions were consolidated as In Re Xerox Corporation ERISA Litigation. On November 15, 2002, a consolidated amended complaint was filed. A fifth class action (Wright) was filed in the District of Columbia. It has been transferred to Connecticut and consolidated with the other actions. The purported class includes all persons who invested or maintained investments in the Xerox Stock Fund in the Xerox 401(k) Plans (either salaried or union) during the proposed class period, May 12, 1997 through November 15, 2002, and allegedly exceeds 50,000 persons. The defendants include Xerox Corporation and the following individuals or groups of individuals during the proposed class period: the Plan Administrator, the Board of Directors, the Fiduciary Investment Review Committee, the Joint Administrative Board, the Finance Committee of the Board of Directors, and the Treasurer. The complaint claims that all the foregoing defendants were fiduciaries of the Plan under ERISA and, as such, were obligated to protect the Plan's assets and act in the interest of Plan participants. The complaint alleges that the defendants failed to do so and thereby breached their fiduciary duties. Specifically, plaintiffs claim that the defendants failed to provide accurate and complete material information to participants concerning Xerox stock, including accounting practices which allegedly artificially inflated the value of the stock, and misled participants regarding the soundness of the stock and the prudence of investing their retirement assets in Xerox stock. Plaintiffs also claim that defendants failed to invest Plan assets prudently, to monitor the other fiduciaries and to disregard Plan directives they knew or should have known were imprudent, and failed to avoid conflicts of interest. The complaint does not specify the amount of damages sought. However, it asks that the losses to the Plan be restored, which it describes as "millions of dollars." It also seeks other legal and equitable relief, as appropriate, to remedy the alleged breaches of fiduciary duty, as well as interest, costs and attorneys' fees. We filed a motion to dismiss the complaint. The plaintiffs subsequently filed a motion for class certification and a motion to commence discovery. Defendants have opposed both motions, contending that both are premature before there is a decision on their motion to dismiss. In the fall of 2004, the Court requested an updated briefing on our motion to dismiss and update briefs were filed in December of that year. We and the other defendants deny any wrongdoing and are vigorously defending the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Digwamaje et al. v. IBM et al: A purported class action was filed in the United States District Court for the Southern District of New York on September 27, 2002. Service of the First Amended Complaint on the Company was deemed effective as of December 6, 2002. On March 19, 2003, Plaintiffs filed a Second Amended Complaint that eliminated a number of corporate defendants but was otherwise identical in all material respects to the First Amended Complaint. The defendants include Xerox and a number of other corporate defendants who are accused of providing material assistance to the apartheid government in South Africa from 1948 to 1994, by engaging in commerce in South Africa and with the South African government and by employing forced labor, thereby violating both international and common law. Specifically, plaintiffs claim violations of the Alien Tort Claims Act, the Torture Victims Protection Act and RICO. They also assert human rights violations and crimes against humanity. Plaintiffs seek compensatory damages in excess of \$200 billion and punitive damages in excess of

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\$200 billion. The foregoing damages are being sought from all defendants, jointly and severally. Xerox filed a motion to dismiss the Second Amended Complaint. Oral argument of the motion was heard on November 6, 2003. By Memorandum Opinion and Order filed November 29, 2004, the court granted the motion to dismiss. A clerk's judgment of dismissal was filed on November 30, 2004. On December 27, 2004, the Company received a notice of appeal dated December 24, 2004. On February 16, 2005, the parties filed a stipulation withdrawing the December 24, 2004 appeal on the ground that the November 30, 2004 judgment of dismissal was not appealable. On March 28, 2005, Plaintiffs submitted a letter requesting permission to file a motion for leave to file an amended and consolidated complaint. By Summary Order filed April 6, 2005, the Court denied the request. In a second Summary Order filed the same day, the Court amended its November 29, 2004, Opinion and Order, which dismissed the action, so as to render the Opinion and Order appealable and plaintiffs filed a new appeal on May 3, 2005. On August 19, 2005, plaintiffs-appellants filed their brief in the Second Circuit Court of Appeals. On October 4, 2005, defendants-appellates filed their brief in the Second Circuit Court of Appeals. Oral argument in the Second Circuit Court of Appeals was held on January 24, 2006. Xerox denies any wrongdoing and is vigorously defending the action. Based upon the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Arbitration between MPI Technologies, Inc. and Xerox Canada Ltd. and Xerox Corporation: In an arbitration proceeding the hearing of which commenced on January 18, 2005, MPI Technologies, Inc. ("MPI") sought damages from Xerox Corporation and Xerox Canada Ltd. ("XCL") for royalties owed under a license agreement made as of March 15, 1994 between MPI and XCL (the "Agreement") and breach of fiduciary duty, breach of confidence, equitable royalties and punitive damages and disgorgement of profits and injunctive relief with respect to a claim of copyright infringement. On September 9, 2005, the arbitration panel rendered its decision, holding in part that the Agreement had been assigned to Xerox and that no punitive damages should be granted, and awarded MPI approximately \$89, plus interest thereon. On December 12, 2005, the arbitration panel rendered its decision on the applicable rate of pre-judgment interest. We have accrued the amount of the \$89 award, as well as \$13 for pre- and post-judgment interest thereon. On December 7, 2005, Xerox filed an application for judicial review of the award with the Ontario Superior Court seeking that the award be set aside in its entirety. The hearing is scheduled for late June 2006. On December 29, 2005, MPI filed an application for judicial recognition and enforcement of the award. On agreement of the parties, that application has been adjourned to be heard after the Xerox application to set aside the award on a date to be set by the Ontario Superior Court. Pending the determination of the application to set aside the award, Xerox has deposited into escrow funds ordered owing in the award as of the date the deposit was made.

National Union Fire Insurance Company v. Xerox Corporation, et al.: On October 24, 2003, a declaratory judgment action was filed in the Supreme Court of the State of New York, County of New York against the Company and several current and former officers and/or members of the Board of Directors. Plaintiff claims that it issued an Excess Directors & Officers Liability and Corporate Reimbursement Policy to the Company in reliance on information from the Company that allegedly misrepresented the Company's financial condition and outlook. The policy at issue provides for \$25 of coverage as a component of the company reimbursement portion of an insurance program that provides for up to \$135 coverage (after deductibles and coinsurance and subject to other policy limitations and requirements) over a three-year period. However, \$10 of the entire amount may be unavailable due to the liquidation of one of the other insurers. Plaintiff seeks judgment (i) that it is entitled to rescind the policy as void from the outset; (ii) in the alternative, limiting coverage under the policy and awarding plaintiff damages in an unspecified amount representing that portion of any required payment under the policy that is attributable to the Company's and the individual defendants' own misconduct; and (iii) for the costs and disbursement of the action and such other relief as the court deems just and proper. On December 19, 2003, the Company and individual defendants moved to dismiss the complaint. On November 10, 2004, the Court issued an opinion partially granting and partially denying the motions. Among other things, the Court granted the motions to dismiss all of the claims for rescission and denied plaintiff's request to replead. The Court denied the Company's and some of the individual defendants' motions to dismiss certain claims that seek to limit coverage

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based on particular provisions in the policy and that at least in part related to settlement with the SEC. Plaintiff filed notices of appeal on January 10, 2005 and February 11, 2005. By order entered on January 3, 2006, the Appellate Division affirmed the portions of the Court's November 10, 2004 decision which dismissed several of plaintiff's claims and denied leave to replead. On February 2, 2006, plaintiff moved for reargument or for leave to appeal to the Court of Appeals. That motion has not been fully briefed. The Appellate Division has not issued a ruling. Separately, on February 22, 2005, the defendants filed a motion seeking dismissal of any remaining claims in light of Xerox's representation that it will not seek coverage from plaintiff for settlement payments to the SEC. By order dated July 12, 2005, the Court denied the motion. On August 23, 2005, defendants moved for leave to reargue the February 22 motion and separately moved for leave to renew the December 19, 2003 motions. Those motions have been fully briefed. The court has not issued a ruling. The Company and the individual defendants deny any wrongdoing and are vigorously defending the action.

Warren, et al. v. Xerox Corporation: On March 11, 2004, the United States District Court for the Eastern District of New York entered an order certifying a nationwide class of all black salespersons employed by Xerox from February 1, 1997 to the present under Title VII of the Civil Rights Act of 1964, as amended, and the Civil Rights Act of 1871. The suit was commenced on May 9, 2001 by six black sales representatives. The plaintiffs allege that Xerox has engaged in a pattern or practice of race discrimination against them and other black sales representatives by assigning them to less desirable sales territories, denying them promotional opportunities, and paying them less than their white counterparts. Although the complaint does not specify the amount of damages sought, plaintiffs do seek, on behalf of themselves and the classes they seek to represent, front and back pay, compensatory and punitive damages, and attorneys' fees. We deny any wrongdoing and are vigorously defending the action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Compression Labs, Inc. v. Agfa et al. (including Xerox Corporation): In April 2004, Compression Labs, Incorporated (CLI) commenced an action in the United States District Court for the Eastern District of Texas, Marshall Division against Xerox, along with 27 other companies, seeking unspecified damages for patent infringement, injunction and other ancillary relief. According to CLI, the patent covers an aspect of a standard for compressing full-color or gray-scale still images (JPEG). In July 2004, along with several of the other defendants in the above named action, we filed a complaint against CLI in Federal Court in Delaware, requesting a declaratory judgment of non-infringement and invalidity; a finding of an implied license to use the patent; a finding that CLI is estopped from enforcing the patent; damages and relief under state law for deceptive trade practices, unfair competition, fraud, negligent misrepresentation, equitable estoppel and patent misuse; and relief under federal anti-trust laws for CLI's violation of Section 2 of the Sherman Act. On February 16, 2005, the U.S. Multi-District Litigation Panel ordered the subject lawsuit (along with all related lawsuits) be transferred from the District Court of the Eastern District of Texas to the District Court for the Northern District of California. All pre-trial proceedings will occur in the Northern District of California and the lawsuit will, if necessary, be transferred back to the Eastern District of Texas for trial. Discovery for all related cases will continue in the Northern District of California. On May 19, 2005 the judge recused herself from the litigation and a new judge was assigned in August 2005. We deny any wrongdoing and are vigorously defending this action. Based on the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Tesseron, Ltd. v. Xerox Corporation: On October 28, 2004, an action was commenced by Tesseron, Ltd., in the United States District Court for the Northern District of Ohio against Xerox seeking unspecified damages for alleged infringement of seven U.S. patents. Tesseron asserts that its patents cover Xerox's variable imaging software sold with Xerox's production printing systems. Xerox filed an answer on January 28, 2005. The parties are currently engaged in discovery. We deny any wrongdoing and intend to vigorously defend the action. Based

upon the stage of the litigation, it is not possible to estimate the amount of loss or range of possible loss that might result from an adverse judgment or a settlement of this matter.

