

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, 2004

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 Chicago Stock Exchange

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

None

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

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

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

The aggregate market value of the voting stock of the registrant held by non-affiliates as of June 30, 2004 was: \$12,167,048,267

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, 2005
Common Stock, \$1 par value	957,373,097 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 2004 Annual Report to Shareholders	I & II
Xerox Corporation Notice of 2005 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 forward-looking. 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.

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 following:

Competition—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.

Expansion of Color—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, we may be unable to capture these opportunities and it could materially adversely affect our results of operations and financial condition.

New Products/Research and Development—The process of developing new high technology products and solutions is inherently complex and uncertain. It requires accurate anticipation of customers’ changing needs and emerging technological trends. We must 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. 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, we could lose our customers and that could materially adversely affect our results of operations and financial condition.

Pricing—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.

Customer Financing Activities—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 is expected to 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 much of our customer financing activity through third-party funding arrangements, including several with General Electric in various geographies, cash generated from operations, cash on hand, capital markets offerings and securitizations. We continue to borrow under third-party funding programs and actively pursue cost effective, alternative forms of financing, including the issuance of public debt securities. Our ability to continue to offer customer financing and be successful in the placement of equipment with customers is, in the near-term, largely dependent on our ability to obtain funding at a reasonable cost, whether through third party funding arrangements (including securitizations and secured borrowings) or directly in the public debt markets, and, longer term, upon having our credit ratings restored to investment grade. If we are unable to continue to offer customer financing, it could materially adversely affect our results of operations and financial condition.

Productivity—Our ability to sustain and improve profit margins is largely dependent on our ability to continue to improve the cost efficiency of our operations through such programs as Lean Six Sigma and, to a lesser extent, our ability to successfully complete information technology initiatives. 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.

Outsourcing of Manufacturing Capacity—Since 2001, we have outsourced a significant portion of our overall worldwide manufacturing operations to Flextronics, Inc. This includes the sale of some of our manufacturing facilities to Flextronics, which has significantly reduced our internal manufacturing capability. Flextronics manufactures and supplies equipment and components, including electronic components, for the Office segment of our business. We expect to increase our purchases from Flextronics commensurate with our future sales. To the extent that we rely on Flextronics and other third party manufacturing relationships, we face the risk that they 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.

International Operations—We derived 47 percent of our revenue from operations outside the United States in 2004. 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 from 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 and local tax issues. We generally hedge foreign currency denominated assets, liabilities and anticipated transactions primarily through the use of currency derivative contracts. The use of these derivative contracts tends to mitigate volatility in our results of operations, but does not completely eliminate the volatility. We do not, however, hedge the translation effect of revenues denominated in currencies where the local currency is the functional currency.

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.

Restructuring Initiatives—Since early 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.

Debt—We have and will continue to have a substantial amount of debt and other obligations, in part to support our customer financing activities. As of December 31, 2004, we had \$10.1 billion of total debt (\$4.4 billion of which is secured by finance receivables) and \$717 million of liabilities to trusts issuing preferred securities. Cash and cash equivalents were \$3.2 billion at December 31, 2004. 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.

Liquidity—Our liquidity is a function of our ability to successfully generate cash flow from an appropriate combination of efficient operations and improvements therein, financing from third parties, access to capital markets and securitizations of our finance receivables portfolios. With \$3.2 billion of cash and cash equivalents on hand at December 31, 2004, borrowing capacity under our 2003 Credit Facility of \$700 million (less \$15 million utilized for letters of credit) 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 a series of monthly secured loans up to \$5 billion outstanding at any time. As of December 31, 2004, \$2.5 billion was outstanding under this Loan Agreement. The Loan Agreement, as well as similar loan agreements with GE in the U.K. and Canada, incorporates the financial maintenance covenants contained in the 2003 Credit Facility and contains other affirmative and negative covenants.

At December 31, 2004, 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 would 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.

Litigation—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 14 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.

Item 1. Business

Overview

References herein to “we,” “us” or “our” refer 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 130 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 companies (collectively “Xerox Limited”). We had approximately 58,100 employees at December 31, 2004.

The document industry is undergoing a transformation 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. Documents are increasingly created and stored in digital electronic form and the internet is increasing the amount of information that can be accessed in the form of electronic documents. We believe these trends play to the strengths of our product and service offerings and represent opportunities for future growth within our \$102 billion served market. (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 pertaining to the markets in which we participate.) In our core markets of Production (\$8 billion) and Office (\$60 billion), we believe we are well placed to capture core growth opportunities by leading the transition to color and reaching new customers with broadened offerings and expanded distribution channels. We are expanding our core markets with Document Services (\$17 billion) and we are creating new market opportunities with digital printing as a complement to traditional offset printing (Eligible Offset \$17 billion). Led by our market-making Xerox iGen3[®] technology and accompanied by the industry’s broadest migration path to digital, Xerox offers leading digital technology which meets the increasing demand for short run, customized and quick turnaround offset quality printing.

We develop document technologies, systems, solutions and services intended to improve our customers’ work processes and business results. Our success rests on our ability to understand our customers’ needs and provide innovative document management solutions and services that deliver value for our customers through the creation of new business opportunities, improved operational efficiencies and lower costs. We provide stand alone and integrated solutions that leverage our leading technology and document knowledge. We uniquely provide the broadest set of integrated offerings which include hardware, software, services and partnerships. These offerings are delivered through the industry’s largest and most experienced global sales and service organization.

Our products include printing and publishing systems, digital multifunction devices (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 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 based on increasing equipment sales and installations in order to build the population of machines in the field (“MIF”) that will produce pages and therefore generate post sale and financing revenue streams. The majority of Xerox’s equipment is sold through sales-type leases that are recorded as equipment sale revenue. Equipment sales represented 28 percent of the Company’s 2004 total revenue. Post sale and financing

revenue includes equipment maintenance and consumable supplies. This large, recurring revenue stream is expected to approximate three times the equipment sale revenue over the life of a lease. Accordingly, installations and equipment sale revenue are key leading indicators of post sale and financing revenue trends as increased MIF should lead to increased pages and ultimately increased post sale revenue. The increasing mix of color pages is also of significant importance to post sale revenue as color pages utilize more consumables per page as compared to black and white. Accordingly, color pages currently generate five times the revenue and profit per page as compared to black and white.

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 herein by reference. We have a very broad and diverse base of customers, both geographically and demographically, ranging from small and medium businesses to commercial 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 monochrome and color systems for three main customer environments: production publishing, transaction printing and enterprise-wide 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 45 to 100 pages per minute. In addition, we offer a variety of pre-press and post-press options and the industry’s broadest set of workflow software. 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 2004 were to drive the “New Business of Printing” by defending our monochrome population, leading in color, and leveraging the power of digital printing in the offset printing market. The “New Business of Printing” includes introducing innovative production systems and solutions to expand our leadership position and focus on the higher growth digital color opportunities. To reach our 2004 goals, we:

- ***Increased our presence in the monochrome digital light production market and introduced our first new monochrome publishing platform (Xerox Nuvera™) since the launch of the DocuTech in 1990.*** With the January 2004 launch of the Xerox Nuvera 100/120 pages per minute (“ppm”) Copier/Printers, we created a new digital mid-production market, bridging the gap between current light-production copier/printers and heavy-duty systems and offering features previously available only on high-end equipment. In the fourth quarter 2004, we began refreshing our line of high-end monochrome production products systems with the launch of the Xerox Nuvera 100/120 full production systems. In addition, in October 2004, we announced three new Highlight Color systems: the 180 HLC, the 155 HLC and the 128 HLC. Operating at 180 ppm, nearly twice the previous Xerox benchmark speed of 92 ppm, the Xerox 180 Highlight Color system is the fastest of three new highlight color products. Printing one color in addition to black, these products add value to newsletters, reports, invoices and statements by using color to focus reader attention on the most critical information.
- ***Broadened our leading product line of color systems and expanded our presence in the commercial printing environment.*** During 2004, we continued to increase installations of our flagship Xerox iGen3 Digital Production Press (“Xerox iGen3”). At 100 ppm and at an operating cost of approximately 5 cents per image, the Xerox iGen3 utilizes 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 October 2004, we launched the The DocuColor™ 8000 Digital Press, 80 ppm digital color press. It is a “next step up” option from the DocuColor 6060, for print providers who are looking for a high-end production press but don’t currently have the applications and volume requirements for a Xerox iGen3 press. Xerox offers customers the best migration path to digital with digital color devices offered at 45, 52, 60, 80 and 100 ppm.

- **Leveraging the power of digital printing in the offset printing market.** In addition to our leading hardware technology, Xerox continues to expand and improve its leading workflow collection. In October 2004, we introduced four additions to the FreeFlow Digital Workflow collection—Process Manager, Makeready, Web Services, and Print Manager. 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 encompass monochrome devices at speeds up to 90 ppm and color devices up to 40 ppm, 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 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, document needs and then 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 2004 were to lead in multifunction devices, drive the transition to color and reach more customers with a broadened product line and expanded distribution channels. To reach our 2004 goals, we:

- **Further expanded our line of office systems including:**
 - The January 2004 launch of the Phaser® 8400, the first office color printer derived from a new solid ink technology platform, which runs at 24 ppm—in color or black-and-white, all for less than \$1,000. Xerox simultaneously rolled out two other office printers and continued to update this product line throughout the year.
 - The launch of 12 new offerings in October 2004 including:
 - The *WorkCentre Pro C2128, C2636 and C3545*—advanced color multi-function devices (“MFDs”) that combine high-performance printing, copying, scanning and faxing in one easy-to-use office system. These products are also available as *CopyCentre C2128, C2636 and C3545* standalone digital copiers.
 - The *WorkCentre Pro123 and 128*—advanced monochrome MFDs that deliver enterprise-level scanning and finishing features designed for small to midsized businesses. These products are also available as *WorkCentre M123 and M128* copier/printers, offering copy/print capabilities and optional fax, as well as *CopyCentre C123 and C128* standalone digital copiers.
 - An expanded line of desktop multifunction devices including the *WorkCentre M20/M20i and PE120/120i*.

- **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. Xerox's patented solid ink technology offers unmatched quality and economics.
- **Further expanded our distribution channels** through increased use of our indirect distribution model in Europe and greater use of Tele-web 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, Russia Central-Eastern Europe and Africa. Brazil represented approximately 25 percent of total DMO revenues in 2004. 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 is currently being implemented in Latin America. DMO operations are managed separately as a segment due to the political and economic volatility and unique nature of its markets. Our 2004 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, value-added services, and Small Office / Home Office ("SOHO").

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.

In line with our strategy to focus on our core business, we announced the disengagement from SOHO, our former consumer/personal inkjet printer business, in June 2001. We continue to sell consumables for the inkjet printers and personal copiers previously sold through indirect channels in North America and Europe. We expect that sales of these supplies will continue to decline as the existing population of equipment is replaced.

Research and Development

Investment in R&D is critical to drive future growth and we have directed our investments to the fastest growing segments of the market. 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 2004, R&D expense was \$760 million, compared with \$868 million in 2003. 2004 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 \$704 million in R&D in 2004.

Patents, Trademarks and Licenses

We are a technology company. With our PARC subsidiary, we were awarded approximately 525 U.S. utility patents in 2004, ranking us 37th 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 over 700 U.S. utility patents in 2004. Our patent portfolio evolves as new patents are awarded to us and as older patents expire. As of December 31, 2004, we held approximately 8,400 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 own approximately 520 trademarks (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.”

In the U.S., we are party to approximately 235 agreements which involve U.S. patent licenses. We are the licensor in approximately 185 of those agreements. Most of the patent licenses expire concurrently with the expiration of the last patent identified in the license.

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, Oce, Konica-Minolta and Lexmark.

We believe that our brand recognition, reputation for quality, innovative technology, breadth of product offerings, 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 and report our financial results 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 principally sold directly to customers by our worldwide sales force totaling approximately 8,500 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,” a combination of telephone and internet selling) 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 2004, 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 2004.

We are increasing our use of partners to improve our market coverage. Through alliances with Premier Partners, Creo and Fuji Ennovation, we expanded coverage to market our DocuColor 2000 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.

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.

Fuji Xerox

Fuji Xerox Co., Limited is an unconsolidated entity in which Xerox Limited currently owns 25 percent and Fuji Photo Film Co., Ltd. (“FujiFilm”) owns 75 percent. 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.

Service

As of December 31, 2004, we had a worldwide service force of approximately 15,000 employees and a 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 to address customers’ more advanced technology requirements. 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 entered into purchase and supply agreements with Flextronics, a global electronics manufacturing services company, for the Office segment of our business. Under these agreements, Flextronics purchased related inventory, property and equipment. Pursuant to the purchase agreement, we sold our operations in Toronto, Canada; Aguascalientes, Mexico; Penang, Malaysia, Venray; The Netherlands and

Resende, Brazil to Flextronics in a series of transactions, which were completed in 2002. Approximately 4,100 Xerox employees in certain of these operations transferred to Flextronics.

The initial term of the Flextronics supply agreement is five years 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. We also must purchase certain electronic components from Flextronics, so long as Flextronics meets certain pricing requirements. 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. Our remaining manufacturing operations are primarily located in Rochester, New York for our high-end production products and consumables and Wilsonville, Oregon for consumable supplies and components for our Office printing products.

The foregoing summary of the supply agreement is not complete and is in all respects subject to the actual provisions of the supply agreement, which has been filed with the Securities and Exchange Commission.

International Operations

Our international operations represented 47 percent of total revenues in 2004. Our largest interest outside the United States is Xerox Limited which operates predominately in Europe. Latin American operations are conducted through subsidiaries or distributors in over 38 countries. Fuji Xerox, an unconsolidated entity of which we own 25 percent, develops, manufactures and distributes document processing products in Japan, China, Hong Kong and other areas of the Pacific Rim, Australia and New Zealand.

Certain financial measures by geographical area for 2004, 2003 and 2002, included in Note 2 to the Consolidated Financial Statements in our 2004 Annual Report, are hereby incorporated by reference.

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 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 7 to the Consolidated Financial Statements in our Annual Report, incorporated by reference), several 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 2004 there were approximately 60 surplus facilities totaling approximately 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 1,400 employees are working virtually and the real estate portfolio has been reduced by approximately 0.5 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, 2004, 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 14 to the Consolidated Financial Statements, "Contingencies" of the Xerox Corporation 2004 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 and Related Stockholder Matters

Market Information, Holders and Dividends

The information set forth under the following captions of the Xerox Corporation 2004 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

Sales of Unregistered Securities During the Quarter ended December 31, 2004

None.

Item 6. Selected Financial Data

The following selected financial data for the five years ended December 31, 2004, as set forth and included under the caption "Five Years in Review," of the Xerox Corporation 2004 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 2004 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 2004 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 2004 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 2004 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 2004 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, 2004, 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, our management has concluded that, as of December 31, 2004, we did not have any material weaknesses in our internal control over financial reporting and our internal control over financial reporting was effective. Our management’s assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included in the Xerox Corporation 2004 Annual Report to Shareholders, which is incorporated by reference in this Form 10-K.

Changes in Internal Control Over Financial Reporting

As a result of our efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the rules issued thereunder, we reported in our Form 10-Q for the third fiscal quarter of 2004 that we had identified certain issues, that required either remediation or the identification of alternative controls. As a result of the remediation and identification of alternative controls that occurred during the fourth fiscal quarter of 2004, we believe that we have appropriately addressed the issues identified in the third fiscal quarter of 2004 and have concluded that our internal control over financial reporting was effective as of December 31, 2004. Other than this remediation and identification of alternative controls, during our fourth fiscal quarter, there were no changes in our internal control over financial reporting or in other factors that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information**Director Retirement**

On February 17, 2005, Mr. John E. Pepper notified the Company of his intention to retire as Director at the conclusion of his current term, which is scheduled to expire on the date of the Annual Meeting of Shareholders on May 19, 2005 or any adjournment thereof. The Company is deeply grateful for his many years of tireless and invaluable service as a member of our Board of Directors and various committees of the Board. Mr. Pepper has been a member of the Company's Board of Directors since 1990 and is currently the Chairman of the Audit Committee and a member of the Compensation Committee.

Executive Compensation

On February 17, 2005, the Compensation Committee of the Board of Directors of the Company took the following actions:

2004 and 2005 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 2004 fiscal year are set out on Exhibit 10(e)(4) attached hereto and the measures for awards for fiscal year 2005 are set out on Exhibit 10(e)(5) attached hereto. The Compensation Committee approved cash awards under the 2004 PIP for fiscal year 2004 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 2004 (collectively with Mrs. Mulcahy, the "Named Officers"). The Compensation Committee approved a cash award of \$1,584,000 to Mrs. Mulcahy, \$441,000 to Ms. Burns, \$420,000 to Mr. Firestone, \$403,200 to Mr. MacDonald and \$441,000 to Mr. Zimmerman.

Base Salary:

The base salaries of the Named Officers were increased as follows, each effective as of April 1, 2005: Ms. Burns will receive a base salary of \$556,500, Mr. Firestone will receive a base salary of \$525,000, Mr. MacDonald will receive a base salary of \$494,400 and Mr. Zimmerman will receive a base salary of \$550,000. The base salary of Mrs. Mulcahy was maintained at the previously disclosed level of \$1,320,000.

2005 E-LTIP Awards:

The Compensation Committee approved the measures for awards of performance shares granted as of January 1, 2005 to the Named Officers under the 2005 Executive Long-Term Incentive Program ("2005 E-LTIP"), a component of our 2004 PIP. The amounts awarded are as follows: Mrs. Mulcahy received 294,100 shares, Ms. Burns received 105,900 shares, Mr. Firestone received 94,100 shares, Mr. MacDonald received 64,700 shares and Mr. Zimmerman received 94,100 shares. The specific performance measures for the 2005 E-LTIP for fiscal year 2005 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)(2).

2005 E-LTIP awards made to officers reflect their leadership role in the Company, their individual performance, and competitive award levels. The purpose of the 2005 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 2005 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 have been earned vest in 2008. Executives who retire or are involuntarily terminated (without cause) 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 2005 E-LTIP are Earnings Per Share (weighted 60%) and Net Cash from Operating Activities (weighted 40%.) Earnings Per Share and Net Cash from Operating Activities 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 2005 E-LTIP may vary from 0% to 150% of the initial number of shares subject to the grant.

Participants in the 2005 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 2005 E-LTIP provides strong performance-based incentives that are in full alignment with the interests of all shareholders of the Company.

Adoption of Rule 10b5-1 Plans

Consistent with Registrant's previous announcement on November 5, 2004 that it intended to accommodate the use of Rule 10b5-1 plans for corporate officers in addition to its Chairman and CEO, on February 8 and 9, 2005, Registrant has been advised that each of the following officers, within the meanings of Rule 16a-1(f) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), of Registrant has adopted a "plan" in accordance with Rule 10b5-1 of the Exchange Act with Salomon Smith Barney Inc. providing for the sale of up to an aggregate number of shares of Registrant's common stock specified next to his or her name during the next three quarters: Ursula Burns (up to 70,000 shares) and Armando Z. Lima (up to 94,354 shares).

Pursuant to the terms of each of these plans, the sale of shares may occur only during Registrant's window periods occurring immediately after Registrant's release of earnings for the first three fiscal quarters of 2005, unless the applicable plan is sooner terminated in accordance with its terms. To the extent these officers are subject to Section 16 of the Exchange Act, all sales under these plans will be publicly disclosed with the SEC in Form 4 filings.

These officers have elected to participate in the Rule 10b5-1 plan for asset diversification and tax planning purposes. Rule 10b5-1 allows corporate officers and directors to adopt written, pre-arranged stock trading plans when they do not have material, non-public information.

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 ("2005 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 19, 2005. The Proxy Statement will be filed within 120 days after the end of our fiscal year ended December 31, 2004.

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 2005 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 2005 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 2005 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*	52	Chairman of the Board and Chief Executive Officer	2002	1992
Lawrence A. Zimmerman	62	Senior Vice President and Chief Financial Officer	2002	2002
Ursula M. Burns	46	Senior Vice President President, Business Group Operations	2002	1997
Thomas J. Dolan	60	Senior Vice President President, Xerox Global Services	2001	1997
James A. Firestone	50	Senior Vice President President, Xerox North America	2004	1998
Hervé J. Gallaire	60	Senior Vice President President, Xerox Innovation Group and Chief Technology Officer	2001	1997

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>
Michael C. Mac Donald	51	Senior Vice President President, Global Accounts and Marketing Operations	2004	1997
Hector J. Motroni	61	Senior Vice President, Chief Staff Officer and Chief Ethics Officer	2003	1994
Jean-Noel Machon	52	Senior Vice President President, Developing Market Operations	2004	2000
Harry R. Beeth	59	Vice President and Contoller	2002	2002
J. Michael Farren	52	Vice President, External and Legal Affairs, General Counsel and Corporate Secretary	2004	1994
Gary R. Kabureck	51	Vice President and Chief Accounting Officer	2003	2000
James H. Lesko	53	Vice President Investor Relations	2004	1993
John E. McDermott	51	Vice President, Corporate Strategy and Alliances	2004	2004
Rhonda L. Seegal	54	Vice President and Treasurer	2003	2003
Armando Zagalo de Lima	46	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 2005 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 2005 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 2005 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 2005 Proxy Statement.

PART IV

Item 15. Exhibits, Financial Statement Schedule and Reports on Form 8-K

(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, 2004

Consolidated Balance Sheets as of December 31, 2004 and 2003

Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2004

Consolidated Statements of Common Shareholders' Equity for each of the years in the three-year period ended December 31, 2004

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 2005 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 (1) separate financial statements of subsidiaries not consolidated and fifty-percent-or-less-owned persons and (2) schedules, are 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 the Company's internal control over financial reporting and of the effectiveness of the Company's internal control over financial reporting referred to in our report dated February 21, 2005, appearing in the 2004 Annual Report to Shareholders of Xerox Corporation (which report and consolidated financial statements 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.

As discussed in Note 1, the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" on January 1, 2002.

/s/ PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP
Stamford, Connecticut
February 21, 2005

SCHEDULE II

Valuation and Qualifying Accounts
Year ended December 31, 2004, 2003 and 2002

(in millions)	Balance at Beginning of period	Additions charged to bad debt provision ⁽¹⁾	Amounts charged (credited) to other income statement accounts ⁽¹⁾	Deductions and other, net of recoveries ⁽²⁾	Balance at end of period
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>
2002					
Allowance for Losses on:					
Accounts Receivable	\$ 306	\$ 187	\$ (3)	\$ (208)	\$ 282
Finance Receivables	368	145	24	(213)	324
	<u>\$ 674</u>	<u>\$ 332</u>	<u>\$ 21</u>	<u>\$ (421)</u>	<u>\$ 606</u>

⁽¹⁾ Bad debt provisions relate to estimated losses due to credit and similar uncollectibility 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.
- (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 1, 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. (This Agreement was previously filed in 1997 and is being re-filed in order to comply with SEC rules regarding incorporation by reference).
- (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) Registrant's 1991 Long-Term Incentive Plan, as amended through October 9, 2000.
Incorporated by reference to Exhibit 10(b) to Registrants' Annual Report on Form 10-K for the fiscal year ended December 13, 2000 filed on June 7, 2001.
- (c) Registrant's 1996 Non-employee Director Stock Option Plan, as amended through May 20, 1999.
Incorporated by reference to Registrant's Notice of the 1999 Annual Meeting of Shareholders and Proxy Statement pursuant to Regulation 14A.
- (d) Registrant's 2004 Equity Compensation Plan for Non-Employee Directors
Incorporated by reference to Exhibit (VI) to Registrant's 2004 Proxy Statement filed on April 2, 2004.
- * (e)(1) Registrant's 2004 Performance Incentive Plan ("2004 PIP")
Incorporated by reference to Exhibit (V) to Registrant's 2004 Proxy Statement filed on April 2, 2004.
- (2) Form of Officer Award Agreement under the 2004 PIP.
- (3) Form of Long Term Incentive Plan Award under the 2004 PIP.
- (4) Annual Performance Incentive Plan for 2004.
- (5) Annual Performance Incentive Plan for 2005.
- (6) 2005 Executive Long-Term Incentive Program
- * (f) 2004 Restatement of Registrant's Unfunded Retirement Income Guarantee Plan, as amended through December 7, 2004.
- * (g) 2004 Restatement of Registrant's Unfunded Supplemental Executive Retirement Plan, as amended through December 7, 2004.
- (h) 1996 Amendment and Restatement of Registrant's Restricted Stock Plan for Directors, as amended through February 4, 2002.
- * (i) Form of severance agreement entered into with various executive officers, effective October 15, 2000.
Incorporated by reference to Exhibit 10(i)(2) to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 filed on June 7, 2001.
- * (j) Registrant's Universal Life Plan effective July 1, 2003.
- (k) Registrant's Deferred Compensation Plan for Directors, 1997 Amendment and Restatement, as amended through December 7, 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.
Incorporated by reference to Exhibit 10(p) to Registrant's Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2000.

- (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 2004 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.

**RESTATED CERTIFICATE OF INCORPORATION
OF
XEROX CORPORATION
UNDER SECTION 807 OF THE
BUSINESS CORPORATION LAW**

We, the undersigned, ANNE M. MULCAHY and LESLIE F. VARON, being respectively the Chairman of the Board and the Secretary of XEROX CORPORATION, DO HEREBY CERTIFY that:

1. The name of the Corporation is "XEROX CORPORATION". The name under which it was formed is "THE HALOID COMPANY".
2. The Certificate of Incorporation was filed in the Office of the Secretary of State of the State of New York on April 18, 1906.
3. This restatement of the Certificate of Incorporation was authorized by a resolution adopted by the Board of Directors of the Corporation at a meeting thereof duly called and held. The text of the Certificate of Incorporation is hereby restated without further amendment to read as herein set forth in full:

FIRST: The name of the Corporation is XEROX CORPORATION.

SECOND: The purposes for which it is formed are as follows:

To engage in the invention, development, production, operation, sale or lease of devices, papers and other items, processes, and services, relating to the communications, photographic, printing and image reproduction arts;

To engage in any commercial, mercantile, manufacturing, mining, industrial, importing, exporting or trading business, venture, activity or service or other business, venture, activity or service of a kind or type described in these purposes;

To engage in scientific and technological research and pursuits of every lawful kind and description and to utilize, employ and exploit any and all knowledge resulting therefrom;

To purchase, lease or otherwise acquire, own, hold, sell, mortgage, charge or otherwise dispose of, invest, trade and deal in and with real and personal property of every kind and description.

THIRD: The office of the Corporation is to be located in the City of Rochester, Monroe County, New York.

FOURTH: The aggregate number of shares which the Corporation shall have the authority to issue is 1,750,000,000 shares of Common Stock, of the par value of \$1.00 each (hereinafter referred to as "Common Stock"), 600,000 shares of Class B Stock of the par value of \$1.00 each (hereinafter referred to as "Class B Stock"), and 22,043,067 shares of Cumulative Preferred Stock, of the par value of \$1.00 each (hereinafter referred to as "Cumulative Preferred Stock").

The designations, preferences, privileges and voting powers of each class of stock of the Corporation, and the restrictions and qualifications thereof, shall be as follows:

1. The Cumulative Preferred Stock may be issued from time to time as follows:

(a) The Cumulative Preferred Stock may be issued from time to time as shares of one or more series of Cumulative Preferred Stock and the Board of Directors is expressly authorized, prior to issuance, in the resolution or resolutions providing for the issue of shares in each particular series, to fix the following:

(i) the distinctive serial designation and number of shares which shall constitute such series, which number may be increased (except where otherwise provided by the Board of Directors in creating such series) or decreased (but not below the number of shares thereof then outstanding) from time to time by like action of the Board of Directors;

(ii) the annual dividend rate for such series, and the date from which dividends on shares of such series shall be cumulative;

(iii) the redemption provisions and price or prices, if any, for such series, which may consist of a redemption price or scale of redemption prices applicable only to redemption for a sinking fund and the same or a different redemption price or scale of redemption prices applicable to any other redemption;

(iv) the amount or amounts which shall be paid to the holders of the shares of such series in the event of voluntary or involuntary liquidation, dissolution or winding up of the Corporation (but not less than \$1.00 in the case of involuntary liquidation);

(v) the obligation, if any, of the Corporation to retire shares of such series pursuant to a sinking fund which shall be applied to the redemption of shares of such series;

(vi) the terms and conditions (with or without limitations), if any, on which shares of such series shall be convertible into, or exchangeable for, shares of stock of any other class or classes, including the price or prices or at the rate or rates of conversion or exchange and the terms and conditions of adjustment thereof, if any; and

(vii) the voting rights, if any, in addition to those specified herein, and any other preferences, privileges and restrictions or qualifications of such series.

(b) All shares of Cumulative Preferred Stock, regardless of series, shall be of equal rank with each other and shall be identical with each other in all respects except as provided in or permitted by paragraph (a) of this subdivision 1 and except as provided in paragraph (b) of subdivision 6; and the shares of the Cumulative Preferred Stock of any one series shall be identical with each other in all respects except as to the dates from and after which dividends thereon shall be cumulative.

(c) In case the stated dividends and the amounts payable on liquidation are not paid in full, the shares of all series of the Cumulative Preferred Stock shall share ratably in the payment of dividends (including accumulations, if any) in accordance with the sums which would be payable on said shares if all dividends were declared and paid in full, and in any distribution of assets other than by way of dividends in accordance with the sums which would be payable on such distributions if all sums payable were discharged in full.

2. The holders of the Cumulative Preferred Stock of each series shall be entitled to receive, when and as declared by the Board of Directors, but only out of funds legally available for the payment of dividends, cumulative cash dividends at the annual rate for such series (as fixed by the Board of Directors in accordance with subdivision 1 in respect of any series), and no more, payable quarter-yearly, on the first day of January, April, July and October in each year, to shareholders of record on the respective dates, not exceeding forty days preceding such dividend payment dates, fixed for the purpose by the Board of Directors in advance of payment of each particular dividend; provided that if dividends on any shares of the

Cumulative Preferred Stock shall be cumulative from a date less than thirty days prior to the first quarter-yearly dividend payment date in respect of such shares, the dividends accrued on such shares to such date shall not be payable on such date but shall be payable on the next following quarter-yearly dividend payment date. The holders of shares of the Cumulative Preferred Stock shall not be entitled to receive any dividends thereon other than the dividends referred to in this subdivision 2.

As provided in paragraph (c) of subdivision 1, no dividend shall be paid upon, or declared or set apart for, any share of Cumulative Preferred Stock of any series for any quarter-yearly dividend period (other than the first quarter-yearly dividend period for any shares if the dividend on such shares for such period shall not then be payable pursuant to the provisions of subdivision 2) unless at the same time a like proportionate dividend for the same quarter-yearly dividend period, ratably in proportion to the respective annual dividend rates fixed therefor, shall be paid upon, or declared and set apart for, all shares of Cumulative Preferred Stock of all series then issued and outstanding and entitled to receive the dividend.

3. So long as any shares of the Cumulative Preferred Stock are outstanding, no dividend whatever shall be paid or declared at any time, and no distribution made, on any junior stock (other than in junior stock) nor shall any shares of junior stock be purchased or otherwise acquired for value or redeemed at any time by the Corporation or any subsidiary:

(a) unless all dividends on the Cumulative Preferred Stock of all series for all past quarter-yearly dividend periods (other than the first quarter-yearly dividend period for any shares if the dividend on such shares for such period shall not then be payable pursuant to the provisions of subdivision 2) shall have been paid and the full dividends thereon for the then current quarter-yearly dividend period shall have been paid or declared and a sum sufficient for the payment thereof set apart; and

(b) unless the Corporation shall have redeemed, retired or purchased all shares of each series of Cumulative Preferred Stock required to have been redeemed, retired or purchased at such time pursuant to the sinking fund fixed for such series by the Board of Directors in accordance with subdivision 1,

provided, however, that the foregoing restrictions in this subdivision 3 shall not apply to the acquisition of any junior stock solely in exchange for, or solely out of the proceeds of sale of, any other junior stock.

Subject to the foregoing provisions of this subdivision 3, and to any further limitations prescribed by the Board of Directors in accordance with subdivision 1, and not otherwise, such dividends (payable in cash, stock or otherwise) as may be determined by the Board of Directors may be declared and paid on any junior stock from time to time out of any funds of the Corporation legally available therefor, and the Cumulative Preferred Stock shall not be entitled to participate in any such dividends.

4. Subject to the provisions of subdivision 5, the Corporation at its option (expressed by resolution of the Board of Directors) or for the purpose of any sinking fund therefor may (except as otherwise provided by the Board of Directors in accordance with subdivision 1 in respect of any series) redeem the outstanding shares of Cumulative Preferred Stock, or of any one or more series thereof, at any time in whole, or from time to time in part, upon notice duly given as hereinafter specified, at the applicable redemption price or prices for such shares (as fixed in accordance with subdivision 1 in respect of any series), including, in each case, an amount equal to all accrued and unpaid dividends thereon to the date fixed for redemption.

Notice of every such redemption of Cumulative Preferred Stock of any series (a) if all the shares of such series are held of record by not more than ten holders, shall be given by mailing such notice not less than 30 nor more than 60 days prior to the date fixed for such redemption to each holder of record of shares of such series so to be redeemed at his address as the same shall appear on the books of the Corporation, or (b) if all the shares of such series are held of record by more than ten holders, shall be given by publication at least once in each of two successive calendar weeks in a newspaper printed in the English language and customarily published on each business day and of general circulation in the Borough of Manhattan, The City of New York, the first publication to be not less than 30 nor more than 60 days prior to the date fixed for such redemption, and notice of such redemption shall also be mailed not less than 30 nor more than 60 days prior to the date fixed for such redemption, to each holder of record of shares of such series so to be

redeemed at his address as the same shall appear on the books of the Corporation; but, if publication is required, no failure to mail any such notice nor any defect therein or in the mailing thereof shall affect the validity of the proceeding for the redemption of any shares to be redeemed.

In case of redemption of a part only of the Cumulative Preferred Stock of any series at the time outstanding, whether for the sinking fund therefor or otherwise, the redemption may (subject to any provision made by the Board of Directors in accordance with subdivision 1 in respect of any series) be either pro rata or by lot, as determined by the Board of Directors. Subject to the foregoing, the Board of Directors shall have full power and authority to prescribe the manner in which the drawings by lot or the pro rata redemption shall be conducted and, subject to the provisions contained in the Certificate of Incorporation or provided by the Board of Directors in accordance with subdivision 1, the terms and conditions upon which the Cumulative Preferred Stock shall be redeemed from time to time.

If any such notice of redemption shall have been duly given and if, on or before the redemption date specified therein, all funds necessary for such redemption shall have been set aside by the Corporation, separate and apart from its other funds, in trust for the pro rata benefit of the holders of the shares so called for redemption, so as to be and continue to be available therefor, then, notwithstanding that any certificate for shares so called for redemption shall not have been surrendered for cancellation, all shares so called for redemption shall no longer be deemed outstanding on and after such redemption date, and the right to receive dividends thereon and all other rights with respect to such shares shall forthwith on such redemption date cease and terminate, except only the right of the holders thereof to receive the amount payable on redemption thereof without interest, and the right to exercise, on or before the date fixed for redemption, all privileges of conversion or exchange, if any, not theretofore expired.

If any such notice of redemption shall have been duly given or if the Corporation shall have given to the bank or trust company hereinafter referred to irrevocable written authorization promptly to give or complete such notice, and if on or before the redemption date specified therein the funds necessary for such redemption shall have been deposited by the Corporation with a bank or trust company in good standing, designated in such notice, organized under the laws of the United States of America or of the State of New York, doing business in the Borough of Manhattan, The City of New York, having a capital, surplus, and undivided profits aggregating at least \$5,000,000 according to its last published statement of condition, in trust for the pro rata benefit of the holders of the shares so called for redemption, then, notwithstanding that any certificate for shares so called for redemption shall not have been surrendered for cancellation, from and after the time of such deposit all shares so called for redemption shall no longer be deemed to be outstanding and all rights with respect to such shares shall forthwith cease and terminate, except only the right of the holders thereof to receive from such bank or trust company at any time after the time of such deposit the funds so deposited, without interest, and the right to exercise, on or before the date fixed for redemption, all privileges of conversion or exchange, if any, not theretofore expired. Any interest accrued on such funds shall be paid to the Corporation from time to time.

Any funds so set aside or deposited, as the case may be, and unclaimed at the end of six years from such redemption date shall be released or repaid to the Corporation, after which the holders of the shares so called for redemption shall look only to the Corporation for payment thereof; provided that any funds so deposited which shall not be required for redemption because of the exercise of any privilege of conversion or exchange subsequent to the date of deposit shall be repaid to the Corporation forthwith.

None of the shares of Cumulative Preferred Stock of any series redeemed or retired pursuant to the sinking fund fixed for such series by the Board of Directors in accordance with subdivision 1, shall be reissued and all such shares shall, in the manner provided by law, be eliminated from the authorized capital stock of the Corporation. The Corporation shall not be prohibited from reissuing any shares of Cumulative Preferred Stock redeemed or retired (other than for the sinking fund therefor) or converted into or exchanged for stock pursuant to the provisions fixed by the Board of Directors in accordance with subdivision 1, and after such redemption, retirement or conversion of the Corporation may, in the manner provided by law, restore such shares to the status of authorized but unissued shares of Cumulative Preferred Stock undesignated as to series.

5. If and so long as all dividends on the Cumulative Preferred Stock of all series for all past quarter-yearly dividend periods (other than the first quarter-yearly dividend period for any shares if the dividend on such shares for such period shall not then be payable pursuant to the provisions of subdivision 2) shall not have been paid and the full dividends thereon for the then current quarter-yearly dividend period shall not have been paid or declared and a sum sufficient for the payment thereof set apart, the Corporation shall not redeem (for sinking fund or otherwise) less than all of the Cumulative Preferred Stock at the time outstanding, and neither the Corporation nor any subsidiary shall purchase or otherwise acquire for value (for sinking fund or otherwise) any of the Cumulative Preferred Stock at the time outstanding.