Derivative Litigation Brought on Behalf of the Company:

Miller, et al. v. Allaire, et al.: Following the voluntary dismissal without prejudice of *In re Xerox Derivative Actions* in the Supreme Court of the State of New York, County of New York, the plaintiffs purportedly brought a substantially similar putative shareholder derivative action in Connecticut Superior Court, Judicial District of Stamford-Norwalk at Stamford in the name of and for the benefit of the Company, which is named as a nominal defendant, and its public shareholders against several current and former members of the Board of Directors including William F. Buehler, B.R. Inman, Antonia Ax:son Johnson, Vernon E. Jordan, Jr., Yotaro Kobayashi, Hilmar Kopper, Ralph Larsen, George J. Mitchell, N.J. Nicholas, Jr., John E. Pepper, Patricia Russo, Martha Seger, Thomas C. Theobald, Paul Allaire, G. Richard Thoman, Anne Mulcahy and Barry Romeril, and KPMG LLP. This action is based on substantially the same allegations and seeks substantially the same relief as the discontinued action. The complaint alleges that each of the director defendants breached their fiduciary duties to the Company and its shareholders by, among other things, ignoring indications of a lack of oversight at the Company and the existence of flawed business and accounting practices within the Company's Mexican and other operations; failing to have in place sufficient controls and procedures to monitor the Company's accounting practices; knowingly and recklessly disseminating and permitting to be disseminated, misleading information to shareholders and the investing public; and permitting the Company to engage in improper accounting practices. The plaintiffs further allege that each of the director defendants breached his/her duties of due care and diligence in the management and administration of the Company's affairs and grossly mismanaged or aided and abetted the gross mismanagement of the Company and its assets. The complaint also asserts claims of negligence, negligent misrepresentation, breach of contract and breach of fiduciary duty against KPMG. Additionally, plaintiffs claim that KPMG is liable to Xerox for contribution, based on KPMG's share of the responsibility for any injuries or damages for which Xerox is held liable to plaintiffs in related pending securities class action litigation. On behalf of the Company, the plaintiffs seek a judgment declaring that the director defendants violated and/or aided and abetted the breach of their fiduciary duties to the Company and its shareholders; awarding the Company unspecified compensatory damages against the director defendants, individually and severally, together with pre-judgment and post-judgment interest at the maximum rate allowable by law; awarding the Company punitive damages against the director defendants; awarding the Company compensatory damages against KPMG; and awarding plaintiffs the costs and disbursements of this action, including reasonable attorneys' and experts' fees. Plaintiffs also demand injunctive relief from the indemnification of six former officers for disgorgements imposed pursuant to their respective settlements with the SEC and related legal fees. On November 23, 2005, defendants filed a motion to dismiss and a separate motion for partial summary judgment. Those motions have not yet been fully briefed or argued before the court. The individual defendants deny any wrongdoing.

Pall v. KPMG, et al.: On May 13, 2003, a shareholder commenced a derivative action in the United States District Court for the District of Connecticut against KPMG and four of its current or former partners. The Company was named as a nominal defendant. The plaintiff had filed an earlier derivative action against certain current and former members of the Xerox Board of Directors and KPMG. That action, captioned *Pall v. Buehler, et al.*, was dismissed for lack of jurisdiction. Plaintiff purports to bring this current action derivatively on behalf and for the benefit of the Company seeking damages allegedly caused to the Company by KPMG and the named individual defendants. The plaintiff asserts claims for contribution under the securities laws, negligence, negligent misrepresentation, breach of contract, breach of fiduciary duty and indemnification. The plaintiff seeks unspecified compensatory damages (together with pre-judgment and post-judgment interest), a declaratory judgment that defendants violated and/or aided and abetted the breach of fiduciary and professional duties to the Company, an award of punitive damages for the Company against the defendants, plus the costs and disbursements of the action. On November 7, 2003, the Company filed a limited motion to dismiss the complaint

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on jurisdictional grounds and reserved its right to seek dismissal on other grounds, if the court denies the initial motion. KPMG and the individual defendants also filed limited motions to dismiss on the same grounds. The motions have not been fully briefed or argued before the court.

Other Litigation:

Xerox Corporation v. 3Com Corporation, et al.: On April 28, 1997, we commenced an action in U.S. District Court for the Western District of New York against Palm, formerly owned by 3Com Corporation, for infringement of the Xerox “Unistrokes” handwriting recognition patent by the Palm Pilot using “Graffiti.” Upon reexamination, the U.S. Patent and Trademark Office confirmed the validity of all 16 claims of the original Unistrokes patent. On June 6, 2000, the District Court found the Palm Pilot with Graffiti did not infringe the Unistrokes patent claims, and on October 5, 2000 the Court of Appeals for the Federal Circuit reversed the finding of no infringement and sent the case back to the lower court to continue toward trial on the infringement claims. On December 20, 2001, the District Court granted our motions on infringement and for a finding of validity, thus establishing liability. In January 2003, Palm announced that it would stop including Graffiti in its future operating systems. On February 20, 2003, the Court of Appeals for the Federal Circuit affirmed the infringement of the Unistrokes patent by Palm’s handheld devices and remanded the validity issues to the District Court for further analysis. On December 5, 2003 Palm moved for sanctions, alleging that Xerox withheld production of material information. Xerox has since responded to the motion denying the basis of claims. On December 10, 2003 the District Court heard oral arguments on summary judgment motions from both parties directed solely to the issue of validity. A decision denying Xerox’s motions and granting Palm’s motion of summary judgment for invalidity (“SJ”) was granted on May 21, 2004. In June 2004, Palm filed a motion requesting clarification of the grant of SJ, Xerox has responded to that motion, and also filed a motion to reconsider the SJ. On February 16, 2005, the District Court denied Xerox’s motion to reconsider and granted Palm’s motion to clarify. Pursuant to granting Palm’s motion, the District Court supplemented its decision of May 21, 2004. On June 10, 2005, Xerox filed an appeal brief with the Court of Appeals for the Federal Circuit, seeking reversal of the District Court’s holding of invalidity. Xerox filed a reply brief to the Palm brief on the issue of invalidity on November 7, 2005. An oral hearing is expected to occur in March 2006.

Other Matters:

It is our policy to promptly and carefully investigate, often with the assistance of outside advisers, allegations of impropriety that may come to our attention. If the allegations are substantiated, appropriate prompt remedial action is taken. When and where appropriate, we report such matters to the U.S. Department of Justice and to the SEC, and/or make public disclosure.

India. In recent years we have become aware of a number of matters at our Indian subsidiary, Xerox Modicorp Ltd., that occurred over a period of several years, much of which occurred before we obtained majority ownership of these operations in mid 1999. These matters include misappropriations of funds and payments to other companies that may have been inaccurately recorded on the subsidiary’s books and certain improper payments in connection with sales to government customers. These transactions were not material to the Company’s financial statements. We have reported these transactions to the Indian authorities, the U.S. Department of Justice and to the SEC. The private Indian investigator engaged by the Indian Ministry of Company Affairs has completed an investigation of these matters. In February 2005, the Indian Ministry of Company Affairs provided our Indian subsidiary with the investigator’s report which addresses the previously disclosed misappropriation of funds and improper payments and requested comments. The report included allegations that Xerox Modicorp Ltd.’s senior officials and the Company were aware of such activities. The report also asserted the need for further investigation into potential criminal acts related to the improper activities

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addressed by the report. The matter is now pending in the Indian Ministry of Company Affairs. The Company reported these developments and made a copy of the report received by Xerox Modicorp Ltd. available to the U.S. Department of Justice and the SEC.

On November 17, 2005, Xerox filed its 40-page Reply (plus attachments) with the DCA. Xerox has sent copies of the Xerox Reply to the SEC and DOJ in the United States. In our Reply, we argue that the alleged violations of Indian Company Law by means of alleged improper payments and alleged defaults/failures of the Xerox Modicorp Ltd. board of directors were generally unsubstantiated and without any basis in law. Further, we stated that the Report's findings of other alleged violations were unsubstantiated and unproven. The DCA (now called the "Ministry of Company Affairs" or "MCA") will consider our Reply and will let us know their conclusions in the coming months. There is the possibility of fines or criminal penalties if conclusive proof of wrongdoing is found. We have told the DCA that Xerox's conduct in voluntarily disclosing the initial information and readily and willingly submitting to investigation, coupled with the non-availability of earlier records, warrants complete closure and early settlement. In January 2006, we learned that the DCA has issued a "Show Cause Notice" to certain former executives of Xerox Modicorp Ltd. seeking a response to allegations of potential violations of the Indian Companies Act.

In March 2005, following the completion of a share buy-back program that increased our controlling ownership interest in our Indian subsidiary to approximately 89 percent from approximately 86 percent at year-end 2004, we changed the name of our Indian subsidiary to Xerox India Ltd.

Note 17—Preferred Stock

As of December 31, 2005, we had one class of preferred stock outstanding as well as one class of preferred stock purchase rights. In total, we are authorized to issue approximately 22 million shares of cumulative preferred stock, \$1.00 par value.

Series C Mandatory Convertible Preferred Stock: In 2003, we issued 9.2 million shares of 6.25% Series C Mandatory Convertible Preferred Stock with a stated liquidation value of \$100 per share for net proceeds of \$889. The proceeds from these securities were used to repay a portion of our indebtedness. Annual dividends of \$6.25 per share are cumulative and payable quarterly in cash, shares of our common stock or a combination thereof.

On July 1, 2006, each share of Series C Mandatory Convertible Preferred Stock will automatically convert into between 8.1301 and 9.7561 shares of our common stock, depending on the then 20-day average market price of our common stock. At any time prior to July 1, 2006, holders may elect to convert each share of Series C Mandatory Convertible Preferred Stock into 8.1301 shares of our common stock. If at any time prior to July 1, 2006, the closing price per share of our common stock exceeds \$18.45 for at least 20 trading days within a period of 30 consecutive trading days, we may elect, subject to certain limitations, to cause the conversion of all, but not less than all, the shares of Series C Mandatory Convertible Preferred Stock then outstanding for shares of our common stock at a conversion rate of 8.1301 shares of our common stock for each share of Series C Mandatory Convertible Preferred Stock.