6. Unless the consent of the holders of a greater number of shares shall then be required by law, the consent of the holders of at least two-thirds of the shares of Cumulative Preferred Stock at the time outstanding, given in person or by proxy, either in writing or at any special or annual meeting called for the purpose, at which the Cumulative Preferred Stock shall vote separately as a class, shall be necessary to permit, effect or validate any one or more of the following:

(a) The authorization of, or any increase in the authorized amount of, any class of stock ranking prior to the Cumulative Preferred Stock;

(b) The amendment, alteration or repeal of any of the provisions of the Certificate of Incorporation, or of the By-Laws of the Corporation which would affect adversely any right, preference, privilege or voting power of the Cumulative Preferred Stock or of the holders thereof; provided, however, that if any such amendment, alteration or repeal would affect adversely any right, preference, privilege or voting power of one or more, but not all, of the series of Cumulative Preferred Stock at the time outstanding, the consent of the holders of at least two-thirds of the outstanding shares of each such series so affected, similarly given, shall be required in lieu of (or if such consent is required by law, in addition to) the consent of the holders of two-thirds of the shares of the Cumulative Preferred Stock as a class; and

(c) The voluntary liquidation, dissolution or winding up of the Corporation, or the sale, lease or conveyance (other than by mortgage) of all or substantially all the property or business of the Corporation, or the consolidation or merger of the Corporation with or into any other corporation, except any such consolidation or merger wherein none of the rights, preferences, privileges or voting powers of any series of the Cumulative Preferred Stock or the holders thereof are adversely affected.

No consent of the holders of the Cumulative Preferred Stock or of any series thereof which would otherwise be required to permit, effect or validate any action of the Corporation or a subsidiary pursuant to the provisions of this subdivision 6 or pursuant to any provision fixed by the Board of Directors in accordance with subdivision 1 shall be required if, prior to or concurrently with such action, provision shall be made in accordance with the provisions of the fourth paragraph of subdivision 4 for the redemption of all outstanding shares of Cumulative Preferred Stock or all outstanding shares of such series, as the case may be, and all funds necessary for such redemption shall be deposited in trust in accordance with the provisions of such paragraph.

7. Unless and until six quarter-yearly dividends on the Cumulative Preferred Stock of any series shall be in default, in whole or in part, the entire voting power, except as otherwise provided in the Certificate of Incorporation or By-Laws, shall be vested exclusively in the Common Stock in accordance with the provisions of, and except as otherwise expressly provided in, the Certificate of Incorporation. If and whenever six full quarter-yearly dividends (whether or not consecutive) payable on the Cumulative Preferred Stock of any series shall be in arrears, in whole or in part, the number of Directors then constituting the Board of Directors shall be increased by two and the holders of the Cumulative Preferred Stock, voting separately as a class, regardless of series, shall be entitled to elect the two additional directors at any annual meeting of shareholders or special meeting held in place thereof, or at a special meeting of the holders of the Cumulative Preferred Stock called as hereinafter provided. Whenever all arrears in dividends on the Cumulative Preferred Stock then outstanding shall have been paid and dividends thereon for the current quarter-yearly dividend period shall have been paid or declared and set apart for payment, then the

right of the holders of the Cumulative Preferred Stock to elect such additional two Directors shall cease (but subject always to the same provisions for the vesting of such voting rights in the case of any similar future arrearages in dividends), and the terms of office of all persons elected as Directors by the holders of the Cumulative Preferred Stock shall forthwith terminate and the number of the Board of Directors shall be reduced accordingly. At any time after such voting power shall have been so vested in the Cumulative Preferred Stock, the Secretary of the Corporation may, and upon the written request of any holder of the Cumulative Preferred Stock (addressed to the Secretary at the principal office of the Corporation) shall, call a special meeting of the holders of the Cumulative Preferred Stock for the election of the two Directors to be elected by them as herein provided, such call to be made by notice similar to that provided in the By-Laws for a special meeting of the shareholders or as required by law. If any such special meeting required to be called as above provided shall not be called by the Secretary within twenty days after receipt of any such request, then any holder of Cumulative Preferred Stock may call such meeting, upon the notice above provided, and for that purpose shall have access to the stock books of the Corporation. The Directors elected at any such special meeting shall hold office until the next annual meeting of the shareholders or special meeting held in place thereof. In case any vacancy shall occur among the Directors elected by the holders of the Cumulative Preferred Stock, a successor shall be elected to serve until the next annual meeting of the shareholders or special meeting held in place thereof by the then remaining Director elected by the holders of the Cumulative Preferred Stock or the successor of such remaining Director.

In any case in which the holders of Cumulative Preferred Stock or any series thereof shall be entitled to vote pursuant to the provisions of the Certificate of Incorporation or pursuant to law, each holder of Cumulative Preferred Stock or of such series, as the case may be, shall be entitled to one vote for each share thereof held.

8. In the event of any liquidation, dissolution or winding up of the Corporation, the holders of the Cumulative Preferred Stock of each series shall be entitled to receive out of the assets of the Corporation, before any distribution or payment shall be made to the holders of any junior stock, (i) if such liquidation, dissolution or winding up shall be involuntary, the amount fixed by the Board of Directors in accordance with subdivision 1 but not less than \$1.00, and (ii) if such liquidation, dissolution or winding up shall be voluntary, the amount per share fixed by the Board of Directors in accordance with the provisions of subdivision 1 in the case of any series of Cumulative Preferred Stock, in effect at the time thereof, together with, in each case, all accrued and unpaid dividends thereon to the date fixed for the payment of such distributive amounts; and the holders of the junior stock shall be entitled, to the exclusion of the holders of the Cumulative Preferred Stock of any and all series, to share ratably in all the remaining assets of the Corporation in accordance with their respective rights. As provided in paragraph (c) of subdivision 1, if upon any liquidation, dissolution or winding up of the Corporation, whether voluntary or involuntary, the assets available for distribution shall be insufficient to pay the holders of all outstanding shares of Cumulative Preferred Stock the full amounts to which they respectively shall be entitled, the holders of shares of Cumulative Preferred Stock of all series shall share ratably in any distribution of assets in accordance with the sums which would be payable on such distribution if all sums payable were discharged in full. Neither the consolidation or merger of the Corporation with or into any other corporation, nor any sale, lease or conveyance of all or any part of the property or business of the Corporation, shall be deemed to be a liquidation, dissolution or winding up of the Corporation within the meaning of this subdivision 8.

9. Except as otherwise expressly provided in the Certificate of Incorporation and except as otherwise provided by law, voting rights upon any and all matters shall be vested exclusively in the holders of the Common Stock and the Class B Stock (each share of Common Stock and of Class B Stock having one vote).

10. No holder of Common Stock, Cumulative Preferred Stock or Class B Stock shall be entitled as such, as a matter of right, to subscribe for or purchase any part of any new or additional issue of stock of any class whatsoever, or of any obligations or other securities convertible into, or exchangeable for, any stock of any class whatsoever, whether now or hereafter authorized and whether issued for cash or other consideration or by way of dividend.

11. The holders of Common Stock and of Class B Stock shall possess equal voting rights and rights as to dividends or distributions, and in the event of any liquidation, dissolution or winding up of the Corporation. No dividend, distribution, split-up, combination, reclassification, or other change in the shares of Common Stock shall be made without the same being made with respect to the Class B Stock.

12. For all purposes of the Certificate of Incorporation:

The term "accrued and unpaid dividends" when used with reference to any share of any series of the Cumulative Preferred Stock shall mean an amount computed at the annual dividend rate for the shares of such series from the date on which dividends on such share became cumulative to and including the date to which such dividends are to be accrued, less the aggregate amount of all dividends theretofore paid on such share; but no interest shall be payable upon any arrearages.

The term "Certificate of Incorporation" shall mean the certificate of incorporation of the Corporation as amended and supplemented by any certificate heretofore or hereafter filed pursuant to law, including any certificate filed pursuant to law with respect to, and providing for the issue of, any series of Cumulative Preferred Stock.

The term "junior stock", when used with reference to the Cumulative Preferred Stock, shall mean the Common Stock, the Class B Stock and any other stock of the Corporation, now or hereafter authorized, over which the Cumulative Preferred Stock has preference or priority either in the payment of dividends or in the distribution of assets upon any liquidation, dissolution or winding up of the Corporation.

The term "sinking fund", as applied to any series of preferred stock, shall mean any fund or requirement for the periodic redemption, retirement or purchase of shares of such series.

The term "stock ranking prior to the Cumulative Preferred Stock" shall mean any stock of the Corporation, now or hereafter authorized, which has preference over the Cumulative Preferred Stock either in the payment of dividends or in any liquidation, dissolution or winding up of the Corporation.

THE SERIES A CUMULATIVE PREFERRED STOCK

13. (a) The distinctive serial designation of the second series of Cumulative Preferred Stock is "Series A Cumulative Preferred Stock" (hereinafter called "Series A Preferred Stock").

(b) The number of shares constituting the Series A Preferred Stock is 1,500,000 shares.

(c) The quarterly dividend rate for the Series A Preferred Stock is an amount per share (rounded to the nearest cent) equal to the greater of (i) \$10.00 or (ii) subject to the provision for adjustment hereinafter set forth, 100 times the aggregate per share amount of all cash dividends, and 100 times the aggregate per share amount (payable in kind) of all noncash dividends or other distributions other than a dividend payable in shares of Common Stock or Class B Stock or a subdivision of the outstanding shares of Common Stock or Class B Stock (by reclassification or otherwise), declared on the Common Stock or Class B Stock of the Corporation since the immediately preceding quarterly dividend payment date, or, with respect to the first quarterly dividend payment date, since the first issuance of any share or fraction of a share of Series A Preferred Stock. In the event the Corporation shall at any time after April 16, 1987 declare or pay any dividend on Common Stock or Class B Stock payable in shares of Common Stock or Class B Stock, or effect a subdivision or combination or consolidation of the outstanding shares of Common Stock or Class B Stock (by reclassification or otherwise than by payment of a dividend in shares of Common Stock or Class B Stock) into a greater or lesser number of shares of Common Stock or Class B Stock, then in each such case the amount to which holders of Series A Preferred Stock were entitled immediately prior to such event under clause (ii) of the preceding sentence shall be adjusted by multiplying such amount by a fraction, the numerator of which is the number of shares of Common Stock or Class B Stock outstanding immediately after such event and the denominator of which is the number of shares of Common Stock or Class B Stock that were outstanding immediately prior to such event.

The Corporation shall declare a dividend or distribution on the Series A Preferred Stock as provided in this paragraph (c) immediately after it declares a dividend or distribution on the Common Stock or Class B

Stock; provided that, in the event no dividend or distribution shall have been declared on the Common Stock or Class B Stock during the period between any quarterly dividend payment date and the next subsequent quarterly dividend payment date, a dividend of \$10.00 per share on the Series A Preferred Stock shall nevertheless be payable on such subsequent quarterly dividend payment date.

Dividends shall begin to accrue and be cumulative on outstanding Series A Preferred Stock from the date of issue of such shares of Series A Preferred Stock.

(d) Except as prescribed by law and in addition to the rights provided for in Section 7 of Article FOURTH of the Certificate of Incorporation of the Corporation and in paragraph (i) of this Section 13, and subject to the provision for adjustment hereinafter set forth, the holders of the Series A Preferred Stock shall be entitled to one vote for each share held and shall be entitled to exercise such voting rights with the holders of Common Stock and Class B Stock, without distinction as to class, at any annual or special meeting of shareholders for the election of directors and on any other matter coming before such meeting.

(e) Any Series A Preferred Stock purchased or otherwise acquired by the Corporation in any manner whatsoever shall be retired and cancelled promptly after the acquisition thereof. All such shares shall upon their cancellation become authorized but unissued Cumulative Preferred Stock and may be reissued as part of a new series of Cumulative Preferred Stock to be created by resolution or resolutions of the Board of Directors, subject to the conditions and restrictions on issuance set forth herein.

(f) (i) Upon any voluntary or involuntary liquidation, dissolution or winding up of the Corporation, no distribution shall be made to the holders of junior stock unless, prior thereto, the holders of Series A Preferred Stock shall have received the greater of (i) \$100.00 per share, plus an amount equal to accrued and unpaid dividends and distributions thereon, whether or not declared, to the date of such payment, or (ii) an amount per share which shall be determined by (A) dividing (1) the value of the assets of the Corporation available for distribution to shareholders, less the amount to be paid upon liquidation, dissolution, or winding up to the holders of all other series of stock ranking on a parity with the Series A Preferred Stock, by (2) the sum of the number of one-hundredths shares of Series A Preferred Stock outstanding as of the date of such event plus the number of shares of Common Stock and Class B Stock, as adjusted by multiplying such number of shares of Common Stock and Class B Stock outstanding as of the date of such event by the Adjustment Number (as defined below), and (B) multiplying the result obtained in clause (A) by 100, (the "Series A Preferred Stock Liquidation Preference"). Following the payment of the full amount of the Series A Preferred Stock Liquidation Preference, no additional distributions shall be made to the holders of shares of Series A Preferred Stock. Following the payment of the full amount of the Series A Preferred Stock Liquidation Preference in respect of all outstanding shares of Series A Preferred Stock holders of Common Stock and Class B Stock shall receive their ratable and proportionate share of the remaining assets to be distributed, on a per share basis.

(ii) In the event, however, that there are not sufficient assets available to permit payment in full of the Series A Preferred Stock Liquidation Preference and the liquidation preferences of all other series of stock ranking on a parity upon liquidation, dissolution or winding up with the Series A Preferred Stock, then such remaining assets shall be distributed ratably to the holders of the Series A Preferred Stock and such other series of parity stock in proportion to the total amounts to which the holders of all such shares are entitled upon liquidation, dissolution or winding up.

(iii) The Adjustment Number as of the date of this Certificate of Amendment shall be one (1). In the event the Corporation shall at any time after April 16, 1987 declare or pay any dividend on Common Stock payable in shares of Common Stock or Class B Stock, or effect a subdivision or combination or consolidation of the outstanding shares of Common Stock or Class B Stock (by reclassification or otherwise than by payment of a dividend in shares of Common Stock or Class B Stock) into a greater or lesser number of shares of Common Stock or Class B Stock, then in each such case the Adjustment Number in effect immediately prior to such event shall be adjusted by multiplying such Adjustment Number by a fraction, the numerator of which is the number of shares of Common Stock and Class B Stock outstanding immediately prior to such event and the denominator of which is the number of shares of Common Stock and Class B Stock that were outstanding immediately after such event.

(iv) The merger or consolidation of the Corporation with or into any other corporation or the merger or consolidation of any other corporation with or into the Corporation, or the sale, transfer, exchange or conveyance by the Corporation of all or substantially all the assets of the Corporation, as an entirety, shall not be deemed to be a liquidation for purposes of paragraph (f) of this Section 13.

(g) In case the Corporation shall enter into any consolidation, merger, combination or other transaction in which the shares of Common Stock or Class B Stock are exchanged for or changed into other stock or securities, cash and/or any other property, then in any such case the Series A Preferred Stock shall at the same time be similarly exchanged or changed in an amount per share (subject to the provision for adjustment hereinafter set forth) equal to 100 times the aggregate amount of stock, securities, cash and/or any other property (payable in kind), as the case may be, into which or for which each share of Common Stock or Class B Stock is changed or exchanged. In the event the Corporation shall at any time after April 16, 1987 declare or pay any dividend on Common Stock or Class B Stock payable in shares of Common Stock or Class B Stock, or effect a subdivision or combination or consolidation of the outstanding shares of Common Stock or Class B Stock (by reclassification or otherwise than by payment of a dividend in shares of Common Stock or Class B Stock) into a greater or lesser number of shares of Common Stock or Class B Stock, then in each such case the amount set forth in the preceding sentence with respect to the exchange or change of Series A Preferred Stock shall be adjusted by multiplying such amount by a fraction the numerator of which is the number of shares of Common Stock and Class B Stock outstanding immediately after such event and the denominator of which is the number of shares of Common Stock and Class B Stock that were outstanding immediately prior to such event.

(h) The Series A Preferred Stock shall not be redeemable.

(i) Series A Preferred Stock may be issued in fractions of a share which shall entitle the holder, in proportion to such holder's fractional shares, to exercise voting rights, receive dividends, participate in liquidating distributions and to have the benefit of all other rights of holders of Series A Preferred Stock.

(j) The Series A Preferred Stock is not convertible into, or exchangeable for, shares of stock of any other class.

THE 6.25% SERIES C MANDATORY CONVERTIBLE PREFERRED STOCK

14. (a) *Designation and Ranking.* The distinctive serial designation of the sixth series of Cumulative Preferred Stock shall be called the "6.25% Series C Mandatory Convertible Preferred Stock" and is hereinafter referred to as the "Series C Mandatory Convertible Preferred Stock"; and the number of shares constituting the Series C Mandatory Convertible Preferred Stock shall be 9,200,000 shares. The Series C Mandatory Convertible Preferred Stock shall rank, with respect to dividend distributions and distributions upon the dissolution, liquidation and winding-up of the Corporation, (i) senior to the common stock, par value \$1.00 per share, of the Corporation (the "*Common Stock*") and the class B common stock, par value \$1.00 per share, of the Corporation (the "*Class B Common Stock*") and to each other class or series of stock of the Corporation (including any series of Cumulative Preferred Stock established after June 25, 2003 by the Board of Directors), now or hereafter existing, the terms of which do not expressly provide that such class or series will rank senior to or *pari passu* with the Series C Senior Mandatory Convertible Preferred Stock as to dividend distributions and distributions upon the liquidation, dissolution or winding-up of the Company (collectively referred to as "*Junior Securities*"); (ii) *pari passu* with the Corporation's Series B Convertible Preferred Stock (the "*Series B Convertible Preferred Stock*" and together, with the "*Series C Mandatory Convertible Preferred Stock*," the "*Cumulative Preferred Stock*") and with each other class or series of stock of the Corporation, now or hereafter existing, the terms of which expressly provide that such class or series will rank *pari passu* with the Series C Mandatory Convertible Preferred Stock as to dividend distributions and distributions upon liquidation, dissolution or winding-up of the Corporation (collectively referred to as "*Parity Securities*"); and (iii) junior to each other class or series of stock of the Corporation, now or hereafter existing, the terms of which expressly provide that such class or series will rank senior to the Series C Mandatory Convertible Preferred Stock as to dividend distributions and distributions upon liquidation, dissolution or winding-up of the Corporation (collectively referred to as "*Senior Securities*").

(b) *Dividends.*

(i) *General.* Dividends on the Series C Mandatory Convertible Preferred Stock shall be payable quarterly, when, as and if declared by the Board of Directors or a duly authorized committee thereof, out of the assets of the Corporation legally available therefor, on the first calendar day (or the following Business Day if the first calendar day is not a Business Day) of January, April, July and October of each year (each such date being referred to herein as a “*Dividend Payment Date*”) at the annual rate of \$6.25 per share subject to adjustment as provided in Section 18(1)(ii). The initial dividend on the Series C Mandatory Convertible Preferred Stock for the dividend period commencing on June 25, 2003, to but excluding October 1, 2003, will be \$1.6667, and shall be payable, when, as and if declared, on October 1, 2003. The dividend on the Series C Mandatory Convertible Preferred Stock for each subsequent dividend period shall be \$1.5625 per share. The amount of dividends payable on each share of Series C Mandatory Convertible Preferred Stock for each full quarterly period thereafter shall be computed by dividing the annual dividend rate by four. The amount of dividends payable for any other period that is shorter or longer than a full quarterly dividend period will be computed on the basis of a 360-day year consisting of twelve 30-day months.

A dividend period with respect to a Dividend Payment Date is the period commencing on the preceding Dividend Payment Date or, if none, the date of issue and ending on the day immediately prior to the next Dividend Payment Date. Dividends payable, when, as and if declared, on a Dividend Payment Date shall be payable to Holders (as defined below) of record on the date not exceeding forty calendar days preceding the relevant Dividend Payment Date, fixed by the Board of Directors in advance of payment of the relevant dividend (each, a “*Dividend Record Date*”).

Dividends on the Series C Mandatory Convertible Preferred Stock shall be cumulative if the Corporation fails to declare one or more dividends on the Series C Mandatory Convertible Preferred Stock in any amount, whether or not there are assets of the Corporation legally available for the payment of such dividends in whole or in part.

The Corporation may pay dividends, at its sole option, (a) in cash, (b) by delivering shares of Common Stock to the Transfer Agent (as defined below) on behalf of the Holders, to be sold on the Holders’ behalf for cash or (c) in any combination thereof. By and upon acquiring the Series C Mandatory Convertible Preferred Stock each Holder is deemed to appoint the Transfer Agent as such Holder’s agent for any such sale, and the Transfer Agent shall serve as a designated agent of the Holders in making any such sales. To pay dividends in shares of Common Stock, the Corporation must deliver to the Transfer Agent a number of shares of Common Stock which, when sold by the Transfer Agent on the Holders’ behalf, will result in net cash proceeds to be distributed to the Holders in an amount equal to the cash dividend otherwise payable to the Holders.

If the Corporation pays dividends in shares of Common Stock by delivering them to the Transfer Agent, those shares shall be owned beneficially by the Holders upon delivery to the Transfer Agent, and the Transfer Agent shall hold those shares and the net cash proceeds from the sale of those shares up to the amount of such dividends for the exclusive benefit of the Holders until the Dividend Payment Date, or such other date as is fixed by the Board of Directors pursuant to the terms and conditions set forth in the last paragraph of this Section 18(b)(i), at which time the portion of such net cash proceeds equal to the non-cash component of the declared dividend on the Series C Mandatory Convertible Preferred Stock shall be distributed to the Holders entitled thereto with any remainder to be returned to the Company.

Holders shall not be entitled to any dividend, whether payable in cash, property or stock, in excess of the then applicable full dividends calculated pursuant to this Section 15(b)(i) (including accrued dividends, if any) on shares of Series C Mandatory Convertible Preferred Stock. No interest or sum of money in lieu of interest shall be payable in respect of any dividend or payment which may be in arrears.

(ii) In order to pay dividends on any Dividend Payment Date, or such other date as is fixed by the Board of Directors or a duly authorized committee thereof pursuant to the terms and conditions set

forth in the last paragraph of Section 15(b)(i) hereof, in shares of Common Stock, (A) the shares of Common Stock delivered to the Transfer Agent shall have been duly authorized, (B) the Corporation shall have provided to the Transfer Agent an effective registration statement under the Securities Act of 1933, as amended, and the rules and regulations thereunder (the “*Securities Act*”) permitting the immediate sale of the shares of Common Stock in the public market, (C) the shares of Common Stock, once purchased by the purchasers thereof, shall be validly issued, fully paid and non-assessable and (D) such shares shall have been registered under the Securities Exchange Act of 1934, as amended, and the rules and regulations thereunder, if required, and shall be listed or admitted for trading on each United States securities exchange on which the Common Stock is then listed.

(c) *Liquidation Preference.* In the event of any voluntary or involuntary liquidation, dissolution or winding-up of the Corporation, the Holders shall be entitled to receive out of the assets of the Corporation available for distribution to shareholders, before any distribution or payment of assets is made on any Junior Securities, \$100.00 per share, subject to adjustment as provided in Section 15(l)(ii) hereof, plus an amount equal to the sum of all accrued and unpaid dividends (whether or not declared) for the then-current dividend period and all dividend periods prior thereto.

Neither the sale, lease or conveyance of all or substantially all of the property or business of the Corporation (other than in connection with the voluntary or involuntary liquidation, dissolution or winding-up of the Corporation), nor the consolidation, or merger of the Corporation into or with any other Person, shall constitute a voluntary or involuntary liquidation, dissolution or winding-up of the Corporation for the purposes of the foregoing paragraph.

In the event the assets of the Corporation available for distribution to the holders of Cumulative Preferred Stock upon any voluntary or involuntary liquidation, dissolution or winding-up of the Corporation shall be insufficient to pay in full all amounts to which such holders are entitled as provided above, the holders of shares of the Cumulative Preferred Stock, including the Series C Mandatory Convertible Preferred Stock, shall share ratably in any distribution of assets of the Corporation based on the relative aggregate liquidation preference of the outstanding shares of each series.

After the payment to the Holders of the full preferential amounts provided above, the Holders will have no right or claim to any remaining assets of the Corporation.

(d) *Voting Rights.*

(i) The Holders shall have no voting rights, except as otherwise set forth in the Certificate of Incorporation of the Corporation or as expressly required by applicable state law. In exercising any such vote, each outstanding share of Series C Mandatory Convertible Preferred Stock shall be entitled to one vote.

(ii) Unless the consent of the holders of a greater number of shares shall then be required by law, the consent of the holders of at least two-thirds of the shares of Cumulative Preferred Stock, including the Series C Mandatory Convertible Preferred Stock, at the time outstanding, given in person or by proxy, either in writing or at any special or annual meeting called for the purpose, at which the Cumulative Preferred Stock, including the Series C Mandatory Convertible Preferred Stock, shall vote separately as a class, shall be necessary to permit, effect or validate any one or more of the following:

(1) The authorization of, or any increase in the authorized amount of any class of stock ranking prior to the Cumulative Preferred Stock, including the Series C Mandatory Convertible Preferred Stock.

(2) The amendment, alteration or repeal of any of the provisions of the Certificate of Incorporation, or of the By-Laws of the Corporation, in either case by way of merger, consolidation or otherwise, which would affect adversely any right, preference, privilege or voting power of the Cumulative Preferred Stock, including the Series C Mandatory Convertible Preferred Stock, or the holders thereof; *provided, however*, that if any such amendment, alteration or repeal

would affect adversely any right, preference, privilege or voting power of one or more, but not all, of the series of Cumulative Preferred Stock, including the Series C Mandatory Convertible Preferred Stock, at the time outstanding, the consent of the holders of at least two-thirds of the outstanding shares of each such series so affected, similarly given, shall be required in lieu of (or if such consent is required by law, in addition to) the consent of the holders of two-thirds of the shares of the Cumulative Preferred Stock, including the Series C Mandatory Convertible Preferred Stock, as a class; or

(3) The voluntary liquidation, dissolution or winding up of the Corporation, or the sale, lease or conveyance (other than by mortgage) of all or substantially all the property or business of the Corporation, or the consolidation or merger of the Corporation with or into any other corporation, except any such consolidation or merger wherein none of the rights, preferences, privileges or voting powers of any series of the Cumulative Preferred Stock or the holders thereof are adversely affected.

(e) *Automatic Conversion.* Each share of Series C Mandatory Convertible Preferred Stock will automatically convert (unless previously converted at the option of the Corporation in accordance with Section 15(f) or at the option of the Holder in accordance with Section 15(g), or a Merger Early Conversion has occurred in accordance with Section 15(h)), on July 1, 2006 (the “*Automatic Conversion Date*”), into a number of newly issued shares of Common Stock equal to the number of shares of Common Stock resulting from the application of the Conversion Rate (as defined in Section 18(i) below). The Holders on the Automatic Conversion Date shall have the right to receive a dividend payment of cash, shares of Common Stock, or any combination thereof, as the Corporation determines in its sole discretion, in an amount equal to any accrued and unpaid dividends on the Series C Mandatory Convertible Preferred Stock as of the Automatic Conversion Date (other than previously declared dividends on the Series C Mandatory Convertible Preferred Stock payable to a Holder of record as of a prior date), whether or not declared, out of legally available assets of the Corporation. To the extent the Corporation pays some or all of such dividend in shares of Common Stock, the number of shares of Common Stock issuable to a Holder in respect of such accrued and unpaid dividends shall equal the amount of accrued and unpaid dividends on the Series C Mandatory Convertible Preferred Stock on the Automatic Conversion Date that the Corporation determines to pay in shares of Common Stock divided by the 5-Day Average Market Price (as defined below).

Dividends on the shares of Series C Mandatory Convertible Preferred Stock shall cease to accrue and such shares of Series C Mandatory Convertible Preferred Stock shall cease to be outstanding on the Automatic Conversion Date. The Corporation shall make such arrangements as it deems appropriate for the issuance of certificates, if any, representing shares of Common Stock (both for purposes of the automatic conversion of shares of Series C Mandatory Convertible Preferred Stock and for purposes of any dividend payment by the Corporation of shares of Common Stock in respect of accrued and unpaid dividends on the Series C Mandatory Convertible Preferred Stock), and for any payment of cash in respect of accrued and unpaid dividends on the Series C Mandatory Convertible Preferred Stock or cash in lieu of fractional shares, if any, in exchange for and contingent upon the surrender of certificates representing the shares of Series C Mandatory Convertible Preferred Stock (if such shares are held in certificated form), and the Corporation may defer the payment of dividends on such shares of Common Stock and the voting thereof until, and make such payment and voting contingent upon, the surrender of such certificates representing the shares of Series C Mandatory Convertible Preferred Stock, *provided, however*, that the Corporation shall give the Holders such notice of any such actions as the Corporation deems appropriate and upon such surrender such Holders shall be entitled to receive such dividends declared and paid on such shares of Common Stock subsequent to the Automatic Conversion Date. Amounts payable in cash in respect of the shares of Series C Mandatory Convertible Preferred Stock or in respect of such shares of Common Stock shall not bear interest.

(f) *Provisional Conversion at the Option of the Corporation.*

(i) Prior to the Automatic Conversion Date, the Corporation may, at its option, cause the conversion of all, but not less than all, the shares of Series C Mandatory Convertible Preferred Stock

then outstanding into shares of Common Stock at a rate of 8.1301 shares of Common Stock for each share of Series C Mandatory Convertible Preferred Stock (the “*Provisional Conversion Rate*”), subject to adjustment as set forth in Section 15(i)(ii) below (as though references in Section 15(i)(ii) to the Conversion Rate were replaced with references to the Provisional Conversion Rate); *provided, however*, that the Closing Price of the Common Stock has exceeded 150% of the Threshold Appreciation Price (as defined below) for at least 20 Trading Days (as defined below) within a period of 30 consecutive Trading Days ending on the Trading Day prior to the date on which the Corporation notifies the Holders (pursuant to Section 15(f)(ii)) that it is exercising its option to cause the conversion of the Series C Mandatory Convertible Preferred Stock pursuant to this Section 15(f) (the “*Provisional Conversion Notice Date*”). The Corporation shall be able to cause this conversion only if, in addition to issuing the Holders shares of Common Stock, the Corporation pays the Holders in cash (a) an amount equal to any accrued and unpaid dividends on the shares of Series C Mandatory Convertible Preferred Stock then outstanding, whether or not declared, and (b) the present value of all remaining dividend payments on the shares of Series C Mandatory Convertible Preferred Stock then outstanding, through and including July 1, 2006, in each case, out of legally available assets of the Corporation. The present value of the remaining dividend payments will be computed using a discount rate equal to the Treasury Yield.

(ii) A written notice (the “*Provisional Conversion Notice*”) shall be sent by or on behalf of the Corporation, by first class mail, postage prepaid, to the Holders of record as they appear on the stock register of the Corporation on the Provisional Conversion Notice Date (a) notifying such Holders of the election of the Corporation to convert and of the Provisional Conversion Date (as defined below), which date shall not be less than 30 days nor be more than 60 days after the Provisional Conversion Notice Date, and (b) stating the Corporate Trust Office of the Transfer Agent at which the shares of Series C Mandatory Convertible Preferred Stock called for conversion shall, upon presentation and surrender of the certificate(s) (if such shares are held in certificated form) evidencing such shares, be converted, and the Provisional Conversion Rate to be applied thereto.

(iii) The Corporation shall deliver to the Transfer Agent irrevocable written instructions authorizing the Transfer Agent, on behalf and at the expense of the Corporation, to cause the Provisional Conversion Notice to be duly mailed as soon as practicable after receipt of such irrevocable instructions from the Corporation and in accordance with the above provisions. The shares of Common Stock to be issued upon conversion of the Series C Mandatory Convertible Preferred Stock pursuant to this Section 15(f) and all funds necessary for the payment in cash of (1) any accrued and unpaid dividends on the shares of Series C Mandatory Convertible Preferred Stock then outstanding, whether or not declared, and (2) the present value of all remaining dividend payments on the shares of Series C Mandatory Convertible Preferred Stock then outstanding through and including July 1, 2006, shall be deposited with the Transfer Agent in trust at least one Business Day prior to the Provisional Conversion Date, for the *pro rata* benefit of the Holders of record as they appear on the stock register of the Corporation, so as to be and continue to be available therefor. Neither failure to mail such Provisional Conversion Notice to one or more such Holders nor any defect in such Provisional Conversion Notice shall affect the sufficiency of the proceedings for conversion as to other Holders.

(iv) If a Provisional Conversion Notice shall have been given as hereinbefore provided, then each Holder shall be entitled to all preferences and relative, participating, optional and other special rights accorded by this certificate until and including the Provisional Conversion Date. From and after the Provisional Conversion Date, upon delivery by the Corporation of the Common Stock and payment of the funds to the Transfer Agent as described in paragraph (iii) above, the Series C Mandatory Convertible Preferred Stock shall no longer be deemed to be outstanding, and all rights of such Holders shall cease and terminate, except the right of the Holders, upon surrender of certificates therefor, to receive Common Stock and any amounts to be paid hereunder.

(v) The deposit of monies in trust with the Transfer Agent up to the amount necessary for the Provisional Conversion shall be irrevocable except that the Corporation shall be entitled to receive

from the Transfer Agent the interest or other earnings, if any, earned on any monies so deposited in trust, and the Holders of the shares converted shall have no claim to such interest or other earnings, and any balance of monies so deposited by the Corporation and unclaimed by the Holders entitled thereto at the expiration of two years from the Provisional Conversion Date shall be repaid, together with any interest or other earnings thereon, to the Corporation, and after any such repayment, the Holders of the shares entitled to the funds so repaid to the Corporation shall look only to the Corporation for such payment without interest.

(g) *Early Conversion at the Option of the Holder.*

(i) Shares of Series C Mandatory Convertible Preferred Stock are convertible, in whole or in part, at the option of the Holders thereof (“*Optional Conversion*”), at any time prior to the Automatic Conversion Date, into shares of Common Stock at a rate of 8.1301 shares of Common Stock for each share of Series C Mandatory Convertible Preferred Stock (the “*Optional Conversion Rate*”), subject to adjustment as set forth in Section 15(i)(ii) below (as though references in Section 15(i)(ii) to the Conversion Rate were replaced with references to the Optional Conversion Rate).

(ii) Optional Conversion of shares of Series C Mandatory Convertible Preferred Stock may be effected by delivering certificates evidencing such shares (if such shares are held in certificated form), together with written notice of conversion and a proper assignment of such certificates to the Corporation or in blank (and, if applicable, payment of an amount equal to the dividend payable on such shares pursuant to paragraph (iii) below), to the Corporate Trust Office of the Transfer Agent for the Series C Mandatory Convertible Preferred Stock or to any other office or agency maintained by the Corporation for that purpose. Each Optional Conversion shall be deemed to have been effected immediately prior to the close of business on the date on which the foregoing requirements shall have been satisfied.

(iii) Holders of shares of Series C Mandatory Convertible Preferred Stock at the close of business on a Dividend Record Date shall be entitled to receive the dividend payable on such shares on the corresponding Dividend Payment Date (if such dividend has been declared) notwithstanding the Optional Conversion of such shares following such Dividend Record Date and prior to such Dividend Payment Date. However, shares of Series C Mandatory Convertible Preferred Stock surrendered for Optional Conversion after the close of business on a Dividend Record Date and before the opening of business on the corresponding Dividend Payment Date must be accompanied by payment in cash of an amount equal to the dividend payable on such shares on such Dividend Payment Date. Except as provided above, upon any Optional Conversion of shares of Series C Mandatory Convertible Preferred Stock, the Corporation shall make no payment or allowance for unpaid preferred dividends, whether or not in arrears, on such shares of Series C Mandatory Convertible Preferred Stock as to which Optional Conversion has been effected or for dividends or distributions on the shares of Common Stock issued upon such Optional Conversion.

(h) *Early Conversion upon Cash Merger.*

(i) In the event of a merger or consolidation of the Corporation of the type described in Section 15(i)(iii)(1) in which the Common Stock outstanding immediately prior to such merger or consolidation is exchanged for consideration consisting of at least 30% cash or cash equivalents (any such event a “*Cash Merger*”), then the Corporation (or the successor to the Corporation hereunder) shall be required to offer all Holders of shares of Series C Mandatory Convertible Preferred Stock that remain outstanding after the Cash Merger (if any) the right to convert their shares of Series C Mandatory Convertible Preferred Stock prior to the Automatic Conversion Date (“*Merger Early Conversion*”) as provided herein.

On or before the fifth Business Day after the consummation of a Cash Merger, the Corporation or, at the request and expense of the Corporation, the Transfer Agent shall give all Holders notice of the

occurrence of the Cash Merger and of the right of Merger Early Conversion arising as a result thereof. The Corporation shall also deliver a copy of such notice to the Transfer Agent. Each such notice shall contain:

- (1) the date, which shall be not less than 20 nor more than 30 calendar days after the date of such notice, on which the Merger Early Conversion will be effected (the “*Merger Early Conversion Date*”);
- (2) the date, which shall be on or one Business Day prior to the Merger Early Conversion Date, by which the Merger Early Conversion right must be exercised;
- (3) the Conversion Rate (as adjusted pursuant to Section 15(i)(ii)) in effect immediately before such Cash Merger and the kind and amount of securities, cash and other property receivable by the Holder upon conversion of its shares of Series C Mandatory Convertible Preferred Stock pursuant to Section 15(i)(iii); and
- (4) the instructions a Holder must follow to exercise the Merger Early Conversion right.

(ii) To exercise a Merger Early Conversion right, a Holder shall deliver to the Transfer Agent at the Corporate Trust Office (as defined below) by 5:00 p.m., New York City time, on or before the date by which the Merger Settlement right must be exercised as specified in the notice, the certificate(s) (if such shares are held in certificated form) evidencing the shares of Series C Mandatory Convertible Preferred Stock with respect to which the Merger Early Conversion right is being exercised duly endorsed for transfer to the Corporation or in blank with a written notice to the Corporation stating the Holder’s intention to convert early in connection with the Cash Merger and providing the Corporation with payment instructions.