Preferred Stock Purchase Rights: We have a shareholder rights plan designed to deter coercive or unfair takeover tactics and to prevent a person or persons from gaining control of us without offering a fair price to all shareholders. Under the terms of this plan, one-half of one preferred stock purchase right ("Right") accompanies each share of outstanding common stock. Each full Right entitles the holder to purchase from us one three-hundredth of a new series of preferred stock at an exercise price of \$250. Within the time limits and under the circumstances specified in the plan, the Rights entitle the holder to acquire either our common stock, the stock of

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

the surviving company in a business combination, or the stock of the purchaser of our assets, having a value of two times the exercise price. The Rights, which expire in April 2007, may be redeemed prior to becoming exercisable by action of the Board of Directors at a redemption price of \$.01 per Right. The Rights are non-voting and, until they become exercisable, have no dilutive effect on the earnings per share or book value per share of our common stock.

Note 18—Common Stock

We have 1.75 billion authorized shares of common stock, \$1 par value. At December 31, 2005, 125 million shares were reserved for issuance under our incentive compensation plans, 90 million shares were reserved for the conversion of the Series C Mandatory Convertible Preferred Stock, 48 million shares were reserved for debt to equity exchanges, and 2 million shares were reserved for the conversion of convertible debt.

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

In January 2005, we implemented changes in our stock-based compensation programs designed to help us continue to attract and retain employees and to better align employee interests with those of our shareholders. With these changes, in lieu of stock options we began granting PSs and expanded the use of RSUs. Each of these awards is subject to settlement with newly issued shares of our common stock. At December 31, 2005 and 2004, 38.9 million and 33.9 million shares, respectively, were available for grant of options or awards.

Total compensation related to these programs was \$40, \$22 and \$15 for the years ended December 31, 2005, 2004 and 2003, respectively. The related income tax benefit recognized was \$16, \$8 and \$7 for 2005, 2004 and 2003, respectively. A description of each of our stock-based compensation programs follows:

Restricted Stock Units: Prior to 2005, the RSUs were generally subject to a three-year ratable vesting period from the date of grant and entitled the holder to one share of common stock. In 2005, the terms of newly-issued RSU’s were changed such that the entire award vests three years from the date of grant. Compensation expense is based upon the grant date market price and is recorded over the vesting period. A summary of the activity for RSUs as of December 31, 2005, 2004 and 2003, and changes during the years then ended, is presented below (RSUs in thousands):

| | 2005 | | 2004 | | 2003 | |
|---|--------------|--|--------------|--|--------------|--|
| | Shares | Weighted Average Grant Date Fair Value | Shares | Weighted Average Grant Date Fair Value | Shares | Weighted Average Grant Date Fair Value |
| Nonvested Restricted Stock Units | | | | | | |
| Outstanding at January 1 | 2,804 | \$ 13.86 | 2,180 | \$ 10.46 | 2,352 | \$ 14.08 |
| Granted | 3,750 | 16.89 | 2,539 | 13.70 | 1,657 | 7.90 |
| Vested | (977) | 15.01 | (1,905) | 9.72 | (1,809) | 12.60 |
| Cancelled | (86) | 16.21 | (10) | 19.14 | (20) | 30.36 |
| Outstanding at December 31 | 5,491 | 15.69 | 2,804 | 13.86 | 2,180 | 10.46 |

At December 31, 2005, the aggregate intrinsic value of RSUs outstanding was \$79. The total intrinsic value of RSUs vested during 2005, 2004 and 2003 was \$13, \$26 and \$15, respectively. The actual tax benefit realized for the tax deductions for vested RSUs totaled \$4, \$9 and \$5 for the years ended December 31, 2005, 2004 and 2003 respectively.

At December 31, 2005, there was \$39 million of total unrecognized compensation cost related to nonvested RSUs, which is expected to be recognized ratably over a remaining weighted-average contractual term of 2 years.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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

A summary of the activity for PSs as of December 31, 2005, and changes during the year then ended, is presented below (shares in thousands):

| Nonvested Performance Shares | Shares | Weighted Average Grant Date Fair Value | Weighted Average Remaining Contractual Term |
|------------------------------|--------|--|---|
| Outstanding at January 1 | — | | |
| Granted | 2,070 | \$ 14.87 | |
| Vested | — | — | |
| Cancelled | (18) | 14.87 | |
| Outstanding at December 31 | 2,052 | 14.87 | 2.0 |

At December 31, 2005, the aggregate intrinsic value of PSs outstanding was \$30.

For 2005, the PSs were accounted for as variable awards requiring that the shares be adjusted to market value at each reporting period. Commencing January 1, 2006, upon the adoption of FAS 123(R), PSs will be recorded prospectively using fair value determined as of the grant date. If the stated targets are not met, any recognized compensation cost would be reversed. As of December 31, 2005, there was \$24 of total unrecognized compensation cost related to nonvested PSs; this cost is expected to be recognized ratably over the next 2 years.

Stock Options: Stock options generally vest over a period of three years and expire between eight and ten years from the date of grant. We have not recognized compensation expense relating to employee stock options because the exercise price of the options was equal to the market value of our common stock on the grant date. The following table provides information relating to the status of, and changes in, stock options granted for each of the three years ended December 31, 2005 (stock options in thousands):

| Employee Stock Options | 2005 | | 2004 | | 2003 | |
|----------------------------|-----------------------|----------------------------|------------------|----------------------------|------------------|----------------------------|
| | Stock Options | Average Option Price | Stock Options | Average Option Price | Stock Options | Average Option Price |
| Outstanding at January 1 | 91,833 | \$ 20.98 | 97,839 | \$ 21.46 | 76,849 | \$ 25.58 |
| Granted | — | — | 11,216 | 13.71 | 31,106 | 9.50 |
| Cancelled | (10,291) | 39.41 | (8,071) | 32.24 | (6,840) | 20.58 |
| Exercised | (5,235) | 7.74 | (9,151) | 7.28 | (3,276) | 6.36 |
| Outstanding at December 31 | 76,307 | 19.40 | 91,833 | 20.98 | 97,839 | 21.46 |
| Exercisable at December 31 | 66,928 ⁽¹⁾ | | 65,199 | | 58,652 | |

⁽¹⁾ On January 1, 2006, an additional 8.1 million stock options became exercisable.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Options outstanding and exercisable at December 31, 2005 were as follows (stock options in thousands):

| | Options Outstanding | | | Options Exercisable | | |
|---------------------------------|---------------------|---|---------------------------------|---------------------|---|---------------------------------|
| | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |
| Range of Exercise Prices | | | | | | |
| \$4.75 to \$6.98 | 6,487 | 4.96 | \$ 4.87 | 5,939 | 4.90 | \$ 4.85 |
| 7.13 to 10.69 | 31,078 | 6.35 | 9.12 | 25,789 | 6.27 | 9.29 |
| 10.70 to 15.27 | 11,119 | 5.97 | 13.66 | 7,577 | 5.96 | 13.65 |
| 16.91 to 22.88 | 12,188 | 4.00 | 21.77 | 12,188 | 4.00 | 21.77 |
| 25.38 to 32.16 | 3,826 | 3.89 | 26.37 | 3,826 | 3.89 | 26.37 |
| 42.83 to 60.95 | 11,609 | 2.38 | 55.79 | 11,609 | 2.38 | 55.79 |
| | <u>76,307</u> | 5.08 | 19.40 | <u>66,928</u> | 4.89 | 20.70 |

At December 31, 2005, the aggregate intrinsic value of stock options outstanding and stock options exercisable was \$247 and \$204, respectively.

The following table provides information relating to stock option exercises for the three years ended December 31, 2005:

| <u>(in millions)</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> |
|---|-------------|-------------|-------------|
| Total Intrinsic Value | \$36 | \$67 | \$14 |
| Cash Received | 41 | 67 | 21 |
| Tax Benefit Realized for Tax Deductions | 12 | 23 | 5 |

Treasury Stock: In October 2005, the Board of Directors authorized the Company to repurchase up to \$500 million of common stock. The stock is expected to be repurchased through the period ending October 31, 2006, primarily through open-market purchases. Repurchases are made in compliance with the Securities and Exchange Commission's Rule 10b-18, and are subject to market conditions as well as applicable legal and other considerations. During the fourth quarter 2005, we repurchased 30,502,200 shares at an aggregate cost of \$433, including associated fees of \$1. These treasury stock shares may be cancelled upon the Board of Directors approval. In 2005, 16,585,300 repurchased shares were cancelled and were recorded as a reduction to both common stock of \$17 and additional paid-in-capital of \$213.

Note 19—Research, Development and Engineering (“R, D&E”)

R, D&E was \$943, \$914 and \$962, for the three years ended December 31, 2005, respectively. Research and development (“R&D”) costs were \$755 in 2005, \$760 in 2004 and \$868 in 2003. Sustaining engineering costs are incurred with respect to ongoing product improvements or environmental compliance after initial product launch. Our sustaining engineering costs were \$188, \$154, and \$94, for the three years ended December 31, 2005, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 20—Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share of common stock (in millions, except shares in thousands):

| | 2005 | 2004 | 2003 |
|---|-----------|-----------|---------|
| Basic Earnings per Share: | | | |
| Income from continuing operations before discontinued operations and cumulative effect of change in accounting principle | \$ 933 | \$ 776 | \$ 360 |
| Accrued dividends on: | | | |
| Series B Convertible Preferred Stock, net | — | (16) | (41) |
| Series C Mandatory Convertible Preferred Stock | (58) | (57) | (30) |
| Adjusted income from continuing operations before discontinued operations and cumulative effect of change in accounting principle | 875 | 703 | 289 |
| Income from discontinued operations, net | 53 | 83 | — |
| Cumulative effect of change in accounting principle, net | (8) | — | — |
| Adjusted net income available to common shareholders | \$ 920 | \$ 786 | \$ 289 |
| Weighted Average Common Shares Outstanding | 957,149 | 834,321 | 769,032 |
| Basic Earnings per Share: | | | |
| Income from continuing operations | \$ 0.91 | \$ 0.84 | \$ 0.38 |
| Income from discontinued operations | 0.06 | 0.10 | — |
| Loss from cumulative effect of change in accounting principle | (0.01) | — | — |
| Basic Earnings per Share | \$ 0.96 | \$ 0.94 | \$ 0.38 |
| Diluted Earnings per Share: | | | |
| Income from continuing operations before discontinued operations and cumulative effect of change in accounting principle | \$ 933 | \$ 776 | \$ 360 |
| ESOP expense adjustment, net | — | (6) | (35) |
| Accrued dividends on Series C Mandatory Convertible Preferred Stock | — | — | (30) |
| Interest on Convertible securities, net | 1 | 51 | — |
| Adjusted income from continuing operations before discontinued operations and cumulative effect of change in accounting principle | 934 | 821 | 295 |
| Income from discontinued operations, net | 53 | 83 | — |
| Cumulative effect of change in accounting principle, net | (8) | — | — |
| Adjusted net income available to common shareholders | \$ 979 | \$ 904 | \$ 295 |
| Weighted Average Common Shares Outstanding | 957,149 | 834,321 | 769,032 |
| Common shares issuable with respect to: | | | |
| Stock options and restricted stock | 11,415 | 14,198 | 8,273 |
| Series B Convertible Preferred Stock | — | 17,359 | 51,082 |
| Series C Mandatory Convertible Preferred Stock | 74,797 | 74,797 | — |
| Convertible securities | 1,992 | 106,272 | — |
| Adjusted Weighted Average Shares Outstanding | 1,045,353 | 1,046,947 | 828,387 |
| Diluted Earnings per Share: | | | |
| Income from continuing operations | \$ 0.90 | \$ 0.78 | \$ 0.36 |
| Income from discontinued operations | 0.05 | 0.08 | — |
| Loss from cumulative effect of change in accounting principle | (0.01) | — | — |
| Diluted Earnings per Share | \$ 0.94 | \$ 0.86 | \$ 0.36 |

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The 2005, 2004 and 2003 computation of diluted earnings per share did not include the effects of 36 million, 38 million and 63 million stock options, respectively, because their respective exercise prices were greater than the corresponding market value per share of our common stock.