(iii) On the Merger Early Conversion Date, the Corporation shall deliver or cause to be delivered the cash, securities and other property to be received by such exercising Holder determined by assuming the Holder had converted the shares of Series C Mandatory Convertible Preferred Stock for which such Merger Early Conversion right was exercised into Common Stock immediately before the Cash Merger at the Conversion Rate (as adjusted pursuant to Section 15(i)(ii)).

(iv) Upon a Merger Early Conversion, the Transfer Agent shall, in accordance with the instructions provided by the Holder thereof on the notice provided to the Corporation as set forth in paragraph (ii) above, deliver to the Holder such cash, securities or other property issuable upon such Merger Early Conversion together with payment in lieu of any fractional shares, as provided herein.

(v) In the event that Merger Early Conversion is effected with respect to shares of Series C Mandatory Convertible Preferred Stock representing less than all the shares of Series C Mandatory Convertible Preferred Stock held by a Holder, upon such Merger Early Conversion the Corporation (or the successor to the Corporation hereunder) shall execute and the Transfer Agent shall authenticate, countersign and deliver to the Holder thereof, at the expense of the Corporation, a certificate evidencing the shares as to which Merger Early Conversion was not effected.

(i) *Definition of Conversion Rate; Anti-dilution Adjustments.*

(i) Subject to the immediately following sentence, the “Conversion Rate” is equal to:

- (1) if the 20-Day Average Market Price is greater than or equal to \$12.30 (the “*Threshold Appreciation Price*”), 8.1301 shares of Common Stock per share of Series C Mandatory Convertible Preferred Stock;
- (2) if the 20-Day Average Market Price is less than the Threshold Appreciation Price, but is greater than \$10.25, the number of shares of Common Stock per share of Series C Mandatory Convertible Preferred Stock equal to \$100.00 (the “*Stated Amount*”) divided by the 20-Day Average Market Price; and

(3) if the 20-Day Average Market Price is equal to or less than \$10.25, 9.7561 shares of Common Stock per share of Series C Mandatory Convertible Preferred Stock,

in each case subject to adjustment as provided in Section 15(i)(ii) (and in each case rounded upward or downward to the nearest 1/10,000th of a share). In each of the clauses in the immediately preceding sentence, the number of newly issued shares of Common Stock issuable upon conversion of each share of the Series C Mandatory Convertible Preferred Stock on the Automatic Conversion Date in respect of a conversion pursuant to Section 18(e) shall be increased by an amount equal to any accrued and unpaid dividends on the Series C Mandatory Convertible Preferred Stock on the Automatic Conversion Date (taking into account any payment of such dividends on the Automatic Conversion Date) divided by the 20-Day Average Market Price.

(ii) In connection with the Conversion Rate as set forth in Section 15(i)(i), the formula for determining the Conversion Rate and the number of shares of Common Stock to be delivered on any conversion date on an early conversion as set forth in Section 15(f), (g) or (h) shall be subject to the following adjustments:

(1) *Stock Dividends.* In case the Corporation shall pay or make a dividend or other distribution on the Common Stock or Class B Common Stock in Common Stock or Class B Common Stock, the Conversion Rate, as in effect at the opening of business on the day following the date fixed for the determination of shareholders entitled to receive such dividend or other distribution, shall be increased by dividing such Conversion Rate by a fraction of which the numerator shall be the number of shares of Common Stock and Class B Common Stock outstanding at the close of business on the date fixed for such determination and the denominator shall be the sum of such number of shares and the total number of shares constituting such dividend or other distribution, such increase to become effective immediately after the opening of business on the day following the date fixed for such determination.

(2) *Stock Purchase Rights.* In case the Corporation shall issue to all holders of its Common Stock and/or Class B Common Stock (such issuance not being available on an equivalent basis to Holders of the shares of Series C Mandatory Convertible Preferred Stock upon conversion) (1) rights, options or warrants entitling them to subscribe for or purchase shares of Common Stock or Class B Common Stock, or (2) securities convertible or exchangeable into shares of Common Stock or Class B Common Stock or rights, options or warrants to purchase or acquire securities convertible or exchangeable into shares of Common Stock or Class B Common Stock, in each case at a price per share of Common Stock or Class B Common Stock, as applicable, less than the Current Market Price on the date fixed for the determination of shareholders entitled to receive such rights, options, warrants or securities (other than pursuant to a dividend reinvestment, share purchase or similar plan), the Conversion Rate in effect at the opening of business on the day following the date fixed for such determination shall be increased by dividing such Conversion Rate by a fraction, the numerator of which shall be the number of shares of Common Stock and Class B Common Stock outstanding at the close of business on the date fixed for such determination plus the number of shares of Common Stock and Class B Common Stock, as applicable, which the aggregate consideration expected to be received by the Corporation upon the exercise, conversion or exchange of such rights, options, warrants or securities (as determined in good faith by the Board of Directors, whose determination shall be conclusive and described in a Board Resolution) would purchase at such Current Market Price and the denominator of which shall be the number of shares of Common Stock and Class B Common Stock outstanding at the close of business on the date fixed for such determination plus the number of shares of Common Stock or Class B Common Stock, as applicable, so offered for subscription or purchase, either directly or indirectly, or into which such securities are convertible or exchangeable, such increase to become effective immediately after the opening of business on the day following the date fixed for such determination.

(3) *Stock Subdivisions, Splits, Reclassifications and Combinations.* In case outstanding shares of Common Stock and/or Class B Common Stock shall be subdivided, split or reclassified into a

greater number of shares of Common Stock or Class B Common Stock, respectively, the Conversion Rate in effect at the opening of business on the day following the day upon which such subdivision, split or reclassification becomes effective shall be proportionately increased, and, conversely, in case outstanding shares of Common Stock and/or Class B Common Stock shall each be combined or reclassified into a smaller number of shares of Common Stock or Class B Common Stock, respectively, the Conversion Rate in effect at the opening of business on the day following the day upon which such combination or reclassification becomes effective shall be proportionately reduced, such increase or reduction, as the case may be, to become effective immediately after the opening of business on the day following the day upon which such subdivision, split, reclassification or combination becomes effective.

(4) Debt, Asset or Security Distributions.

(A) In case the Corporation shall, by dividend or otherwise, distribute to all holders of its Common Stock and/or Class B Common Stock evidences of its indebtedness, assets or securities (but excluding (w) any rights, options, warrants or securities referred to in Section 15(i)(ii)(2), (x) any dividend or distribution paid exclusively in cash, (y) any dividend, shares of capital stock of any class or series, or similar equity interests, of or relating to a subsidiary or other business unit in the case of a Spin-Off referred to in Section 15(i)(ii)(4)(B), or (z) any dividend or distribution referred to in Section 15(i)(ii)(1)), the Conversion Rate shall be increased by dividing the Conversion Rate in effect immediately prior to the close of business on the date fixed for the determination of shareholders entitled to receive such distribution by a fraction, the numerator of which shall be the Current Market Price on the date fixed for such determination less the then fair market value (as determined in good faith by the Board of Directors, whose determination shall be conclusive and described in a Board Resolution) of the portion of the assets or evidences of indebtedness so distributed applicable to one share of Common Stock or Class B Common Stock, as the case may be, and the denominator of which shall be such Current Market Price, such adjustment to become effective immediately prior to the opening of business on the day following the date fixed for the determination of shareholders entitled to receive such distribution. In any case in which this Section 15(i)(ii)(4)(A) is applicable, Section 15(i)(ii)(4)(B) shall not be applicable.

(B) In the case of a Spin-Off, the Conversion Rate in effect immediately before the close of business on the record date fixed for determination of shareholders entitled to receive that distribution will be increased by multiplying the Conversion Rate by a fraction, the numerator of which is the Current Market Price plus the Fair Market Value (as defined below) of the portion of those shares of Capital Stock or similar equity interests so distributed applicable to one share of Common Stock or Class B Common Stock, as the case may be, and the denominator of which is the Current Market Price. Any adjustment to the Conversion Rate under this Section 15(i)(ii)(4)(B) will occur at the earlier of (A) the tenth Trading Day from, and including, the effective date of the Spin-Off and (B) the date of the securities being offered in the Initial Public Offering of the Spin-Off, if that Initial Public Offering is effected simultaneously with the Spin-Off.

(5) *Cash Distributions.* In case the Corporation shall (A) by dividend or otherwise, distribute to all holders of its Common Stock and/or Class B Common Stock, cash (excluding (x) any cash that is distributed in a Reorganization Event to which Section 15(i)(iii) applies or as part of a distribution referred to in Section 15(i)(ii)(4)) in an aggregate amount that, combined together with (B) the aggregate amount of any other distributions to all holders of Common Stock and/or Class B Common Stock made exclusively in cash within the 12 months preceding the date of payment of such distribution and in respect of which no adjustment pursuant to this Section 15(i)(ii)(5) or (6) has been made and (C) the aggregate of any cash plus the fair market value, as of the date of the expiration of the tender or exchange offer referred to below (as determined in good faith by the Board of Directors, whose determination shall be conclusive and described in a

Board Resolution), of the consideration payable in respect of any tender or exchange offer by the Corporation or any of its subsidiaries for all or any portion of the Common Stock and/or Class B Common Stock concluded within the 12 months preceding the date of payment of the distribution described in clause (A) of this Section 15(i)(ii)(5) and in respect of which no adjustment pursuant to this Section 15(i)(ii)(5) or (6) has been made, exceeds 10% of the product of the Current Market Price on the date for the determination of shareholders entitled to receive such distribution times the number of shares of Common Stock and Class B Common Stock outstanding on such date, then, and in each such case, immediately after the close of business on such date for determination, the Conversion Rate shall be increased by dividing the Conversion Rate in effect immediately prior to the close of business on the date fixed for determination of the shareholders entitled to receive such distribution by a fraction (A) the numerator of which shall be equal to the Current Market Price on the date fixed for such determination less an amount equal to the quotient of (x) the combined amount distributed or payable in the transactions described in clauses (A), (B) and (C) of this Section 15(i)(ii)(5) and (y) the number of shares of Common Stock and Class B Common Stock outstanding on the date fixed for such determination and (B) the denominator of which shall be equal to the Current Market Price on the date fixed for such determination.

(6) *Tender Offers.* In case (A) a tender or exchange offer made by the Corporation or any subsidiary of the Corporation for all or any portion of the Common Stock and/or Class B Common Stock shall expire and such tender or exchange offer (as amended through the expiration thereof) shall require the payment to shareholders (based on the acceptance (up to any maximum specified in the terms of the tender or exchange offer) of Purchased Shares (as defined below)) of an aggregate consideration having a fair market value (as determined in good faith by the Board of Directors, whose determination shall be conclusive and described in a Board Resolution) that combined together with (B) the aggregate of the cash plus the fair market value (as determined in good faith by the Board of Directors, whose determination shall be conclusive and described in a Board Resolution), as of the expiration of such tender or exchange offer, of consideration payable in respect of any other tender or exchange offer by the Corporation or any subsidiary of the Corporation for all or any portion of the Common Stock and/or Class B Common Stock expiring within the 12 months preceding the expiration of such tender or exchange offer and in respect of which no adjustment pursuant to Section 15(i)(ii)(5) or (6) has been made and (C) the aggregate amount of any distributions to all holders of shares of Common Stock and/or Class B Common Stock made exclusively in cash within the 12 months preceding the expiration of such tender or exchange offer and in respect of which no adjustment pursuant to Section 15(i)(ii)(5) or (6) has been made, exceeds 10% of the product of the Current Market Price as of the last time (the “*Expiration Time*”) tenders could have been made pursuant to such tender or exchange offer (as amended through the expiration thereof) times the number of shares of Common Stock and Class B Common Stock outstanding (including any tendered shares) at the Expiration Time, then, and in each such case, immediately prior to the opening of business on the day after the date of the Expiration Time, the Conversion Rate shall be increased by dividing the Conversion Rate immediately prior to the close of business on the date of the Expiration Time by a fraction (A) the numerator of which shall be equal to (x) the product of (I) the Current Market Price on the date of the Expiration Time and (II) the number of shares of Common Stock and Class B Common Stock outstanding (including any tendered shares) on the date of the Expiration Time less (y) the amount of cash plus the fair market value (determined as aforesaid) of the aggregate consideration payable to shareholders based on the transactions described in clauses (A), (B) and (C) of this Section 15(i)(ii)(6) (assuming in the case of clause (A) the acceptance, up to any maximum specified in the terms of the tender or exchange offer, of Purchased Shares), and (B) the denominator of which shall be equal to the product of (x) the Current Market Price on the date of the Expiration Time and (y) the number of shares of Common Stock and Class B Common Stock outstanding (including any tendered shares) on the date of the Expiration Time less the number of all shares validly tendered, not withdrawn and accepted for payment on the date of the Expiration Time

(such validly tendered shares, up to any such maximum, being referred to as the “*Purchased Shares*”).

(7) *Calculation of Adjustments.* All adjustments to the Conversion Rate shall be calculated to the nearest 1/10,000th of a share of Common Stock (or if there is not a nearest 1/10,000th of a share to the next lower 1/10,000th of a share). No adjustment in the Conversion Rate shall be required unless such adjustment would require an increase or decrease of at least one percent therein; *provided*, that any adjustments which by reason of this subparagraph are not required to be made shall be carried forward and taken into account in any subsequent adjustment. If an adjustment is made to the Conversion Rate pursuant to Section 15(i)(ii)(1), (2), (3), (4), (5), (6) or (7), an adjustment shall also be made to the 20-Day Average Market Price solely to determine which of clauses (1), (2) or (3) of the definition of Conversion Rate will apply on the Automatic Conversion Date. Such adjustment shall be made by multiplying the 20-Day Average Market Price by a fraction, the numerator of which shall be the Conversion Rate immediately before such adjustment and the denominator of which shall be the Conversion Rate immediately after such adjustment pursuant to Section 15(i)(ii)(1), (2), (3), (4), (5), (6) or (7); *provided*, however, that if such adjustment to the Conversion Rate is required to be made pursuant to the occurrence of any of the events contemplated Section 15(i)(ii)(1), (2), (3), (4), (5), (6) or (7) during the period taken into consideration for determining the 20-Day Average Market Price, appropriate and customary adjustments shall be made to the Conversion Rate.

(8) *Increase of Conversion Rate.* The Corporation may make such increases in the Conversion Rate, in addition to those required by this Section 15(i)(ii), as it considers to be advisable in order to avoid or diminish any income tax to any holders of shares of Common Stock resulting from any dividend or distribution of stock or issuance of rights or warrants to purchase or subscribe for stock or from any event treated as such for income tax purposes or for any other reasons.

(9) *Notice of Adjustment.* Whenever the Conversion Rate is adjusted in accordance with this Section 15(i)(ii), the Corporation shall: (A) forthwith compute the Conversion Rate in accordance with this Section 15(i)(ii) and prepare and transmit to the Transfer Agent an Officer’s Certificate setting forth the Conversion Rate, the method of calculation thereof in reasonable detail, and the facts requiring such adjustment and upon which such adjustment is based; and (B) as soon as practicable following the occurrence of an event that requires an adjustment to the Conversion Rate pursuant to this Section 15(i)(ii) (or if the Corporation is not aware of such occurrence, as soon as practicable after becoming so aware), provide a written notice to the Holders of the occurrence of such event and a statement setting forth in reasonable detail the method by which the adjustment to the Conversion Rate was determined and setting forth the adjusted Conversion Rate.

(iii) In the event of:

- (1) any consolidation or merger of the Corporation with or into another Person or of another Person with or into the Corporation; or
- (2) any sale, transfer, lease or conveyance to another Person of the property of the Corporation as an entirety or substantially as an entirety; or
- (3) any reclassification (other than a reclassification to which Section 15(i)(ii)(3) applies),

(any such event, a “*Reorganization Event*”), each share of Series C Mandatory Convertible Preferred Stock prior to such Reorganization Event shall, after such Reorganization Event, be converted into the right to receive the kind and amount of securities, cash and other property receivable in such Reorganization Event (without any interest thereon, and without any right to dividends or distributions thereon which have a record date that is prior to the date of the Reorganization Event) per share of Series C Mandatory Convertible Preferred Stock by a holder of Common Stock that (A) is not a Person

with which the Corporation consolidated or into which the Corporation merged or which merged into the Corporation or to which such sale or transfer was made, as the case may be (any such Person, a “*Constituent Person*”), or an Affiliate (as defined below) of a Constituent Person to the extent such Reorganization Event provides for different treatment of Common Stock held by Affiliates of the Corporation and non-Affiliates, and (B) has failed to exercise the rights of election, if any, as to the kind or amount of securities, cash and other property receivable upon such Reorganization Event (provided that if the kind or amount of securities, cash and other property receivable upon such Reorganization Event is not the same for each share of Common Stock held immediately prior to such Reorganization Event by other than a Constituent Person or an Affiliate thereof and in respect of which such rights of election shall not have been exercised (“*Non-electing Share*”), then for the purpose of this Section 15(i)(iii) the kind and amount of securities, cash and other property receivable upon such Reorganization Event by each Non-electing Share shall be deemed to be the kind and amount so receivable per share by a plurality of the Non-electing Shares). On the Automatic Conversion Date, the Conversion Rate then in effect shall be applied to the value or amount on the Automatic Conversion Date of such securities, cash or other property.

On the occurrence of such a Reorganization Event, the Person formed by such consolidation or merger or the Person which acquires the assets of the Corporation shall execute and deliver to the Transfer Agent an agreement supplemental hereto providing that the Holder of each share of Series C Mandatory Convertible Preferred Stock that remains outstanding after the Reorganization Event (if any) shall have the rights provided by this Section 15(i)(iii). Such supplemental agreement shall provide for adjustments which, for events subsequent to the effective date of such supplemental agreement, shall be as nearly equivalent as may be practicable to the adjustments provided for in this Section 15(i). The above provisions of this Section 15(i)(iii) shall similarly apply to successive Reorganization Events.

(j) *Definitions.*

(i) “*5-Day Average Market Price*” as of any date means the arithmetic average of the volume-weighted average price per share of the Common Stock for each of the five Trading Days ending on the earlier of the day preceding the date in question and the day before the “ex date” with respect to the issuance or distribution requiring such computation, as reported by Bloomberg Professional Service accessed using the reference “XRQ Equity VAP” for the period beginning at 9:30 am, New York City time, and ending at 4:00 pm, New York City time. If such day is not a Trading Day, the five Trading Days will end on the last Trading Day prior to such day. For purposes of this paragraph, the term “Ex Date,” when used with respect to any such issuance or distribution, means the first date on which the Common Stock trades without the right to receive such issuance or distribution. If, on any trading day no volume-weighted average price is reported for the Common Stock by Bloomberg Professional Service, the Closing Price of a share of the Common Stock will be substituted for the volume-weighted average price for such day.

(ii) “*20-Day Average Market Price*” as of any conversion date means the arithmetic average of the volume-weighted average price per share of the Common Stock for each of the 20 Trading Days ending on the third business day prior to the applicable conversion date, as reported by Bloomberg Professional Service accessed using the reference “XRQ Equity VAP” for the period beginning at 9:30 am, New York City time, and ending at 4:00 pm, New York City time. If the third business day prior to such conversion date is not a Trading Day, the 20 Trading Days will end on the last trading day prior to the third business day prior to such conversion date. For purposes of this definition, the term “ex date,” when used with respect to any such issuance or distribution, means the first date on which the Common Stock trades without the right to receive such issuance or distribution. If, on any Trading Day no volume-weighted average price is reported for the Common Stock by Bloomberg Professional Service, the Closing Price of a share of the Common Stock will be substituted for the volume-weighted average price for such day.