In 2003, the following potentially dilutive securities were not included in the computation of diluted EPS because to do so would have been anti-dilutive (in thousands of shares on weighted-average basis):

| | 2003 |
|---|----------------|
| Series C Mandatory Convertible Preferred Stock | 43,656 |
| Liability to subsidiary trust issuing preferred securities—Trust II | 113,426 |
| Convertible subordinated debentures | 1,992 |
| Total | 159,074 |

All such securities were dilutive or converted to common stock in 2005 and 2004.

Note 21—Divestitures and Other Sales

During the three years ended December 31, 2005, the following significant divestitures occurred:

Integic: In March 2005, we completed the sale of our entire equity interest in Integic Corporation (“Integic”) for \$96 in cash, net of transaction costs. The sale resulted in a pre-tax gain of \$93 (\$58 after-tax). Prior to this transaction, our investment in Integic was accounted for using the equity method and was included in Investments in affiliates, at equity within our Consolidated Balance Sheets. The pre-tax gain is classified within Other (income) expenses, net in the accompanying Consolidated Statements of Income.

ScanSoft: In April 2004, we completed the sale of our ownership interest in ScanSoft, Inc. (“ScanSoft”) to affiliates of Warburg Pincus for approximately \$79 in cash, net of transaction costs. Prior to the sale, we beneficially owned approximately 15% of ScanSoft’s outstanding equity interests. The sale resulted in a pre-tax gain of \$38. Prior to this transaction, our investment in ScanSoft was accounted for as an “available for sale” investment. The gain is classified within Other (income) expenses, net in the accompanying Consolidated Statements of Income.

ContentGuard: In March 2004, we sold all but 2% of our 75% ownership interest in ContentGuard Inc. (“ContentGuard”) to Microsoft Corporation and Time Warner Inc. for \$66 in cash. The sale resulted in a pre-tax gain of \$109 as our investment reflected the recognition of cumulative operating losses. The gain on sale has been presented within the accompanying consolidated statements of income considering the reporting requirements related to discontinued operations of SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” The revenues, operating results and net assets of ContentGuard were immaterial for all periods presented. ContentGuard, which was originally created out of research developed at the Xerox Palo Alto Research Center (“PARC”), licenses intellectual property and technologies related to digital rights management. During 2005, we sold our remaining interest in ContentGuard.

Xerox Engineering Systems: In the second quarter 2003, we sold our Xerox Engineering Systems (“XES”) subsidiaries in France and Germany for a nominal amount and recognized a loss of \$12.

Note 22—Financial Statements of Subsidiary Guarantors

The Senior Notes due 2009, 2010, 2011 and 2013 are guaranteed by Xerox International Joint Marketing, Inc. (“XIJM”) (the “Guarantor Subsidiary”), which is wholly-owned by Xerox Corporation (the “Parent Company”).

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Effective December 31, 2005, one of the prior guarantors, Intelligent Electronics, Inc., was merged into the Parent Company based on an internal reorganization. This resulted in a retroactive restatement of the condensed consolidating financial information to reflect XIJM as the sole guarantor subsidiary as of December 31, 2005. The following supplemental financial information sets forth, on a condensed consolidating basis, statements of income, the balance sheets and statements of cash flows for the Parent Company, the Guarantor Subsidiary, the non-guarantor subsidiaries and total consolidated Xerox Corporation and subsidiaries for the years ended December 31, 2005, 2004, and 2003 and as of December 31, 2005 and December 31, 2004.

Condensed Consolidating Statements of Income for the Year Ended December 31, 2005

| | <u>Parent Company</u> | <u>Guarantor Subsidiary</u> | <u>Non-Guarantor Subsidiaries</u> | <u>Eliminations*</u> | <u>Total Company</u> |
|--|---------------------------|---------------------------------|---------------------------------------|----------------------|--------------------------|
| Revenues | | | | | |
| Sales | \$ 3,292 | \$ — | \$ 4,108 | \$ — | \$ 7,400 |
| Service, outsourcing and rentals | 4,006 | — | 3,629 | (209) | 7,426 |
| Finance income | 313 | — | 679 | (117) | 875 |
| Intercompany revenues | 1,178 | — | 319 | (1,497) | — |
| Total Revenues | 8,789 | — | 8,735 | (1,823) | 15,701 |
| Costs and Expenses | | | | | |
| Cost of sales | 2,034 | — | 2,823 | (162) | 4,695 |
| Cost of service, outsourcing and rentals | 2,253 | — | 1,956 | (2) | 4,207 |
| Equipment financing interest | 152 | — | 291 | (117) | 326 |
| Intercompany cost of sales | 1,044 | — | 252 | (1,296) | — |
| Research, development and engineering expenses | 865 | — | 117 | (39) | 943 |
| Selling, administrative and general expenses | 2,289 | — | 2,028 | (207) | 4,110 |
| Restructuring and asset impairment charges | 167 | — | 201 | (2) | 366 |
| Other (income) expenses, net | (170) | (23) | 420 | (3) | 224 |
| Total Costs and Expenses | 8,634 | (23) | 8,088 | (1,828) | 14,871 |
| Income from Continuing Operations before Income Taxes, Equity | | | | | |
| Income, Discontinued Operations and Cumulative Effect of | | | | | |
| Change in Accounting Principle | | | | | |
| Income tax (benefits) expenses | 155 | 23 | 647 | 5 | 830 |
| Income tax (benefits) expenses | (184) | 9 | 163 | 7 | (5) |
| Equity in net income of unconsolidated affiliates | 5 | — | 99 | (6) | 98 |
| Equity in net income of consolidated affiliates | 584 | 8 | 2 | (594) | — |
| Income from Continuing Operations before Discontinued | | | | | |
| Operations and Cumulative Effect of Change in Accounting | | | | | |
| Principle | | | | | |
| Income from Discontinued Operations, net of tax | 928 | 22 | 585 | (602) | 933 |
| Income from Discontinued Operations, net of tax | 53 | — | — | — | 53 |
| Cumulative Effect of Change in Accounting Principle, net of tax | (3) | — | (5) | — | (8) |
| Net Income (Loss) | \$ 978 | \$ 22 | \$ 580 | \$ (602) | \$ 978 |

* The information primarily includes elimination entries necessary to consolidate Xerox Corporation, the parent, with the guarantor subsidiary and non-guarantor subsidiaries.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Condensed Consolidating Balance Sheets as of December 31, 2005

| | Parent Company | Guarantor Subsidiary | Non-Guarantor Subsidiaries | Eliminations* | Total Company |
|---|-------------------|-------------------------|-------------------------------|-------------------|------------------|
| Assets | | | | | |
| Cash and cash equivalents | \$ 640 | \$ — | \$ 682 | \$ — | \$ 1,322 |
| Short-term investments | 244 | — | — | — | 244 |
| | <u>884</u> | <u>—</u> | <u>682</u> | <u>—</u> | <u>1,566</u> |
| Total cash, cash equivalents and short-term investments | 884 | — | 682 | — | 1,566 |
| Accounts receivable, net | 475 | — | 1,562 | — | 2,037 |
| Billed portion of finance receivables, net | 178 | — | 118 | — | 296 |
| Finance receivables, net | 894 | — | 1,710 | — | 2,604 |
| Inventories | 721 | — | 521 | (41) | 1,201 |
| Other current assets | 463 | — | 543 | 26 | 1,032 |
| | <u>3,615</u> | <u>—</u> | <u>5,136</u> | <u>(15)</u> | <u>8,736</u> |
| Total current assets | 3,615 | — | 5,136 | (15) | 8,736 |
| Finance receivables due after one year, net | 1,678 | — | 3,271 | — | 4,949 |
| Equipment on operating leases, net | 263 | — | 168 | — | 431 |
| Land, buildings and equipment, net | 946 | — | 681 | — | 1,627 |
| Investments in affiliates, at equity | 42 | — | 819 | (79) | 782 |
| Investments in and advances to consolidated subsidiaries | 8,397 | 46 | (19) | (8,424) | — |
| Intangible assets, net | 276 | — | 13 | — | 289 |
| Goodwill | 381 | — | 1,282 | 8 | 1,671 |
| Other long-term assets | 1,704 | — | 1,764 | — | 3,468 |
| | <u>17,302</u> | <u>46</u> | <u>13,115</u> | <u>(8,510)</u> | <u>21,953</u> |
| Total Assets | \$17,302 | \$ 46 | \$ 13,115 | \$ (8,510) | \$21,953 |
| Liabilities and Equity | | | | | |
| Short-term debt and current portion of long-term debt | \$ 1 | \$ — | \$ 1,138 | \$ — | \$ 1,139 |
| Accounts payable | 537 | — | 491 | 15 | 1,043 |
| Other current liabilities | 925 | 28 | 1,211 | — | 2,164 |
| | <u>1,463</u> | <u>28</u> | <u>2,840</u> | <u>15</u> | <u>4,346</u> |
| Total current liabilities | 1,463 | 28 | 2,840 | 15 | 4,346 |
| Long-term debt | 3,516 | — | 2,623 | — | 6,139 |
| Intercompany payables, net | 1,829 | (212) | (1,595) | (22) | — |
| Liabilities to subsidiary trusts issuing preferred securities | 626 | — | — | — | 626 |
| Other long-term liabilities | 2,660 | — | 992 | (18) | 3,634 |
| | <u>10,094</u> | <u>(184)</u> | <u>4,860</u> | <u>(25)</u> | <u>14,745</u> |
| Total liabilities | 10,094 | (184) | 4,860 | (25) | 14,745 |
| Series C mandatory convertible preferred stock | 889 | — | — | — | 889 |
| Common shareholders' equity | 6,319 | 230 | 8,255 | (8,485) | 6,319 |
| | <u>17,302</u> | <u>46</u> | <u>13,115</u> | <u>(8,510)</u> | <u>21,953</u> |
| Total Liabilities and Equity | \$17,302 | \$ 46 | \$ 13,115 | \$ (8,510) | \$21,953 |