(iii) “*Affiliate*” has the same meaning as given to that term in Rule 405 of the Securities Act or any successor rule thereunder.

(iv) “*Board Resolution*” means a copy of a resolution certified by the Secretary or any Assistant Secretary of the Corporation to have been duly adopted by the Board of Directors or any authorized committee thereof and to be in full force and effect and filed with the Transfer Agent.

(v) “*Business Day*” means any day other than a Saturday or Sunday or any other day on which banks in The City of New York are authorized or required by law or executive order to close.

(vi) “*Capital Stock*” of any Person means any and all shares, interests, participations or other equivalents however designated of corporate stock or other equity participations, including partnership interests, whether general or limited, of such Person and any rights (other than debt securities convertible or exchangeable into an equity interest), warrants or options to acquire an equity interest in such Person.

(vii) The “*Closing Price*” of the Common Stock or any securities distributed in a Spin-Off, as the case may be, on any date of determination means the closing sale price (or, if no closing sale price is reported, the last reported sale price) per share on the New York Stock Exchange (the “*NYSE*”) on such date or, if such security is not listed for trading on NYSE on any such date, as reported in the composite transactions for the principal United States securities exchange on which such security is so listed or quoted or, if such security is not so listed or quoted on a United States national or regional securities exchange, as reported by the Nasdaq stock market or, if such security is not so reported, the last quoted bid price for such security in the over-the-counter market as reported by the National Quotation Bureau or similar organization or, if such bid price is not available, the market value of such security on such date as determined by a nationally recognized independent investment banking firm retained for this purpose by the Corporation.

(viii) “*Corporate Trust Office*” means the principal corporate trust office of the Transfer Agent at which, at any particular time, its corporate trust business shall be administered.

(ix) “*Current Market Price*” means (1) on any day the average of the Closing Prices of the Common Stock for the five consecutive Trading Days preceding the earlier of the day preceding the day in question and the day before the “*ex date*” with respect to the issuance or distribution requiring computation, (2) in the case of any Spin-Off that is effected simultaneously with an Initial Public Offering of the securities being distributed in the Spin-Off, the Closing Price of the Common Stock on the Trading Day on which the initial public offering price of the securities being distributed in the Spin-Off is determined, and (3) in the case of any other Spin-Off, the average of the Closing Prices of the Common Stock over the first 10 Trading Days after the effective date of such Spin-Off. For purposes of this paragraph, the term “*ex date*,” when used with respect to any issuance or distribution, shall mean the first date on which the Common Stock trades in a regular way on such exchange or in such market without the right to receive such issuance or distribution.

(x) “*Fair Market Value*” means (1) in the case of any Spin-Off that is effected simultaneously with an Initial Public Offering of the securities being distributed in the Spin-Off, the initial public offering price of those securities, and (2) in the case of any other Spin-Off, the average of the Closing Prices of the securities being distributed in the Spin-Off over the first 10 Trading Days after the effective date of such Spin-Off.

(xi) “*Holder*” means the Person in whose name a share of Series C Mandatory Convertible Preferred Stock is registered.

(xii) “*Initial Public Offering*” means the first time securities of the same class or type as the securities being distributed in the Spin-Off are offered to the public for cash.

(xiii) “*Officer*” means the Chairman of the Board, the Chief Executive Officer, the Chief Financial Officer, the President, any Vice President, the Treasurer or the Secretary of the Corporation.

(xiv) “*Officer’s Certificate*” means a certificate signed by two Officers.

(xv) “*Person*” means any individual, corporation, limited liability corporation, partnership, joint venture, trust, unincorporated organization or government or any agency or political subdivision thereof.

(xvi) “*Provisional Conversion Date*” means the date fixed for conversion of shares of Series C Mandatory Convertible Preferred Stock into shares of Common Stock pursuant to Section 15(f) above or, if the Corporation shall default in the cash payment of (1) an amount equal to any accrued and unpaid dividends on the shares of Series C Mandatory Convertible Preferred Stock then outstanding, whether or not declared, and (2) the present value of all remaining dividend payments on the shares of Series C Mandatory Convertible Preferred Stock then outstanding, through and including July 1, 2006, in connection with such conversion on such date, the date the Corporation actually makes such payment.

(xvii) “*Spin-Off*” means a dividend or other distribution of shares of capital stock of any class or series, or similar equity interests, of or relating to a subsidiary or other business unit of the Corporation.

(xviii) “*Subsidiary*” means, with respect to any Person, (1) any corporation, association or other business entity of which more than 50% of the total voting power of shares of Capital Stock entitled (without regard to the occurrence of any contingency) to vote in the election of directors, managers or trustees thereof is at the time owned or controlled, directly or indirectly, by such Person or one or more of the other Subsidiaries of such Person (or a combination thereof) and (2) any partnership (A) the sole general partner or the managing general partner of which is such Person or a Subsidiary of such Person or (B) the only general partners of which are such Person or one or more Subsidiaries of such Person (or any combination thereof).

(xix) “*Trading Day*” means a day on which the Common Stock or any security distributed in a Spin-Off, as the case may be, (1) is not suspended from trading on any national or regional securities exchange or association or over-the-counter market at the close of business and (2) has traded at least once on the national or regional securities exchange or association or over-the-counter market that is the primary market for the trading of such security.

(xx) “*Treasury Yield*” means the yield to maturity at the time of computation of U.S. Treasury securities with a constant maturity (as compiled and published in the most recent Federal Reserve Statistical Release H.15 (519) which has become publicly available at least two Business Days prior to the Provisional Conversion Date (or, if such Statistical Release is no longer published, any publicly available source for similar market data)) most nearly equal to the then remaining term to July 1, 2006; *provided, however*, that if the then remaining term to July 1, 2006 is not equal to the constant maturity of a U.S. Treasury security for which a weekly average yield is given, the Treasury Yield shall be obtained by linear interpolation (calculated to the nearest one-twelfth of a year) from the weekly average yields of U.S. Treasury securities for which such yields are given, except that if the then remaining term to July 1, 2006 is less than one year, the weekly average yield on actually traded U.S. Treasury securities adjusted to a constant maturity of one year shall be used.

(xxi) “*Transfer Agent*” means the Equiserve Trust Company, N.A. unless and until a successor is selected by the Corporation, and then such successor.

(k) *Fractional Shares.*

No fractional shares of Common Stock shall be issued to Holders. In lieu of any fraction of a share of Common Stock which would otherwise be issuable in respect of the aggregate number of shares of the Series C Mandatory Convertible Preferred Stock surrendered by the same Holder upon a conversion as described in Section 15(e), (f)(i), (g)(ii) or (h)(i) or which would otherwise be issuable in respect of a stock dividend payment upon a conversion as described in Section 18(e), such Holder shall have the right to receive an amount in cash (computed to the nearest cent) equal to the same fraction of (i) in the case of Section 15(e), the 5-Day Average Market Price or (b) in the case of Section 6(a), 7(b) or 8(c), the Closing

Price of the Common Stock determined as of the second Trading Day immediately preceding the effective date of conversion. If more than one share of Series C Mandatory Convertible Preferred Stock shall be surrendered for conversion at one time by or for the same Holder, the number of full shares of Common Stock issuable upon conversion thereof shall be computed on the basis of the aggregate number of shares of the Series C Mandatory Convertible Preferred Stock so surrendered.

(l) *Miscellaneous.*

(i) Procedures for conversion of shares of Series C Mandatory Convertible Preferred Stock, in accordance with Section 15(e), (f), (g) or (h), not held in certificated form will be governed by arrangements among the depository of the shares of Series C Mandatory Convertible Preferred Stock, its participants and persons that may hold beneficial interests through such participants designed to permit settlement without the physical movement of certificates. Payments, transfers, deliveries, exchanges and other matters relating to beneficial interests in global security certificates may be subject to various policies and procedures adopted by the depository from time to time.

(ii) The Liquidation Preference and the annual dividend rate set forth in this Section 15 each shall be subject to equitable adjustment whenever there shall occur a stock split, combination, reclassification or other similar event involving the Series C Mandatory Convertible Preferred Stock. Such adjustments shall be determined in good faith by the Board of Directors and submitted by the Board of Directors to the Transfer Agent.

(iii) For the purposes of Section 15(i), the number of shares of Common Stock at any time outstanding shall not include shares held in the treasury of the Corporation but shall include shares issuable in respect of scrip certificates issued in lieu of fractions of shares of Common Stock.

(iv) If the Corporation shall take any action affecting the Common Stock, other than any action described in Section 15(i), that in the opinion of the Board of Directors would materially adversely affect the conversion rights of the Holders, then the Conversion Rate, the Provisional Conversion Rate and/or the Optional Conversion Rate for the Series C Mandatory Convertible Preferred Stock may be adjusted, to the extent permitted by law, in such manner, and at such time, as the Board of Directors may determine to be equitable in the circumstances.

(v) The Corporation covenants that it will at all times reserve and keep available, free from preemptive rights, out of the aggregate of its authorized but unissued shares of Common Stock for the purpose of effecting conversion of the Series C Mandatory Convertible Preferred Stock, the full number of shares of Common Stock deliverable upon the conversion of all outstanding shares of Series C Mandatory Convertible Preferred Stock not theretofore converted. For purposes of this Section 15(l)(v), the number of shares of Common Stock that shall be deliverable upon the conversion of all outstanding shares of Series C Mandatory Convertible Preferred Stock shall be computed as if at the time of computation all such outstanding shares were held by a single Holder.

(vi) The Corporation covenants that any shares of Common Stock issued upon conversion of the Series C Mandatory Convertible Preferred Stock or issued in respect of a stock dividend payment upon a conversion described in Section 15(e) shall be validly issued, fully paid and non-assessable.

(vii) The Corporation shall use its best efforts to list the shares of Common Stock required to be delivered upon conversion of the Series C Mandatory Convertible Preferred Stock or upon issuance in respect of a stock dividend payment upon a conversion described in Section 18(e), prior to such delivery, upon each national securities exchange or quotation system, if any, upon which the outstanding Common Stock is listed at the time of such delivery.

(viii) Prior to the delivery of any securities that the Corporation shall be obligated to deliver upon conversion of the Series C Mandatory Convertible Preferred Stock or upon issuance in respect of a stock dividend payment upon a conversion described in Section 15(e), the Corporation shall use its best efforts to comply with all federal and state laws and regulations thereunder requiring the registration of

such securities with, or any approval of or consent to the delivery thereof by, any governmental authority.

(ix) The Corporation shall pay any and all documentary, stamp or similar issue or transfer taxes payable in respect of the issue or delivery of shares of Common Stock or other securities or property upon conversion of the Series C Mandatory Convertible Preferred Stock pursuant thereto or upon issuance in respect of a stock dividend payment upon a conversion described in Section 15(e); *provided, however*, that the Corporation shall not be required to pay any tax that may be payable in respect of any transfer involved in the issue or delivery of shares of Common Stock or other securities or property in a name other than that of the Holder of the Series C Mandatory Convertible Preferred Stock to be converted and no such issue or delivery shall be made unless and until the person requesting such issue or delivery has paid to the Corporation the amount of any such tax or established, to the reasonable satisfaction of the Corporation, that such tax has been paid or is not applicable.

(x) The Series C Senior Mandatory Convertible Preferred Stock is not redeemable.

(xi) The Series C Senior Mandatory Convertible Preferred Stock is not entitled to any preemptive or subscription rights in respect of any securities of the Corporation.

(xii) Whenever possible, each provision hereof shall be interpreted in a manner as to be effective and valid under applicable law, but if any provision hereof is held to be prohibited by or invalid under applicable law, such provision shall be ineffective only to the extent of such prohibition or invalidity, without invalidating or otherwise adversely affecting the remaining provisions hereof. If a court of competent jurisdiction should determine that a provision hereof would be valid or enforceable if a period of time were extended or shortened or a particular percentage were increased or decreased, then such court may make such change as shall be necessary to render the provision in question effective and valid under applicable law.

(xiii) Series C Mandatory Convertible Preferred Stock may be issued in fractions of a share which shall entitle the Holder, in proportion to such Holder's fractional shares, to exercise voting rights, receive dividends, participate in distributions and have the benefit of all other rights of Holders of Series C Mandatory Convertible Preferred Stock.

(xiv) Subject to applicable escheat laws, any monies set aside by the Corporation in respect of any payment with respect to shares of the Series C Mandatory Convertible Preferred Stock, or dividends thereon, and unclaimed at the end of two years from the date upon which such payment is due and payable shall revert to the general funds of the Corporation, after which reversion the Holders of such shares shall look only to the general funds of the Corporation for the payment thereof. Any interest accrued on funds so deposited shall be paid to the Corporation from time to time.

(xv) Except as may otherwise be required by law, the shares of Series C Mandatory Convertible Preferred Stock shall not have any voting powers, preferences and relative, participating, optional or other special rights, other than those specifically set forth in this Certificate of Incorporation.

(xvi) The headings of the various subdivisions hereof are for convenience of reference only and shall not affect the interpretation of any of the provisions hereof.

(xvii) If any of the voting powers, preferences and relative, participating, optional and other special rights of the Series C Mandatory Convertible Preferred Stock and qualifications, limitations and restrictions thereof set forth herein is invalid, unlawful or incapable of being enforced by reason of any rule of law or public policy, all other voting powers, preferences and relative, participating, optional and other special rights of the Series C Mandatory Convertible Preferred Stock and qualifications, limitations and restrictions thereof set forth herein which can be given effect without the invalid, unlawful or unenforceable voting powers, preferences and relative, participating, optional and other special rights of the Series C Mandatory Convertible Preferred Stock and qualifications, limitations and restrictions thereof shall, nevertheless, remain in full force and effect, and no voting powers,

preferences and relative, participating, optional or other special rights of the Series C Mandatory Convertible Preferred Stock and qualifications, limitations and restrictions thereof herein set forth shall be deemed dependent upon any other such voting powers, preferences and relative, participating, optional or other special rights of the Series C Mandatory Convertible Preferred Stock and qualifications, limitations and restrictions thereof unless so expressed herein.

(xviii) Shares of Series C Mandatory Convertible Preferred Stock that (a) have not been issued on or before August 1, 2003 or (b) have been issued and reacquired in any manner, including shares purchased or redeemed or exchanged or converted, shall (upon compliance with any applicable provisions of the laws of New York) have the status of authorized but unissued shares of Cumulative Preferred Stock of the Corporation undesignated as to series and may be designated or redesignated and issued or reissued, as the case may be, as part of any series of preferred stock of the Corporation; *provided, however*, that any issuance of such shares as Series C Mandatory Convertible Preferred Stock must be in compliance with the terms hereof.

(xix) If any of the Series C Mandatory Convertible Preferred Stock certificates shall be mutilated, lost, stolen or destroyed, the Corporation shall issue, in exchange and in substitution for and upon cancellation of the mutilated Series C Mandatory Convertible Preferred Stock certificate, or in lieu of and substitution for the Series C Mandatory Convertible Preferred Stock certificate lost, stolen or destroyed, a new Series C Mandatory Convertible Preferred Stock certificate of like tenor and representing an equivalent number of shares of Series C Mandatory Convertible Preferred Stock, but only upon receipt of evidence of such loss, theft or destruction of such Series C Mandatory Convertible Preferred Stock certificate and indemnity, if requested, satisfactory to the Corporation and the Transfer Agent. The Corporation is not required to issue any certificates representing Series C Mandatory Convertible Preferred Stock on or after the Automatic Conversion Date. In place of the delivery of a replacement certificate following the Automatic Conversion Date, the Transfer Agent, upon delivery of the evidence and indemnity described above, will deliver the shares of Common Stock pursuant to the terms of the Series C Mandatory Convertible Preferred Stock evidenced by the certificate.

FIFTH: The Secretary of State of the State of New York is hereby designated as the agent of the Corporation upon whom process in any action or proceeding against it may be served. The post office address to which the Secretary of State shall mail a copy of any process against it served on him is:

XEROX CORPORATION
800 Long Ridge Road
P.O. Box 1600
Stamford, CT 06904-1600
Attention: General Counsel

SIXTH: Its duration is to be perpetual.

SEVENTH: The number of directors shall be not less than five (5) nor more than twenty-one (21) as determined in the manner prescribed by the By-Laws.

EIGHTH: The Corporation may purchase, acquire, hold and dispose of the stocks, bonds and other evidences of indebtedness of any corporation, domestic or foreign, and may issue in exchange therefor, its stock, bonds or other obligations.

NINTH: A person who is or was a director of the Corporation shall not be personally liable to the Corporation or its shareholders for damages for any breach of duty in such capacity, except to the extent that the Business Corporation Law of the State of New York as in effect from time to time expressly provides that the foregoing provisions shall not eliminate or limit such personal liability. Nothing in this Article shall directly or indirectly increase the liability of any such person based upon acts or omissions occurring before the adoption hereof. No amendment, modification or repeal of this Article shall adversely affect any right or protection of any director that exists at the time of such change.

IN WITNESS WHEREOF, this Certificate has been signed on the 6th day of November, 2003 and the statements contained therein are affirmed as true under penalties of perjury.

/s/ ANNE M. MULCAHY

Anne M. Mulcahy
Chairman of the Board

/s/ LESLIE F. VARON

Leslie F. Varon
Secretary

XEROX CORPORATION

and

THE FIRST NATIONAL BANK OF BOSTON,

Rights Agent

Rights Agreement

Dated as of April 7, 1997

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RIGHTS AGREEMENT

RIGHTS AGREEMENT, dated as of April 7, 1997 (the "Agreement"), between XEROX CORPORATION, a New York corporation (the "Company"), and THE FIRST NATIONAL BANK OF BOSTON (the "Rights Agent").

WITNESSETH

WHEREAS, on April 6, 1987 (the "1987 Rights Dividend Declaration Date"), the Board of Directors of the Company authorized the Rights Agreement, dated as of April 6, 1987, which was amended and restated as of February 6, 1989, between the Company and Chase Lincoln First Bank, N.A. as Rights Agent (the "1987 Agreement"), declared a dividend distribution of one Right (a "1987 Right") for each share of common stock, par value \$1.00 per share, of the Company (the "Common Stock"), and Class B Stock, par value \$1.00 per share, of the Company (the "Class B Stock"), outstanding at the close of business on April 16, 1987 (the "1987 Record Date"), and authorized the issuance of one 1987 Right for each share of Common Stock and Class B Stock issued (whether as an original issuance or from the Company's treasury) between the 1987 Record Date and the Distribution Date (as such term is defined in the 1987 Agreement), each 1987 Right representing the right to purchase one one-hundredth of a share of Series A Cumulative Preferred Stock, par value \$1.00 per share (the "Preferred Stock"), of the Company having the rights, powers and preferences set forth in the Restated Certificate of Incorporation of the Company, upon the terms, and subject to the conditions set forth in the 1987 Agreement;

WHEREAS, on April 7, 1997, the Board of Directors of the Company determined it desirable and in the best interests of the Company and its shareholders for the Company to extend the benefits afforded by the 1987 Agreement and to implement such extension by executing this Agreement;

WHEREAS, on April 7, 1997 (the "Rights Dividend Declaration Date"), the Board of Directors of the Company authorized and declared a dividend distribution of one Right (as hereinafter defined) for each share of Common Stock outstanding upon the close of business on April 16, 1997 (the "Record Date"), and has authorized the issuance of one Right (as such number may hereinafter be adjusted pursuant to the provisions of Section 11(p) hereof) for each share of Common Stock issued (whether as an original issuance or from the Company's treasury) between the Record Date and the Distribution Date (as hereinafter defined) and in certain other circumstances provided herein, each Right initially representing the right to purchase one three-hundredth of a share of Preferred Stock of the Company upon the terms and subject to the conditions hereinafter set forth (the "Rights");

NOW, THEREFORE, in consideration of the premises and the mutual agreements herein set forth, the parties hereby agree as follows:

Section 1. Certain Definitions.