* The information primarily includes elimination entries necessary to consolidate Xerox Corporation, the parent, with the guarantor subsidiary and non-guarantor subsidiaries.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Condensed Consolidating Statements of Cash Flows for the Year Ended December 31, 2005

| | <u>Parent Company</u> | <u>Guarantor Subsidiary</u> | <u>Non-Guarantor Subsidiaries</u> | <u>Total Company</u> |
|--|---------------------------|---------------------------------|---------------------------------------|--------------------------|
| Net cash (used in) provided by operating activities | \$ (1,018) | \$ — | \$ 2,438 | \$ 1,420 |
| Net cash used in investing activities | (290) | — | (5) | (295) |
| Net cash used in financing activities | (496) | — | (2,466) | (2,962) |
| Effect of exchange rate changes on cash and cash equivalents | — | — | (59) | (59) |
| Decrease in cash and cash equivalents | (1,804) | — | (92) | (1,896) |
| Cash and cash equivalents at beginning of year | 2,444 | — | 774 | 3,218 |
| Cash and cash equivalents at end of year | \$ 640 | \$ — | \$ 682 | \$ 1,322 |

Condensed Consolidating Statements of Income for the Year Ended December 31, 2004

| | <u>Parent Company</u> | <u>Guarantor Subsidiary</u> | <u>Non-Guarantor Subsidiaries</u> | <u>Eliminations*</u> | <u>Total Company</u> |
|--|---------------------------|---------------------------------|---------------------------------------|----------------------|--------------------------|
| Revenues | | | | | |
| Sales | \$ 3,263 | \$ — | \$ 3,996 | \$ — | \$ 7,259 |
| Service, outsourcing and rentals | 4,119 | — | 3,627 | (217) | 7,529 |
| Finance income | 314 | — | 713 | (93) | 934 |
| Intercompany revenues | 1,004 | — | 365 | (1,369) | — |
| Total Revenues | 8,700 | — | 8,701 | (1,679) | 15,722 |
| Cost and Expenses | | | | | |
| Cost of sales | 2,040 | — | 2,636 | (131) | 4,545 |
| Cost of service, outsourcing and rentals | 2,312 | — | 2,000 | (17) | 4,295 |
| Equipment financing interest | 106 | — | 332 | (93) | 345 |
| Intercompany cost of sales | 914 | — | 297 | (1,211) | — |
| Research, development and engineering expenses | 822 | — | 128 | (36) | 914 |
| Selling, administrative and general expenses | 2,363 | — | 2,046 | (206) | 4,203 |
| Restructuring and asset impairment charges | 51 | — | 35 | — | 86 |
| Other (income) expenses, net | (35) | (19) | 424 | (1) | 369 |
| Total Cost and Expenses | 8,573 | (19) | 7,898 | (1,695) | 14,757 |
| Income from Continuing Operations before Income Taxes, Equity Income, Discontinued Operations and Cumulative Effect of Change in Accounting Principle | | | | | |
| | 127 | 19 | 803 | 16 | 965 |
| Income tax expenses | 94 | 7 | 229 | 10 | 340 |
| Equity in net income of unconsolidated affiliates | 15 | — | 131 | 5 | 151 |
| Equity in net income of consolidated affiliates | 728 | 8 | — | (736) | — |
| Income from Continuing Operations before Discontinued Operations and Cumulative Effect of Change in Accounting Principle | | | | | |
| | 776 | 20 | 705 | (725) | 776 |
| Income from Discontinued Operations, net of tax | 83 | — | — | — | 83 |
| Cumulative Effect of Change in Accounting Principle, net of tax | — | — | — | — | — |
| Net Income (Loss) | \$ 859 | \$ 20 | \$ 705 | \$ (725) | \$ 859 |

*The information primarily includes elimination entries necessary to consolidate Xerox Corporation, the parent, with the guarantor subsidiary and non-guarantor subsidiaries.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Condensed Consolidating Balance Sheets as of December 31, 2004

| | Parent Company | Guarantor Subsidiary | Non- Guarantor Subsidiaries | Eliminations* | Total Company |
|---|-------------------|-------------------------|-----------------------------------|-------------------|------------------|
| Assets | | | | | |
| Cash and cash equivalents | \$ 2,444 | \$ — | \$ 774 | \$ — | \$ 3,218 |
| Short-term investments | — | — | — | — | — |
| Total cash, cash equivalents and short-term investments | 2,444 | — | 774 | — | 3,218 |
| Accounts receivable, net | 380 | — | 1,696 | — | 2,076 |
| Billed portion of finance receivables, net | 206 | — | 171 | — | 377 |
| Finance receivables, net | 581 | — | 2,351 | — | 2,932 |
| Inventories | 672 | — | 511 | (40) | 1,143 |
| Other current assets | 465 | — | 664 | 53 | 1,182 |
| Total current assets | 4,748 | — | 6,167 | 13 | 10,928 |
| Finance receivables due after one year, net | 1,099 | — | 4,089 | — | 5,188 |
| Equipment on operating leases, net | 232 | — | 166 | — | 398 |
| Land, buildings and equipment, net | 982 | — | 777 | — | 1,759 |
| Investments in affiliates, at equity | 40 | — | 862 | (57) | 845 |
| Investments in and advances to consolidated subsidiaries | 9,294 | 36 | (165) | (9,165) | — |
| Intangible assets, net | 316 | — | 8 | — | 324 |
| Goodwill | 381 | — | 1,459 | 8 | 1,848 |
| Other long-term assets | 1,082 | — | 2,512 | — | 3,594 |
| Total Assets | \$18,174 | \$ 36 | \$ 15,875 | \$ (9,201) | \$24,884 |
| Liabilities and Equity | | | | | |
| Short-term debt and current portion of long-term debt | \$ 5 | \$ — | \$ 3,069 | \$ — | \$ 3,074 |
| Accounts payable | 481 | — | 517 | 39 | 1,037 |
| Other current liabilities | 871 | 13 | 1,317 | (12) | 2,189 |
| Total current liabilities | 1,357 | 13 | 4,903 | 27 | 6,300 |
| Long-term debt | 3,632 | — | 3,418 | — | 7,050 |
| Intercompany payables, net | 2,592 | (184) | (2,386) | (22) | — |
| Liabilities to subsidiary trusts issuing preferred securities | 717 | — | — | — | 717 |
| Other long-term liabilities | 2,743 | — | 956 | (15) | 3,684 |
| Total liabilities | 11,041 | (171) | 6,891 | (10) | 17,751 |
| Series C mandatory convertible preferred stock | 889 | — | — | — | 889 |
| Common shareholders' equity | 6,244 | 207 | 8,984 | (9,191) | 6,244 |
| Total Liabilities and Equity | \$18,174 | \$ 36 | \$ 15,875 | \$ (9,201) | \$24,884 |

* The information primarily includes elimination entries necessary to consolidate Xerox Corporation, the parent, with the guarantor subsidiary and non-guarantor subsidiaries.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Condensed Consolidating Statements of Cash Flows for the Year Ended December 31, 2004

| | Parent Company | Guarantor Subsidiary | Non- Guarantor Subsidiaries | Total Company |
|--|-------------------|-------------------------|-----------------------------------|------------------|
| Net cash provided by operating activities | \$ 1,122 | \$ — | \$ 628 | \$ 1,750 |
| Net cash provided by investing activities | 72 | — | 131 | 203 |
| Net cash provided by (used in) financing activities | 153 | — | (1,446) | (1,293) |
| Effect of exchange rate changes on cash and cash equivalents | (2) | — | 83 | 81 |
| Increase (decrease) in cash and cash equivalents | 1,345 | — | (604) | 741 |
| Cash and cash equivalents at beginning of year | 1,099 | — | 1,378 | 2,477 |
| Cash and cash equivalents at end of year | \$ 2,444 | \$ — | \$ 774 | \$ 3,218 |

Condensed Consolidating Statements of Income for the Year Ended December 31, 2003

| | Parent Company | Guarantor Subsidiary | Non- Guarantor Subsidiaries | Eliminations* | Total Company |
|--|-------------------|-------------------------|-----------------------------------|-----------------|------------------|
| Revenues | | | | | |
| Sales | \$ 3,321 | \$ — | \$ 3,649 | \$ — | \$ 6,970 |
| Service, outsourcing and rentals | 4,301 | — | 3,636 | (203) | 7,734 |
| Finance income | 337 | — | 750 | (90) | 997 |
| Intercompany revenues | 595 | — | 427 | (1,022) | — |
| Total Revenues | 8,554 | — | 8,462 | (1,315) | 15,701 |
| Cost and Expenses | | | | | |
| Cost of sales | 2,054 | — | 2,438 | (146) | 4,346 |
| Cost of service, outsourcing and rentals | 2,364 | — | 1,965 | (22) | 4,307 |
| Equipment financing interest | 88 | — | 364 | (90) | 362 |
| Intercompany cost of sales | 533 | — | 342 | (875) | — |
| Research, development and engineering expenses | 859 | — | 116 | (13) | 962 |
| Selling, administrative and general expenses | 2,521 | — | 1,919 | (191) | 4,249 |
| Restructuring and asset impairment charges | 105 | — | 71 | — | 176 |
| Other expenses (income), net | 504 | (18) | 371 | 6 | 863 |
| Total Cost and Expenses | 9,028 | (18) | 7,586 | (1,331) | 15,265 |
| Income from Continuing Operations before Income Taxes, Equity Income, Discontinued Operations and Cumulative Effect of Change in Accounting Principle | (474) | 18 | 876 | 16 | 436 |
| Income tax (benefits) expenses | (108) | 7 | 224 | 11 | 134 |
| Equity in net income of unconsolidated affiliates | — | — | 61 | (3) | 58 |
| Equity in net income of consolidated affiliates | 726 | 12 | — | (738) | — |
| Income (Loss) from Continuing Operations before Discontinued Operations and Cumulative Effect of Change in Accounting Principle | 360 | 23 | 713 | (736) | 360 |
| Income from Discontinued Operations, net of tax | — | — | — | — | — |
| Cumulative Effect of Change in Accounting Principle, net of tax | — | — | — | — | — |
| Net Income (Loss) | \$ 360 | \$ 23 | \$ 713 | \$ (736) | \$ 360 |

*The information primarily includes elimination entries necessary to consolidate Xerox Corporation, the parent, with the guarantor subsidiary and non-guarantor subsidiaries.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Condensed Consolidating Statements of Cash Flows for the Year Ended December 31, 2003

| | <u>Parent Company</u> | <u>Guarantor Subsidiary</u> | <u>Non-Guarantor Subsidiaries</u> | <u>Total Company</u> |
|--|---------------------------|---------------------------------|---------------------------------------|--------------------------|
| Net cash provided by (used in) operating activities | \$ 2,672 | \$ — | \$ (793) | \$ 1,879 |
| Net cash (used in) provided by investing activities | (475) | — | 524 | 49 |
| Net cash (used in) provided by financing activities | (2,769) | — | 299 | (2,470) |
| Effect of exchange rate changes on cash and cash equivalents | — | — | 132 | 132 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| (Decrease) increase in cash and cash equivalents | (572) | — | 162 | (410) |
| Cash and cash equivalents at beginning of year | 1,671 | — | 1,216 | 2,887 |
| | <hr/> | <hr/> | <hr/> | <hr/> |
| Cash and cash equivalents at end of year | \$ 1,099 | \$ — | \$ 1,378 | \$ 2,477 |

Note 23—Subsequent Events

In January 2006, the board of directors authorized an additional repurchase of up to \$500 of the company's common stock. The company expects the stock to be repurchased over the next 6-12 months, primarily through open-market purchases. Open-market repurchases will be made in compliance with the Securities and Exchange Commission's Rule 10b-18, and are subject to market conditions as well as applicable legal and other considerations.

Through February 16, 2006, we repurchased the following through our authorized repurchase programs:

| | <u>Common Stock Shares</u> | <u>Aggregate Costs</u> |
|---------------------------------|--------------------------------|----------------------------|
| October 2005 Repurchase Program | 35,213,032 | \$ 501* |
| January 2006 Repurchase Program | 3,556,168 | 52** |
| | <hr/> | <hr/> |
| Total | 38,769,200 | \$ 553 |

* This amount included \$1 of associated fees.

** This amount included an insignificant amount of associated fees.

REPORTS OF MANAGEMENT

Management's Responsibility for Financial Statements

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

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

Management's Report on Internal Control Over Financial Reporting

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

Based on the above evaluation, management has concluded that, our internal control over financial reporting was effective as of December 31, 2005. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

/s/ ANNE M. MULCAHY
Chief Executive Officer

/s/ LAWRENCE A. ZIMMERMAN
Chief Financial Officer

/s/ GARY R. KABURECK
Chief Accounting Officer

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Xerox Corporation:

We have completed integrated audits of Xerox Corporation's 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005 and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, cash flows and common shareholders' equity present fairly, in all material respects, the financial position of Xerox Corporation and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made

only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

/s/ PRICEWATERHOUSECOOPERS LLP
Stamford, Connecticut
February 17, 2006

QUARTERLY RESULTS OF OPERATIONS (Unaudited) (in millions, except per-share data)

| | <u>First Quarter</u> | <u>Second Quarter</u> | <u>Third Quarter</u> | <u>Fourth Quarter</u> | <u>Full Year</u> |
|---|--------------------------|---------------------------|--------------------------|---------------------------|----------------------|
| 2005 | | | | | |
| Revenues | \$3,771 | \$3,921 | \$3,759 | \$4,250 | \$15,701 |
| Costs and Expenses ⁽¹⁾ | 3,482 | 3,804 | 3,682 | 3,903 | 14,871 |
| Income from Continuing Operations before Income Taxes, Equity Income, Discontinued Operations and Cumulative Effect of Change in Accounting Principle | 289 | 117 | 77 | 347 | 830 |
| Income tax expenses (benefits) ⁽²⁾ | 116 | (233) | 29 | 83 | (5) |
| Equity in net income of unconsolidated affiliates | 37 | 20 | 23 | 18 | 98 |
| Income from discontinued operations, net | — | 53 | — | — | 53 |
| Cumulative effect of change in accounting principle, net | — | — | (8) | — | (8) |
| Net Income | \$ 210 | \$ 423 | \$ 63 | \$ 282 | \$ 978 |
| Basic Earnings per Share ⁽³⁾ | \$ 0.20 | \$ 0.43 | \$ 0.05 | \$ 0.28 | \$ 0.96 |
| Diluted Earnings per Share ⁽³⁾ | \$ 0.20 | \$ 0.40 | \$ 0.05 | \$ 0.27 | \$ 0.94 |
| 2004 | | | | | |
| Revenues | \$3,827 | \$3,853 | \$3,716 | \$4,326 | \$15,722 |
| Costs and Expenses ⁽¹⁾ | 3,625 | 3,581 | 3,553 | 3,998 | 14,757 |
| Income from Continuing Operations before Income Taxes, Equity Income, Discontinued Operations and Cumulative Effect of Change in Accounting Principle | 202 | 272 | 163 | 328 | 965 |
| Income benefits taxes | 67 | 91 | 62 | 120 | 340 |
| Equity in net income of unconsolidated affiliates ⁽⁴⁾ | 30 | 27 | 62 | 32 | 151 |
| Income from discontinued operations, net | 83 | — | — | — | 83 |
| Cumulative effect of change in accounting principle, net | — | — | — | — | — |
| Net Income | \$ 248 | \$ 208 | \$ 163 | \$ 240 | \$ 859 |
| Basic Earnings per Share ⁽³⁾ | \$ 0.28 | \$ 0.23 | \$ 0.18 | \$ 0.26 | \$ 0.94 |
| Diluted Earnings per Share ⁽³⁾ | \$ 0.25 | \$ 0.21 | \$ 0.17 | \$ 0.24 | \$ 0.86 |

⁽¹⁾ Costs and expenses include restructuring and asset impairment charges of \$85, \$194, \$17 and \$70 for the first, second, third and fourth quarters of 2005, respectively, and \$6, \$33, \$23 and \$24 for the first, second, third and fourth quarters of 2004, respectively. Also included are \$93 from the 2005 first quarter sale of our entire equity interest in Integic (See Note 21) and \$115 from the MPI arbitration panel ruling and probable losses for other legal matters incurred in the third quarter of 2005 (See Note 16). In addition, a gain of \$38 from the sale of our investment in ScanSoft was included in the second quarter of 2004.

⁽²⁾ The 2005 second quarter included \$343 of net income benefits related to the finalization of the 1996-1998 IRS audit, of which \$233 was included in income taxes, \$57 was included in other expenses, net and \$53 was included in discontinued operations (See Note 15).

⁽³⁾ The sum of quarterly earnings per share may differ from the full-year amounts due to rounding, or in the case of diluted earnings per share, because securities that are anti-dilutive in certain quarters may not be anti-dilutive on a full-year basis.

⁽⁴⁾ Equity in net income of unconsolidated affiliates for the third quarter 2004 includes an after-tax \$38 pension settlement benefit from Fuji Xerox.

FIVE YEARS IN REVIEW

| | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|----------|----------|----------|----------|-----------|
| (in millions, except per-share data) | | | | | |
| Per-Share Data ⁽¹⁾ | | | | | |
| Income (Loss) from continuing operations before discontinued operations and cumulative effect of change in accounting principle | | | | | |
| Basic | \$ 0.91 | \$ 0.84 | \$ 0.38 | \$ 0.11 | \$ (0.15) |
| Diluted | 0.90 | 0.78 | 0.36 | 0.10 | (0.15) |
| Earnings (Loss) | | | | | |
| Basic | \$ 0.96 | \$ 0.94 | \$ 0.38 | \$ 0.02 | \$ (0.15) |
| Diluted | 0.94 | 0.86 | 0.36 | 0.02 | (0.15) |
| Common stock dividends | — | — | — | — | 0.05 |
| Operations | | | | | |
| Revenues | \$15,701 | \$15,722 | \$15,701 | \$15,849 | \$17,008 |
| Sales | 7,400 | 7,259 | 6,970 | 6,752 | 7,443 |
| Service, outsourcing and rentals | 7,426 | 7,529 | 7,734 | 8,097 | 8,436 |
| Finance income | 875 | 934 | 997 | 1,000 | 1,129 |
| Research, development and engineering expenses ⁽³⁾ | 943 | 914 | 962 | 980 | 1,058 |
| Selling, administrative and general expenses | 4,110 | 4,203 | 4,249 | 4,437 | 4,728 |
| Income (loss) from continuing operations before discontinued operations and cumulative effect of change in accounting principle | 933 | 776 | 360 | 154 | (92) |
| Net income (loss) ⁽¹⁾ | 978 | 859 | 360 | 91 | (94) |
| Financial Position | | | | | |
| Cash, cash equivalents and Short-term investments | \$ 1,566 | \$ 3,218 | \$ 2,477 | \$ 2,887 | \$ 3,990 |
| Accounts and finance receivables, net | 9,886 | 10,573 | 10,972 | 11,077 | 11,574 |
| Inventories | 1,201 | 1,143 | 1,152 | 1,231 | 1,364 |
| Equipment on operating leases, net | 431 | 398 | 364 | 450 | 804 |
| Land, buildings and equipment, net | 1,627 | 1,759 | 1,827 | 1,757 | 1,999 |
| Investment in discontinued operations | 420 | 440 | 449 | 728 | 749 |
| Total assets | 21,953 | 24,884 | 24,591 | 25,550 | 27,746 |
| Consolidated Capitalization | | | | | |
| Short-term debt and current portion of long-term debt | 1,139 | 3,074 | 4,236 | 4,377 | 6,637 |
| Long-term debt | 6,139 | 7,050 | 6,930 | 9,794 | 10,107 |
| Total debt | 7,278 | 10,124 | 11,166 | 14,171 | 16,744 |
| Minorities' interests in equity of subsidiaries | 90 | 80 | 102 | 73 | 73 |
| Liabilities to subsidiary trusts issuing preferred securities | 626 | 717 | 1,809 | 1,793 | 1,787 |
| Series B convertible preferred stock | — | — | 499 | 508 | 470 |
| Series C mandatory convertible preferred stock | 889 | 889 | 889 | — | — |
| Common shareholders' equity | 6,319 | 6,244 | 3,291 | 1,893 | 1,797 |
| Total capitalization | \$15,202 | \$18,054 | \$17,756 | \$18,438 | \$20,871 |
| Selected Data and Ratios | | | | | |
| Common shareholders of record at year-end | 53,017 | 55,152 | 56,326 | 57,300 | 59,830 |
| Book value per common share | \$ 6.79 | \$ 6.53 | \$ 4.15 | \$ 2.56 | \$ 2.49 |
| Year-end common stock market price | \$ 14.65 | \$ 17.01 | \$ 13.80 | \$ 8.05 | \$ 10.42 |
| Employees at year-end | 55,220 | 58,100 | 61,100 | 67,800 | 78,900 |
| Gross margin | 41.2% | 41.6% | 42.6% | 42.8% | 38.6% |
| Sales gross margin | 36.6% | 37.4% | 37.6% | 38.2% | 31.3% |
| Service, outsourcing and rentals gross margin | 43.3% | 43.0% | 44.3% | 44.5% | 42.2% |
| Finance gross margin | 62.7% | 63.1% | 63.7% | 59.9% | 59.5% |
| Working capital | \$ 4,390 | \$ 4,628 | \$ 2,666 | \$ 3,242 | \$ 2,340 |
| Current ratio | 2.0 | 1.7 | 1.4 | 1.4 | 1.2 |
| Cost of additions to land, buildings and equipment | \$ 181 | \$ 204 | \$ 197 | \$ 146 | \$ 219 |
| Depreciation on buildings and equipment | \$ 280 | \$ 305 | \$ 299 | \$ 341 | \$ 402 |