For purposes of this Agreement, the following terms have the meanings indicated:

(a) "Acquiring Person" shall mean any Person who constitutes an "Interested Shareholder" as defined in Section 912 of the New York Business Corporation Law, in effect from time to time (the "NYBCL"), but shall not include (i) the Company, (ii) any Subsidiary of the Company, (iii) any employee benefit plan of the Company or of any Subsidiary of the Company, (iv) any Person or entity organized, appointed or established by the Company for or pursuant to the terms of any such plan, (v) any Person who becomes an "Interested Shareholder" as a result of a reduction in the number of shares of Common Stock outstanding due to the repurchase of shares of Common Stock from time to time by the Company unless and until such Person, after becoming aware that such Person has become an "Interested Shareholder" acquires beneficial

ownership of additional shares of Common Stock representing one percent (1%) or more of the shares of Common Stock then outstanding or (vi) any such Person who has reported or is required to report such ownership on Schedule 13G under the Securities Exchange Act of 1934, as amended from time to time (the "Exchange Act") (or any comparable or successor report) or on Schedule 13D under the Exchange Act (or any comparable or successor report) which Schedule 13D does not state any intention to or reserve the right to control or influence the management or policies of the Company or engage in any of the actions specified in Item 4 (or any comparable or successor Item) of such Schedule (other than the disposition of the Common Stock) and, within ten (10) business days of being requested by the Company to advise it regarding the same, certifies to the Company that such Person acquired shares of Common Stock causing such Person to become an "Interested Shareholder" inadvertently or without knowledge of the terms of the Rights and who, together with all Affiliates and Associates, thereafter does not acquire additional shares of Common Stock while such Person is an "Interested Shareholder"; provided, however, that if the Person requested to so certify fails to do so within ten (10) business days, then such Person shall become an Acquiring Person immediately after such ten (10) business day period; provided, further, however, that for purposes of determining whether such Person is an "Acquiring Person," a Person engaged in business as an underwriter of securities shall not be deemed to be an Acquiring Person as a result of such Person becoming the "Beneficial Owner" of any securities acquired through such Person's participation in good faith in a firm commitment underwriting unless such Person is the "Beneficial Owner" of such securities upon the expiration of forty (40) days after the date of such acquisition.

(b) "Adjustment Shares" shall have the meaning specified in Section 11(a)(ii) hereof.

(c) "Affiliate" and "Associate" shall have the respective meanings ascribed to such terms in Section 912 of the NYBCL.

(d) A Person shall be deemed the "Beneficial Owner" of, and shall be deemed to "beneficially own," any securities if such Person constitutes, with respect to such securities, a "Beneficial Owner" as defined in Section 912 of the NYBCL; provided, however, that for purposes of this Agreement (including for purposes of determining whether a Person will be deemed an Interested Shareholder under Section 912 of the NYBCL), a Person engaged in business as an underwriter of securities shall not be deemed to be the "Beneficial Owner" of, or to "beneficially own," (A) any securities acquired through such Person's participation in good faith in a firm commitment underwriting until the expiration of forty (40) days after the date of such acquisition, (B) securities issuable upon exercise of Rights at any time prior to the occurrence of a Triggering Event or (C) securities issuable upon exercise of Rights from and after the occurrence of a Triggering Event which Rights were acquired by such Person or any of such Person's Affiliates or Associates prior to the Distribution Date or pursuant to Section 3(a) or Section 22 hereof (the "Original Rights") or pursuant to Section 11(i) hereof in connection with an adjustment made with respect to any Original Rights.

(e) "Business day" shall mean any day other than a Saturday, Sunday or a day on which banking institutions in the State of New York are authorized or obligated by law or executive order to close.

(f) "Close of business" on any given date shall mean 5:00 P.M., New York City time, on such date; provided, however, that if such date is not a business day it shall mean 5:00 P.M., New York City time, on the next succeeding business day.

(g) "Closing Price" shall mean for each day the last sale price or, in case no such sale takes place on such day, the average of the closing bid and asked prices, in either case as reported in the principal consolidated transaction reporting system with respect to securities listed or admitted to trading on the New York Stock Exchange or, if the securities in question are not listed or admitted to trading on the New York Stock Exchange, as reported in the principal consolidated transaction reporting system with respect to securities listed on the principal national securities exchange on which the securities in question are listed or admitted to trading or, if the securities in question are not listed or admitted to trading on any national securities exchange, the last quoted price or, if not so quoted, the average of the high bid and low asked prices in the over-the-counter market, as reported by the National Association of Securities Dealers, Inc.

Automated Quotation System (“NASDAQ”) or such other system then in use, or, if on any such date the securities in question are not quoted by any such organization, the average of the closing bid and asked prices as furnished by a professional market maker selected by the Board of Directors of the Company and making a market in the securities in question. If on any such date no market maker is making a market in the securities in question, the fair value of such securities on such date as determined in good faith by the Board of Directors of the Company shall be used. If the securities in question are not publicly held or not so listed or traded, “current market price” per share shall mean the fair value per share as determined in good faith by the Board of Directors of the Company, whose determination shall be described in a statement filed with the Rights Agent and shall be conclusive for all purposes.

(h) “Common Stock” shall mean the common stock, par value \$1.00 per share, of the Company, except that “Common Stock” when used with reference to any Person other than the Company shall mean the capital stock of such Person with the greatest voting power, or the equity securities or other equity interest having power to control or direct the management of such Person.

(i) “Common stock equivalents” shall have the meaning specified in Section 11(a)(iii) hereof.

(j) “Current Value” shall have the meaning set forth in Section 11(a)(iii) hereof.

(k) “Distribution Date” shall mean the earlier of (i) the close of business on the tenth business day after the Stock Acquisition Date, as hereinafter defined (or, if the tenth business day after the Stock Acquisition Date occurs before the Record Date, the close of business on the Record Date), or (ii) the close of business on the tenth business day (or such later day as may be determined by the Board of Directors) after the date of the commencement of, or the first public announcement of the intent to commence (as determined pursuant to Rule 14d-2(a) of the General Rules and Regulations under the Exchange Act in effect on the date of this Agreement), a tender or exchange offer by any Person (other than the Company, any Subsidiary of the Company, any employee benefit plan of the Company or of any Subsidiary of the Company or any Person or entity organized, appointed or established by or for the Company for or pursuant to the terms of any such plan), if upon consummation thereof, such Person would be an Acquiring Person (including any such date which is after the date of this Agreement and prior to the issuance of the Rights).

(l) “Expiration Date” shall mean the earliest of (i) the close of business on the tenth anniversary of the Record Date (the “Final Expiration Date”), (ii) the time at which the Rights are redeemed as provided in Section 23 hereof or (iii) the time at which the Rights are exchanged pursuant to Section 24 hereof.

(m) “Person” shall mean any individual, firm, corporation, partnership or other entity, and shall include any successor (by merger or otherwise) of such entity.

(n) “Preferred Stock” shall mean shares of Series A Cumulative Preferred Stock, par value \$1.00 per share, of the Company and, to the extent necessary to permit the full exercise of the then outstanding Rights, any other series of Preferred Stock of the Company designated by the Board of Directors of the Company for such purposes containing terms substantially similar to the Series A Cumulative Preferred Stock.

(o) “Principal Party” shall have the meaning specified in Section 13(b) hereof.

(p) “Purchase Price” shall have the meaning specified in Section 4(a) and Section 7(b) hereof, as modified by Section 11(a)(ii) and Section 13(a) hereof.

(q) “Redemption Price” shall have the meaning specified in Section 23(a) hereof.

(r) “Rights Certificates” shall have the meaning specified in Section 3(a) hereof.

(s) “Securities Act” shall have the meaning specified in Section 9(c) hereof.

(t) “Section 11(a)(ii) Event” shall mean any event described in Section 11(a)(ii) hereof.

(u) “Section 11(a)(ii) Trigger Date” shall have the meaning specified in Section 11(a)(iii) hereof.

(v) “Section 13 Event” shall mean any event described in clauses (x), (y) or (z) of Section 13(a) hereof.

(w) “Spread” shall have the meaning specified in Section 11(a)(iii) hereof.

(x) “Stock Acquisition Date” shall mean the first date of public announcement (which, for purposes of this definition, shall include, without limitation, a report filed or amended pursuant to Section 13(d) under the Exchange Act) by the Company or an Acquiring Person that an Acquiring Person has become such.

(y) “Subsidiary” shall mean, with reference to any Person, any corporation of which an amount of voting securities sufficient to elect at least a majority of the directors of such corporation is beneficially owned, directly or indirectly, by such Person or any corporation otherwise controlled by such Person.

(z) “Substitution Period” shall have the meaning specified in Section 11(a)(iii) hereof.

(aa) “Summary of Rights” shall have the meaning specified in Section 3(b) hereof.

(bb) “Trading Day” shall mean a day on which the principal national securities exchange on which the securities in question are listed or admitted to trading is open for the transaction of business or, if such securities are not listed or admitted to trading on any national securities exchange, a business day.

(cc) “Triggering Event” shall mean any Section 11(a)(ii) Event or any Section 13 Event.

Section 2. Appointment of Rights Agent.

The Company hereby appoints the Rights Agent to act as agent for the Company and the holders of the Rights (who, in accordance with Section 3 hereof, shall, prior to the Distribution Date, also be the holders of the Common Stock) in accordance with the terms and conditions hereof, and the Rights Agent hereby accepts such appointment. The Company may from time to time appoint such co-Rights Agents as it may deem necessary or desirable, upon ten days prior written notice to the Rights Agent. The Rights Agent shall have no duty to supervise, and shall in no event be liable for the acts or omissions of, any co-Rights Agent so appointed.

Section 3. Issuance of Rights Certificates.

(a) Until the Distribution Date, the Rights will be evidenced by the certificates for the Common Stock registered in the names of the holders of the Common Stock (which certificates for Common Stock shall be deemed also to be certificates for Rights) and not by separate certificates, and the Rights will be transferred with and only with the transfer of the underlying shares of Common Stock (including a transfer to the Company). As soon as practicable after the Distribution Date, the Rights Agent will send by first-class mail, insured, postage prepaid, to each record holder of the Common Stock as of the close of business on the Distribution Date, at the address of such holder shown on the records of the Company, one or more rights certificates, in substantially the form of Exhibit A hereto (the “Rights Certificates”), evidencing one Right for each share of Common Stock so held, subject to adjustment as provided herein. In the event that an adjustment in the number of Rights per share of Common Stock has been made pursuant to Section 11(p) hereof, at the time of distribution of the Rights Certificates, the Company shall make the necessary and appropriate rounding adjustments (in accordance with Section 14(a) hereof) so that Rights Certificates representing only whole numbers of Rights are distributed, and cash is paid in lieu of any fractional Rights. As of and after the Distribution Date, the Rights will be evidenced solely by such Rights Certificates.

(b) The Company will make available a copy of a Summary of Rights, in substantially the form attached hereto as Exhibit B (the “Summary of Rights”), to any holder of Rights who may so request from time to time. With respect to certificates for the Common Stock outstanding as of the Record Date or issued subsequent to the Record Date, until the Distribution Date, the Rights will be evidenced by such certificates for the Common Stock and the registered holders of the Common Stock shall also be the registered holders of the associated Rights. Until the earlier of the Distribution Date or the Expiration Date, the transfer of any certificates representing shares of Common Stock in respect of which Rights have been issued shall also constitute the transfer of the Rights associated with such shares of Common Stock.

(c) Subject to Section 22 hereof, Rights shall be issued in respect of all shares of Common Stock which are outstanding on the Record Date and which are issued (whether originally issued or from the Company's treasury) after the Record Date but prior to the earlier of the Distribution Date or the Expiration Date. Certificates representing such shares of Common Stock shall also be deemed to be certificates for Rights, and shall bear the following legend (or the legend required under the 1987 Agreement):

This certificate also evidences and entitles the holder hereof to certain Rights as set forth in the Rights Agreement between Xerox Corporation (the "Company") and the Rights Agent thereunder (the "Rights Agreement"), the terms of which are hereby incorporated herein by reference and a copy of which is on file at the principal offices of the Company. Under certain circumstances, as set forth in the Rights Agreement, such Rights will be evidenced by separate certificates and will no longer be evidenced by this certificate. The Company will mail to the holder of this certificate a copy of the Rights Agreement, as in effect on the date of mailing, without charge, promptly after receipt of a written request therefor. Under certain circumstances set forth in the Rights Agreement, Rights issued to, or held by, any Person who is, was or becomes an Acquiring Person or any Affiliate or Associate thereof (as such terms are defined in the Rights Agreement), whether currently held by or on behalf of such Person or by any subsequent holder of such Rights, shall become null and void.

With respect to such certificates containing the foregoing legend (or the legend required under the 1987 Agreement), until the earlier of (i) the Distribution Date or (ii) the Expiration Date, the Rights associated with the Common Stock represented by such certificates shall be evidenced by such certificates alone and the registered holders of Common Stock shall also be the registered holders of the associated Rights, and the transfer of any of such certificates shall also constitute the transfer of the Rights associated with the Common Stock represented by such certificates. At the time of the distribution of the Rights Certificates, the Board of Directors may, at its discretion, distribute Rights to the holders of any series of preferred stock which is convertible into shares of the Company's Common Stock on the basis of the number of shares of Common Stock into which such shares of preferred stock are convertible.

Section 4. Form of Rights Certificates.

(a) The Rights Certificates (and the forms of election to purchase and of assignment to be printed on the reverse thereof) shall each be substantially in the form set forth in Exhibit A hereto and may have such marks of identification or designation and such legends, summaries or endorsements printed thereon as the Company may deem appropriate and as are not inconsistent with the provisions of this Agreement, or as may be required to comply with any applicable law or with any rule or regulation made pursuant thereto or with any rule or regulation of any stock exchange on which the Rights may from time to time be listed, or to conform to usage. Subject to the provisions of Section 11 and Section 22 hereof, the Rights Certificates, whenever distributed, shall be dated as of the Record Date and on their face shall entitle the holders thereof to purchase such number of one three-hundredths of a share of Preferred Stock as shall be set forth therein at the price set forth therein (such exercise price per one three-hundredth of a share, the "Purchase Price"), but the amount and type of securities purchasable upon the exercise of each Right and the Purchase Price thereof shall be subject to adjustment as provided herein.

(b) Any Rights Certificate issued pursuant to Section 3(a), Section 11(i) or Section 22 hereof that represents Rights beneficially owned by: (i) an Acquiring Person or any Associate or Affiliate of an Acquiring Person, (ii) a transferee of an Acquiring Person (or of any such Associate or Affiliate) who becomes a transferee after the Acquiring Person becomes such, or (iii) a transferee of an Acquiring Person (or of any such Associate or Affiliate) who becomes a transferee prior to or concurrently with the Acquiring Person becoming such and receives such Rights pursuant to either (A) a transfer (whether or not for consideration) from the Acquiring Person to holders of equity interests in such Acquiring Person or to any Person with whom such Acquiring Person has any agreement, arrangement or understanding (whether or not in writing) regarding the transferred Rights or (B) a transfer which the Board of Directors has determined is part of a plan, arrangement or understanding (whether or not in writing) which has as a primary purpose or effect avoidance of Section 7(e) hereof, and any Rights Certificate issued pursuant to Section 6 or Section 11 hereof upon transfer, exchange,

replacement or adjustment of any other Rights Certificate referred to in this sentence, shall (to the extent feasible) contain the following legend:

The Rights represented by this Rights Certificate are or were beneficially owned by a Person who was or became an Acquiring Person or an Affiliate or Associate of an Acquiring Person (as such terms are defined in the Rights Agreement). Accordingly, this Rights Certificate and the Rights represented hereby shall become null and void in the circumstances specified in Section 7(e) of the Rights Agreement.

Section 5. Countersignature and Registration.

(a) The Rights Certificates shall be executed on behalf of the Company by its Chairman of the Board or any President or any Vice President, either manually or by facsimile signature, and shall have affixed thereto the Company's seal or a facsimile thereof which shall be attested by the Secretary or an Assistant Secretary or the Treasurer or an Assistant Treasurer of the Company, either manually or by facsimile signature. The Rights Certificates shall be countersigned by the Rights Agent, either manually or by facsimile signature, and shall not be valid for any purpose unless so countersigned. In case any officer of the Company who shall have signed any of the Rights Certificates shall cease to be such officer of the Company before countersignature by the Rights Agent and issuance and delivery by the Company, such Rights Certificates, nevertheless, may be countersigned by the Rights Agent, and issued and delivered by the Company with the same force and effect as though the person who so signed such Rights Certificates had not ceased to be such officer of the Company; and any Rights Certificates may be signed on behalf of the Company by any person who, at the actual date of the execution of such Rights Certificate, shall be a proper officer of the Company to sign such Rights Certificate, although at the date of the execution of this Rights Agreement any such person was not such an officer.

(b) Following the Distribution Date, the Rights Agent will keep or cause to be kept, at its principal office or offices designated as the appropriate place for the surrender of Rights Certificates upon exercise or transfer, books for registration and transfer of the Rights Certificates issued hereunder. Such books shall show the names and addresses of the respective holders of the Rights Certificates, the number of Rights evidenced on its face by each of the Rights Certificates and the date of each of the Rights Certificates.

Section 6. Transfer, Split Up, Combination and Exchange of Rights Certificates; Mutilated, Destroyed, Lost or Stolen Rights Certificates.

(a) Subject to the provisions of Section 4(b), Section 7(e) and Section 14 hereof, at any time after the close of business on the Distribution Date, and at or prior to the close of business on the Expiration Date, any Rights Certificate or Certificates (other than Rights Certificates representing Rights that have been exchanged pursuant to Section 24 hereof), may be transferred, split up, combined or exchanged for another Rights Certificate or Certificates, entitling the registered holder to purchase a like number of one three-hundredths of a share of Preferred Stock (or, following a Triggering Event, Common Stock, other securities, cash or other assets, as the case may be) as the Rights Certificate or Certificates surrendered then entitled such holder (or former holder in the case of a transfer) to purchase. Any registered holder desiring to transfer, split up, combine or exchange any Rights Certificate or Certificates shall make such request in writing delivered to the Rights Agent, and shall surrender the Rights Certificate or Certificates to be transferred, split up, combined or exchanged at the principal office or offices of the Rights Agent designated for such purpose. Neither the Rights Agent nor the Company shall be obligated to take any action whatsoever with respect to the transfer, split up, combination or exchange of any such surrendered Rights Certificate until the registered holder thereof shall have completed and signed the form of assignment and related certificate on the reverse side of such Rights Certificate and shall have provided such additional evidence of the identity of the Beneficial Owner (or former Beneficial Owner) or Affiliates or Associates thereof as the Company shall reasonably request. Thereupon the Rights Agent shall, subject to Section 4(b), Section 7(e), Section 14 and Section 24 hereof, countersign and deliver to the Person entitled thereto a Rights Certificate or Rights Certificates, as the case may be, as so requested. The Company may require payment of a sum sufficient to cover any tax or governmental charge that may be imposed in connection with any transfer, split up, combination or exchange of Rights Certificates.