⁽¹⁾ Net income (loss), as well as Basic and Diluted Earnings per Share for the years ended December 31, 2005, 2004, 2003 and 2002 exclude the effect of amortization of goodwill in accordance with the adoption of Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets." Amortization expense, net, related to Goodwill was \$59 in 2001.

⁽²⁾ In March 2001, we sold half of our ownership interest in Fuji Xerox to Fuji Photo Film Co. Ltd. for \$1.3 billion in cash. In connection with the sale, we recorded a pre-tax gain of \$773. As a result, our ownership percentage decreased from 50% to 25%.

⁽³⁾ Effective July 1, 2005, we reclassified sustaining engineering costs from cost of sales and cost of service, outsourcing and rentals to a new line item in our Consolidated Statements of Income entitled Research, Development and Engineering. This presentation aligns our external reporting presentation to our internal management of these costs.

Subsidiaries of Xerox Corporation

The following companies are subsidiaries of Xerox Corporation as of December 31, 2005. Unless otherwise noted, a subsidiary is a company in which Xerox Corporation or a subsidiary of Xerox Corporation holds 50% or more of the voting stock. The names of other subsidiaries have been omitted as they would not, if considered in the aggregate as a single subsidiary, constitute a significant subsidiary:

| <u>Name of Subsidiary</u> | <u>Incorporated In</u> |
|--|---------------------------------------|
| AMTX, Inc. | Delaware |
| Carmel Valley, Inc. | Delaware |
| dpiX | Delaware |
| FairCopy Services Inc. | Canada |
| GroupFire, Inc. | California |
| Gyricon, LLC | Delaware |
| IGHI, Inc. | Delaware |
| Xerox Global Services Limited | United Kingdom |
| Delphax Systems GmbH | Germany |
| Ighi Finland Oy | Finland |
| Infotonics Technology Center Inc. | New York |
| Institute for Research on Learning | Delaware |
| Jeremiad Co. | Delaware |
| Low-Complexity Manufacturing Group, Inc. | Delaware |
| NEWPARC LLC | Delaware |
| Pacific Services and Development Corporation | Delaware |
| Palo Alto Research Center Incorporated | Delaware |
| Proyectos Inverdoco, C.A. | Venezuela |
| Securities Information Center, Inc. | Delaware |
| SCC Burton Corporation | Delaware |
| 79861 Ontario Inc. | Ontario |
| STHQ Realty LLC | Delaware |
| The Xerox Foundation | Delaware |
| XDI, Inc. | Delaware |
| Xerox Argentina, I.C.S.A. | Argentina ⁽¹⁾ |
| Xerox Canada Capital Ltd. | Canada |
| Xerox Canada Inc. | Ontario |
| 832667 Ontario Inc. | Ontario |
| Xerox (Barbados) SRL | Barbados ⁽¹⁴⁾ |
| Xerox (Barbados) Leasing SRL | Barbados |
| Xerox Business Centre (Ireland) Limited | Ireland |
| Xerox Electronic (Ireland) Limited | Ireland |
| Xerox Finance (Luxembourg) Sarl | Luxembourg |
| Xerox Hardware (Ireland) Limited | Ireland |
| Xerox Toner (Ireland) Limited | Ireland |
| Xerox Canada Facilities Management Ltd. | Ontario |
| Xerox Canada Finance Inc. | Ontario |
| Xerox Canada Leasing Partnership | Ontario ⁽¹⁶⁾ |
| Xerox Canada Ltd. | Canada ⁽⁴⁾ |
| Ionographic Operations Partnership | Massachusetts ⁽¹⁸⁾ |
| XESystems Canada Inc. | Ontario |
| Xerox Canada Leasing Company | Nova Scotia |
| Xerox Canada Realty Inc. | Ontario ⁽³⁾ |
| Xerox Capital, LLC | Turks & Caicos Islands ⁽⁹⁾ |
| Xerox Capital Services LLC | Delaware ⁽¹⁷⁾ |
| Xerox Capital Trust I | Delaware ⁽¹¹⁾ |

| <u>Name of Subsidiary</u> | <u>Incorporated In</u> |
|---|--------------------------------|
| Xerox de Chile S.A. | Chile |
| Xerox de Colombia S.A. | Colombia |
| Xerox Color Printing, Inc. | Delaware |
| Xerox Developing Markets Limited | Bermuda |
| Sidh Securities Limited | Mauritius |
| Xerox del Ecuador, S.A. | Ecuador |
| Xerox Engineering Systems NV | Belgium |
| Xerox Export, LLC | Delaware |
| Xerox Finance, Inc. | Delaware |
| Xerox (Austria) Holdings GmbH | Austria |
| Xerox Investments Holding (Bermuda) Limited | Bermuda |
| Xerox Financial Services, Inc. | Delaware |
| Ridge Reinsurance Limited | Bermuda |
| Talegen Holdings, Inc. | Delaware |
| Xerox Credit Corporation | Delaware |
| Xerox Foreign Sales Corporation | Barbados |
| Xerox d'Haiti, S.A. | Haiti |
| Xerox de Honduras, S.A. | Honduras |
| Xerox Imaging Systems, Inc. | Delaware |
| Xerox International Joint Marketing, Inc. | Delaware |
| Xerox International Partners | California ⁽¹⁰⁾ |
| Xerox Investments Europe B.V. | Netherlands |
| Xerox Holdings (Ireland) Limited | Ireland |
| Xerox (Europe) Limited | Ireland |
| Bipolar Limited | Ireland |
| Monocolour Limited | Ireland |
| Xerox Ink Jet (Ireland) Limited | Ireland |
| Xerox Ink Tanks (Ireland) Limited | Ireland |
| Xerox XF Holdings (Ireland) Limited | Ireland |
| Xerox Finance (Ireland) Limited | United Kingdom |
| Xerox Leasing Ireland Limited | Jersey |
| Xerox S.A.S. | France ⁽²²⁾ |
| Xerobail SAS | France |
| Xerox Financial Services SAS | France |
| Xerox Document Services SNC | France ⁽²⁵⁾ |
| Set Electronique SA | France |
| Set Belgium (EPC) | Belgium |
| Set Engineering SA | France |
| Set Italia | Italy |
| Set R&D Belgium (EES) | Belgium |
| Xerox Global Services SAS | France ⁽²³⁾ |
| Xerox Document Supplies SNC | France ⁽²⁴⁾ |
| Xerox Israel Ltd. | Israel |
| Xerox UK Holdings Limited | United Kingdom |
| Triton Business Finance Limited | United Kingdom |
| Xerox Engineering Systems Limited | United Kingdom |
| Xerox Research (UK) Limited | United Kingdom |
| Xerox Trading Enterprises Limited | United Kingdom |
| Xerox Overseas Holdings Limited | United Kingdom |
| Xerox Business Equipment Limited | United Kingdom |
| Xerox Computer Services Limited | United Kingdom |
| Xerox Mailing Systems Limited | United Kingdom |
| Xerox Capital (Europe) plc | United Kingdom ⁽¹²⁾ |

| <u>Name of Subsidiary</u> | <u>Incorporated In</u> |
|--|-------------------------------|
| Xerox Holding (Nederland) B.V. | Netherlands |
| Xerox Manufacturing (Nederland) B.V. | Netherlands |
| Xerox Office Printing Distribution B.V. | Netherlands |
| Xerox Limited | United Kingdom ⁽⁶⁾ |
| City Paper Limited | United Kingdom |
| Continua Limited | United Kingdom |
| Continua S.A. | France |
| Continua Sanctum Limited | United Kingdom |
| NV Xerox Credit S.A. | Belgium |
| Xerox Financial Services Belux NV | Belgium |
| NV Xerox Management Services S.A. | Belgium |
| N.V. Xerox S.A. | Belgium |
| Xerox Luxembourg S.A. | Luxembourg ⁽²⁸⁾ |
| The Xerox (UK) Trust | United Kingdom |
| Xerox AB | Sweden |
| Xerox AG | Switzerland |
| Xerox Office Supplies AG | Switzerland |
| Xerox A/S | Denmark |
| Xerox AS | Norway |
| Xerox Austria GmbH | Austria |
| Xerox Business Services GmbH | Austria |
| Xerox Leasing GmbH | Austria |
| Xerox Office Supplies GmbH | Austria |
| Xerox Bulgaria EOOD | Bulgaria |
| Xerox Buro Araciari Ticaret ve Servis A.S. | Turkey |
| Xerox Channels Limited | United Kingdom |
| Limited Liability Company Xerox (C.I.S.) | Russia |
| XEROX CZECH Republic s r.o. | Czech Republic |
| Xerox Direct Rhein-Main GmbH | Germany |
| Xerox Espana-The Document Company, S.A.U. | Spain |
| Xerox Financiacion S.A.U. | Spain |
| Xerox Renting S.A.U. | Spain |
| Xerox Office Supplies S.A.U. | Spain |
| Xerox Exports Limited | United Kingdom |
| Xerox Finance AG | Switzerland |
| Xerox Finance (Nederland) BV | Netherlands |
| Xerox Financial Services B.V. | Netherlands ⁽²⁰⁾ |
| Xerox GmbH | Germany |
| Xerox Capital Services Verwaltungs GmbH | Germany |
| Xerox Capital Services GmbH & Co. KG | Germany ⁽¹⁹⁾ |
| Xerox Dienstleistungsgesellschaft GmbH | Germany |
| Xerox Leasing Deutschland GmbH | Germany |
| Xerox Reprographische Services GmbH | Germany |
| Xerox Hellas AEE | Greece |
| Xerox Hungary Trading Limited | Hungary |
| Xerox (Ireland) Limited | Ireland |
| Xerox India Limited | India ⁽⁸⁾ |
| Xerox (Nederland) BV | Netherlands |
| “Veco” Beheer Onroerend Goed BV | Netherlands |
| Xerox Document Supplies BV | Netherlands |
| Xerox Rentalease BV | Netherlands |
| Xerox Services BV | Netherlands |
| Xerox Oy | Finland |

| <u>Name of Subsidiary</u> | <u>Incorporated In</u> |
|---|-------------------------------|
| Xerox Pensions Limited | United Kingdom |
| Xerox Polska Sp.zo.o | Poland |
| Xerox Portugal Equipamentos de Escritorio, Limitada | Portugal ⁽²¹⁾ |
| CREDITEX—Aluguer de Equipamentos S.A. | Portugal |
| Xerox Professional Services Limited | United Kingdom |
| Xerox Property Services Limited | United Kingdom |
| Xerox (Romania) Echipmante Si Servici S.A. | Romania |
| Xerox Slovenia d.o.o. | Slovenia |
| Xerox S.p.A. | Italy |
| Xerox Italia Rental Services s.r.l. | Italy |
| Xerox Sverige AB | Sweeden |
| Xerox Telebusiness GmbH | Germany |
| Xerox (UK) Limited | United Kingdom |
| Bessemer Trust Limited | United Kingdom |
| Inserco Manufacturing Limited | United Kingdom |
| Xerox Finance Limited | United Kingdom |
| Xerox Office Supplies Limited | United Kingdom |
| Xerox (R & S) Limited | United Kingdom |
| Xerox (Ukraine) Ltd LLC | Ukraine |
| Xerox West Africa Limited | United Kingdom |
| XESystems UK Limited | United Kingdom |
| Xerox Engineering Systems Limited | United Kingdom |
| Xexco Trading Limited | United Kingdom |
| Xerox XHB Limited | Bermuda ⁽⁶⁾ |
| Xerox XIB Limited | Bermuda ⁽⁶⁾ |
| XRO Limited | United Kingdom |
| Nemo (AKS) Limited | United Kingdom |
| XRI Limited | United Kingdom |
| RRXH Limited | United Kingdom |
| RRXO Limited | United Kingdom |
| RRXIL Limited | United Kingdom ⁽⁶⁾ |
| Xerox Latinamerican Holdings, Inc. | Delaware |
| Xerox Lease Funding LLC | Delaware |
| Xerox Lease Equipment LLC | Delaware |
| Xerox Mexicana, S.A. de C.V. | Mexico ⁽²⁹⁾ |
| Xerox Middle East Investments (Bermuda) Limited | Bermuda |
| Bessemer Insurance Limited | Bermuda |
| Reprographics Egypt Limited | Egypt |
| Xerox Egypt S.A.E. | Egypt |
| Xerox Finance Leasing S.A.E. | Egypt |
| Xerox Equipment Limited | Bermuda |
| Xerox Maroc S.A. | Morocco ⁽²⁾ |
| Xerox Products Limited | Bermuda |
| Xerox de Nicaragua, S.A. | Nicaragua |
| Xerox Participacoes Ltda. | Brazil |
| Xerox Comercio e Industria Ltda | Brazil |
| Xerox del Peru, S.A. | Peru |
| Xerox Realty Corporation | Delaware |
| Lansdowne Residential LLC | Virginia |
| Xerox Trade Receivables LLC | Delaware |
| Xerox Trinidad Limited | Trinidad |
| Xerox de Venezuela, C.A. | Venezuela ⁽⁵⁾ |
| Xerox XBS Warehouse Holding LLC | Delaware |

| <u>Name of Subsidiary</u> | <u>Incorporated In</u> |
|-------------------------------------|------------------------|
| Xerox XBS Warehouse Funding LLC | Delaware |
| Xerox XBS Warehouse Funding II LLC | Delaware |
| XESystems Foreign Sales Corporation | Barbados |
| XGUA Servicios, Ltda. | Guatemala |

- (1) Xerox Corporation owns 90% of the shares of Xerox Argentina; the remaining 10% is owned by Pacific Services and Development Corporation, a wholly-owned subsidiary of Xerox Corporation.
- (2) Owned 99.9% by XMEIBL and .1% by several individuals.
- (3) 1,000 shares held by Xerox Canada Inc. and 9,000 shares held by Xerox Corporation.
- (4) Owned 65% by Xerox Canada Inc. and 35% by Xerox Canada Finance Inc.
- (5) Owned 86.25% by Xerox Corporation, and 13.25% by Pacific Services and Development Corporation.
- (6) Includes indirect holdings.
- (7) [Reserved]
- (8) Owned 45.579% by Xerox Limited, 38.871% by Sidh Securities Limited (Mauritius) (a subsidiary of Xerox Developing Markets Limited) and 4.421% through Xerox's wholly-owned subsidiary, Xerox Developing Markets Limited. The total ownership by Xerox Corporation is 88.871%.
- (9) Owned 99.9% by Xerox Corporation and .1% by Pacific Services and Development Corporation, a wholly-owned subsidiary of Xerox Corporation.
- (10) Xerox International Partners is a California general partnership between FX Global, Inc. (49%) and Xerox International Joint Marketing, Inc. (51%).
- (11) Xerox Capital Trust I is a Delaware statutory business trust which is 100% beneficially owned by Xerox Corporation. The Trust is a special purpose financing vehicle.
- (12) Owned 99% by Xerox Overseas Holdings Limited and 1% by Xerox Property Services Limited as nominee for Xerox Overseas Holdings Limited.
- (13) [Reserved]
- (14) Owned 88.27% by Xerox Canada Inc. and 11.73% by Xerox Corporation.
- (15) This a not-for-profit corporation which will act as a research and development consortium of businesses and universities. The initial members are Xerox, Corning, Kodak, University of Rochester, RIT and Cornell.
- (16) Xerox Canada Leasing Partnership is an Ontario general partnership between Xerox Canada Inc. (99%) and Xerox Canada Finance Inc. (1%).
- (17) Owned 19% by Xerox Corporation and 81% by GE Capital Information Technology Solutions, Inc. [Included in Xerox Corporation's consolidated financial statements.]
- (18) Owned 66.995% by Xerox Canada Ltd. and 33.005% by Xerox Canada Inc.
- (19) Owned by Xerox GmbH and Xerox Capital Services Verwaltungs GmbH.
- (20) Xerox Financial Services B.V. is a joint venture between De Lage Landen International B.V. (51%) and Xerox Limited (49%), established on 12/14/01 for the purpose of offering financing for the business of Xerox (Nederland) B.V. [Included in Xerox Corporation's consolidated financial statements.].
- (21) Owned 76% by Xerox Limited and 24% by Xerox Property Services Limited.
- (22) Owned 89.77% by Xerox XF Holdings (Ireland) Limited and 10.23% by Xerox Limited.
- (23) Owned 99.96% by Xerox Document Services SNC and 0.4% by Xerobail SAS.
- (24) Owned 99.99% by XEROX S.A.S. and .01% by Xerobail SAS.
- (25) Owned 99.96% by XEROX S.A.S. and .04% by Xerobail SAS.
- (26) [Reserved]
- (27) [Reserved]
- (28) Owned 99% by NV Xerox SA and 1% by NV Xerox Credit SA.
- (29) Owned 99.99% by Xerox Corporation and .01% by Pacific Services and Development Corporation.

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We hereby consent to the incorporation by reference in the Registration Statements on Form S-3 (Nos. 33-32215, 333-101164, 333-02187 and 333-111623) and Form S-8 (Nos. 333-125250, 333-93269, 333-09821, 333-22059, 333-22037, 333-22313, 333-35790, 33-65269, 33-44314, 2-86275 and 2-86274) of Xerox Corporation of our report dated February 17, 2006 relating to the financial statements, management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of internal control over financial reporting, which appears in the Annual Report to Shareholders, which is incorporated in this Annual Report on Form 10-K. We also consent to the incorporation by reference of our report dated February 17, 2006 relating to the financial statement schedule, which appears in this Form 10-K.

/s/ PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP
Stamford, CT
February 17, 2006

CEO CERTIFICATIONS

I, Anne M. Mulcahy, Chairman of the Board and Chief Executive Officer, certify that:

1. I have reviewed this Annual Report on Form 10-K of Xerox Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- (a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 17, 2006

/s/ ANNE M. MULCAHY

Anne M. Mulcahy
Principal Executive Officer

CFO CERTIFICATIONS

I, Lawrence A. Zimmerman, Senior Vice President and Chief Financial Officer, certify that:

1. I have reviewed this Annual Report on Form 10-K of Xerox Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- (a) All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 17, 2006

/s/ LAWRENCE A. ZIMMERMAN

Lawrence A. Zimmerman
Principal Financial Officer

**CERTIFICATION OF CEO AND CFO PURSUANT TO
18 U.S.C. § 1350,
AS ADOPTED PURSUANT TO
§ 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Form 10-K of Xerox Corporation, a New York corporation (the "Company"), for the year ending December 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Anne M. Mulcahy, Chairman of the Board and Chief Executive Officer of the Company, and Lawrence A. Zimmerman, Senior Vice President and Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, to the best of his/her knowledge, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ ANNE M. MULCAHY

Anne M. Mulcahy
Chief Executive Officer
February 17, 2006

/s/ LAWRENCE A. ZIMMERMAN

Lawrence A. Zimmerman
Chief Financial Officer
February 17, 2006

This certification accompanies this Report pursuant to § 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of § 18 of the Securities Exchange Act of 1934, as amended.

A signed original of this written statement required by § 906 has been provided to Xerox Corporation and will be retained by Xerox Corporation and furnished to the Securities and Exchange Commission or its staff upon request.