(b) Upon receipt by the Company and the Rights Agent of evidence reasonably satisfactory to them of the loss, theft, destruction or mutilation of a Rights Certificate, and, in case of loss, theft or destruction, of indemnity or security reasonably satisfactory to them, and reimbursement to the Company and the Rights Agent of all reasonable expenses incidental thereto, and upon surrender to the Rights Agent and cancellation of the Rights Certificate if mutilated, the Company will execute and deliver a new Rights Certificate of like tenor to the Rights Agent for countersignature and delivery to the registered owner in lieu of the Rights Certificate so lost, stolen, destroyed or mutilated.

Section 7. Exercise of Rights; Purchase Price; Expiration Date of Rights.

(a) Subject to Section 7(e) hereof, the registered holder of any Rights Certificate may exercise the Rights evidenced thereby (except as otherwise provided herein including, without limitation, the restrictions on exercisability set forth in Section 9(c), Section 11(a)(iii) and Section 23(a) hereof) in whole or in part at any time after the Distribution Date upon surrender of the Rights Certificate, with the form of election to purchase and related certificate on the reverse side thereof duly executed, to the Rights Agent at the principal office or offices of the Rights Agent designated for such purpose, together with payment of the aggregate Purchase Price for the total number of one three-hundredths of a share of Preferred Stock (or other securities, cash or other assets, as the case may be) as to which such surrendered Rights are then exercisable, at or prior to the Expiration Date.

(b) The Purchase Price for each one three-hundredth of a share of Preferred Stock pursuant to the exercise of a Right shall initially be \$[], and shall be subject to adjustment from time to time as provided in Section 11(a)(ii) and Section 13(a) hereof and shall be payable in lawful money of the United States of America in accordance with paragraph (c) below.

(c) Upon receipt of a Rights Certificate representing exercisable Rights, with the form of election to purchase and the certificate duly executed, accompanied by payment with respect to each Right so exercised, of the Purchase Price per one three-hundredth of a share of Preferred Stock (or other shares, securities, cash or other assets, as the case may be) to be purchased as set forth below and an amount equal to any applicable transfer tax, the Rights Agent shall, subject to Section 20(k) hereof, thereupon promptly (i) (A) requisition from any transfer agent of the shares of Preferred Stock (or make available, if the Rights Agent is the transfer agent for such shares) certificates for the total number of one three-hundredths of a share of Preferred Stock to be purchased and the Company hereby irrevocably authorizes its transfer agent to comply with all such requests, or (B) if the Company shall have elected to deposit the total number of shares of Preferred Stock issuable upon exercise of the Rights hereunder with a depository agent, requisition from the depository agent depository receipts representing such number of one three-hundredths of a share of Preferred Stock as are to be purchased (in which case certificates for the shares of Preferred Stock represented by such receipts shall be deposited by the transfer agent with the depository agent) and the Company will direct the depository agent to comply with such request, (ii) requisition from the Company the amount of cash, if any, to be paid in lieu of fractional shares in accordance with Section 14 hereof, (iii) after receipt of such certificates or depository receipts, cause the same to be delivered to or, upon the order of the registered holder of such Rights Certificate, registered in such name or names as may be designated by such holder, and (iv) after receipt thereof, deliver such cash, if any, to or upon the order of the registered holder of such Rights Certificate. The payment of the Purchase Price (as such amount may be reduced pursuant to Section 11(a)(iii) hereof) shall be made in cash or by certified bank check or bank draft payable to the order of the Company. In the event that the Company is obligated to issue other securities (including Common Stock) of the Company, pay cash and/or distribute other property pursuant to Section 11(a) hereof, the Company will make all arrangements necessary so that such other securities, cash and/or other property are available for distribution by the Rights Agent, if and when appropriate. The Company reserves the right to require, prior to the occurrence of a Triggering Event, that upon any exercise of Rights, a number of Rights be exercised so that only whole shares of Preferred Stock would be issued.

(d) In case the registered holder of any Rights Certificate shall exercise less than all the Rights evidenced thereby, a new Rights Certificate evidencing Rights equivalent to the Rights remaining unexercised shall be

issued by the Rights Agent and delivered to, or upon the order of, the registered holder of such Rights Certificate, registered in such name or names as may be designated by such holder, subject to the provisions of Section 14 hereof.

(e) Notwithstanding anything in this Agreement to the contrary, from and after the first occurrence of a Section 11(a)(ii) Event, any Rights beneficially owned by: (i) an Acquiring Person or an Associate or Affiliate of an Acquiring Person, (ii) a transferee of an Acquiring Person (or of any such Associate or Affiliate) who becomes a transferee after the Acquiring Person becomes such, or (iii) a transferee of an Acquiring Person (or of any such Associate or Affiliate) who becomes a transferee prior to or concurrently with the Acquiring Person becoming such and receives such Rights pursuant to either (A) a transfer (whether or not for consideration) from the Acquiring Person to holders of equity interests in such Acquiring Person or to any Person with whom the Acquiring Person has any agreement, arrangement or understanding (whether or not in writing) regarding the transferred Rights or (B) a transfer which the Board of Directors of the Company has determined is part of a plan, arrangement or understanding (whether or not in writing) which has as a primary purpose or effect the avoidance of this Section 7(e), shall become null and void without any further action, and no holder of such Rights shall thereupon have any rights whatsoever with respect to such Rights, whether under any provision of this Agreement or otherwise from and after such occurrence. The Company shall use all reasonable efforts to insure that the provisions of this Section 7(e) and Section 4(b) hereof are complied with, but shall have no liability to any holder of Rights Certificates or any other Person as a result of its failure to make any determinations with respect to an Acquiring Person or its Affiliates, Associates or transferees hereunder.

(f) Notwithstanding anything in this Agreement to the contrary, neither the Rights Agent nor the Company shall be obligated to undertake any action with respect to a registered holder upon the occurrence of any purported exercise as set forth in this Section 7 unless such registered holder shall have (i) completed and signed the certificate contained in the form of election to purchase set forth on the reverse side of the Rights Certificate surrendered for such exercise, and (ii) provided such additional evidence of the identity of the Beneficial Owner (or former Beneficial Owner) or Affiliates or Associates thereof as the Company shall reasonably request.

Section 8. Cancellation and Destruction of Rights Certificates.

All Rights Certificates surrendered for the purpose of exercise, transfer, split up, combination or exchange shall, if surrendered to the Company or any of its agents, be delivered to the Rights Agent for cancellation or in cancelled form, or, if surrendered to the Rights Agent, shall be cancelled by it, and no Rights Certificates shall be issued in lieu thereof except as expressly permitted by any of the provisions of this Agreement. The Company shall deliver to the Rights Agent for cancellation and retirement, and the Rights Agent shall so cancel and retire, any other Rights Certificate purchased or acquired by the Company otherwise than upon the exercise thereof. The Rights Agent shall deliver all cancelled Rights Certificates to the Company, or shall, at the written request of the Company, destroy such cancelled Rights Certificates, and in such case shall deliver a certificate of destruction thereof to the Company.

Section 9. Reservation and Availability of Capital Stock.

(a) The Company covenants and agrees that it will cause to be reserved and kept available out of its authorized and unissued shares of Preferred Stock (and, following the occurrence of a Triggering Event, out of its authorized and unissued shares of Common Stock and/or other securities or out of its authorized and issued shares held in its treasury), the number of shares of Preferred Stock (and, following the occurrence of a Triggering Event, Common Stock and/or other securities) that, as provided in this Agreement, will be sufficient to permit the exercise in full of all outstanding Rights.

(b) So long as the shares of Preferred Stock (and, following the occurrence of a Triggering Event, Common Stock and/or other securities) issuable and deliverable upon the exercise of the Rights may be listed on any national securities exchange, the Company shall use its best efforts to cause, from and after such time as the Rights become exercisable, all shares reserved for such issuance to be listed on such exchange upon official

notice of issuance upon such exercise; provided, however, that the Company shall have no obligation hereunder to list the shares of Preferred Stock on any national securities exchange.

(c) The Company shall use its best efforts to (i) file, as soon as practicable following the earliest date after the first occurrence of a Section 11(a)(ii) Event upon which the consideration to be delivered by the Company upon exercise of the Rights has been determined in accordance with Section 11(a)(iii) hereof, or, if required by law, the Distribution Date, a registration statement under the Securities Act of 1933, as amended (the "Securities Act"), with respect to the securities purchasable upon exercise of the Rights on an appropriate form, (ii) cause such registration statement to become effective as soon as practicable after such filing, and (iii) cause such registration statement to remain effective (with a prospectus at all times meeting the requirements of the Securities Act) until the earlier of (A) the date as of which the Rights are no longer exercisable for such securities and (B) the date of the expiration of the Rights. The Company will also take such action as may be appropriate under, or to ensure compliance with, the securities or "blue sky" laws of the various states in connection with the exercisability of the Rights. The Company may temporarily suspend, for a period of time not to exceed ninety (90) days after the date set forth in clause (i) of the first sentence of this Section 9(c), the exercisability of the Rights in order to prepare and file such registration statement and permit it to become effective. Upon any such suspension, the Company shall issue a public announcement stating that the exercisability of the Rights has been temporarily suspended, as well as a public announcement at such time as the suspension is no longer in effect. In addition, if the Company shall determine that a registration statement is required following the Distribution Date, the Company may temporarily suspend the exercisability of the Rights until such time as a registration statement has been declared effective. Notwithstanding any provision of this Agreement to the contrary, the Rights shall not be exercisable in any jurisdiction if the requisite qualification in such jurisdiction has not been obtained, the exercise thereof is not permitted under applicable law or a registration statement has not been declared effective.

(d) The Company covenants and agrees that it will take all such action as may be necessary to ensure that all one three-hundredths of a share of Preferred Stock (and, following the occurrence of a Triggering Event, Common Stock and/or other securities) delivered upon exercise of the Rights shall, at the time of delivery of the certificates for such shares (subject to payment of the Purchase Price), be duly and validly authorized and issued and fully paid and nonassessable.

(e) The Company further covenants and agrees that it will pay when due and payable any and all federal and state transfer taxes and charges which may be payable in respect of the issuance or delivery of the Rights Certificates and of any certificates for a number of one three-hundredths of a share of Preferred Stock (or Common Stock and/or other securities, as the case may be) upon the exercise of Rights. The Company shall not, however, be required to pay any transfer tax which may be payable in respect of any transfer or delivery of Rights Certificates to a Person other than, or the issuance or delivery of a number of one three-hundredths of a share of Preferred Stock (or Common Stock and/or other securities, as the case may be) in respect of a name other than that of, the registered holder of the Rights Certificate evidencing Rights surrendered for transfer or exercise, or to issue or deliver any certificates for a number of one three-hundredths of a share of Preferred Stock (or Common Stock and/or other securities, as the case may be) in a name other than that of the registered holder upon the exercise of any Rights until such tax shall have been paid (any such tax being payable by the holder of such Rights Certificate at the time of surrender) or until it has been established to the Company's satisfaction that no such tax is due.

Section 10. Preferred Stock Record Date.

Each Person in whose name any certificate for a number of one three-hundredths of a share of Preferred Stock (or Common Stock and/or other securities, as the case may be) is issued upon the exercise of Rights shall for all purposes be deemed to have become the holder of record of the shares of Preferred Stock (or Common Stock and/or other securities, as the case may be) represented thereby on, and such certificate shall be dated, the date upon which the Rights Certificate evidencing such Rights was duly surrendered and payment of the Purchase Price (and all applicable transfer taxes) was made; provided, however, that if the date of such surrender and payment is a date upon which the Preferred Stock (or Common Stock and/or other securities, as the case may be) transfer books of the Company are closed, such Person shall be deemed to have become the record holder of such shares on, and such

certificate shall be dated, the next succeeding business day on which the Preferred Stock (or Common Stock and/or other securities, as the case may be) transfer books of the Company are open. Prior to the exercise of the Rights evidenced thereby, the holder of a Rights Certificate shall not be entitled to any rights of a shareholder of the Company with respect to shares for which the Rights shall be exercisable, including, without limitation, the right to vote, to receive dividends or other distributions or to exercise any preemptive rights, and shall not be entitled to receive any notice of any proceedings of the Company, except as provided herein.

Section 11. Adjustment of Purchase Price, Number and Kind of Shares or Number of Rights.

The Purchase Price, the number and kind of shares covered by each Right and the number of Rights outstanding are subject to adjustment from time to time as provided in this Section 11.

(a) (i) In the event the Company shall at any time after the date of this Agreement (A) declare a dividend on the Preferred Stock payable in shares of Preferred Stock, (B) subdivide the outstanding Preferred Stock, (C) combine the outstanding Preferred Stock into a smaller number of shares, or (D) issue any shares of its capital stock in a reclassification of the Preferred Stock (including any such reclassification in connection with a consolidation or merger in which the Company is the continuing or surviving corporation), except as otherwise provided in this Section 11(a) and Section 7(e) hereof, the Purchase Price in effect at the time of the record date for such dividend or of the effective date of such subdivision, combination or reclassification, and the number and kind of shares of Preferred Stock or capital stock, as the case may be, issuable on such date, shall be proportionately adjusted so that the holder of any Right exercised after such time shall be entitled to receive, upon payment of the Purchase Price then in effect, the aggregate number and kind of shares of Preferred Stock or capital stock, as the case may be, which, if such Right had been exercised immediately prior to such date and at a time when the Preferred Stock transfer books of the Company were open, such holder would have owned upon such exercise and been entitled to receive by virtue of such dividend, subdivision, combination or reclassification. If an event occurs which would require an adjustment under both this Section 11(a)(i) and Section 11(a)(ii) hereof, the adjustment provided for in this Section 11(a)(i) shall be in addition to, and shall be made prior to, any adjustment required pursuant to Section 11(a)(ii) hereof.

(ii) Subject to Section 24 of this Agreement, in the event any Person shall, at any time after the Rights Dividend Declaration Date, becomes an Acquiring Person, unless the event causing such Person to become an Acquiring Person is a transaction set forth in Section 13(a) hereof, or is an acquisition of shares of Common Stock pursuant to a tender offer or an exchange offer for all outstanding shares of Common Stock at a price and on terms determined by at least a majority of the members of the Board of Directors who are not officers of the Company and who are not representatives, nominees, Affiliates or Associates of an Acquiring Person, after receiving advice from one or more investment banking firms, to be (a) at a price which is fair and adequate to shareholders (taking into account all factors which such members of the Board of Directors of the Company deem relevant including, without limitation, prices which could reasonably be achieved if the Company or its assets were sold on an orderly basis designed to realize maximum value) and (b) otherwise in the best interests of the Company and its shareholders, then, promptly following the occurrence of such event, proper provision shall be made so that each holder of a Right (except as provided below and in Section 7(e) hereof) shall thereafter have the right to receive, upon exercise thereof at the then current Purchase Price in accordance with the terms of this Agreement, in lieu of a number of one three-hundredths of a share of Preferred Stock, such number of shares of Common Stock of the Company as shall equal the result obtained by (x) multiplying the then current Purchase Price by the number of one three-hundredths of a share of Preferred Stock for which a Right was exercisable immediately prior to the first occurrence of a Section 11(a) (ii) Event, and (y) dividing that product (which, following such first occurrence, shall thereafter be referred to as the "Purchase Price" for each Right and for all purposes of this Agreement) by fifty percent (50%) of the current market price (determined pursuant to Section 11(d) hereof) per share of Common Stock on the date of such first occurrence (such number of shares, the "Adjustment Shares").

(iii) In the event that the number of shares of Common Stock which is authorized by the Company's Restated Certificate of Incorporation but not outstanding or reserved for issuance for purposes other than

upon exercise of the Rights is not sufficient to permit the exercise in full of the Rights in accordance with the foregoing subparagraph (ii) of this Section 11(a), the Company shall: (A) determine the excess of (1) the value of the Adjustment Shares issuable upon the exercise of a Right (the "Current Value") over (2) the Purchase Price (such excess, the "Spread"), and (B) with respect to each Right (subject to Section 7(e) hereof), make adequate provision to substitute for the Adjustment Shares, upon the exercise of a Right and payment of the applicable Purchase Price, (1) cash, (2) a reduction in the Purchase Price, (3) Common Stock or other equity securities of the Company (including, without limitation, shares, or units of shares, of preferred stock, such as the Preferred Stock, which the Board of Directors of the Company has deemed to have essentially the same value or economic rights as shares of Common Stock (such shares of preferred stock referred to herein as "common stock equivalents")), (4) debt securities of the Company, (5) other assets or (6) any combination of the foregoing, having an aggregate value equal to the Current Value (less the amount of any reduction in the Purchase Price), where such aggregate value has been determined by the Board of Directors of the Company based upon the advice of a nationally recognized investment banking firm selected by the Board of Directors of the Company; provided, however, that if the Company shall not have made adequate provision to deliver value pursuant to clause (B) above within thirty (30) days following the later of (x) the first occurrence of a Section 11(a)(ii) Event and (y) the date on which the Company's right of redemption pursuant to Section 23(a) expires (the later of (x) and (y) being referred to herein as the "Section 11(a)(ii) Trigger Date"), then the Company shall be obligated to deliver, upon the surrender for exercise of a Right and without requiring payment of the Purchase Price, shares of Common Stock (to the extent available) and then, if necessary, cash, which shares and/or cash have an aggregate value equal to the Spread. If the Board of Directors of the Company shall determine in good faith that it is likely that sufficient additional shares of Common Stock could be authorized for issuance upon exercise in full of the Rights, the thirty (30) day period set forth above may be extended to the extent necessary, but not more than ninety (90) days after the Section 11(a) (ii) Trigger Date, in order that the Company may seek shareholder approval for the authorization of such additional shares (such thirty (30) day period, as it may be extended, referred to herein as the "Substitution Period"). To the extent that the Company determines that some action need be taken pursuant to the first and/or second sentences of this Section 11(a)(iii), the Company (x) shall provide, subject to Section 7(e) hereof, that such action shall apply uniformly to all outstanding Rights, and (y) may suspend the exercisability of the Rights until the expiration of the Substitution Period in order to seek such shareholder approval for such authorization of additional shares and/or to decide the appropriate form of distribution to be made pursuant to such first sentence and to determine the value thereof. In the event of any such suspension, the Company shall issue a public announcement stating that the exercisability of the Rights has been temporarily suspended, as well as a public announcement at such time as the suspension is no longer in effect. For purposes of this Section 11(a)(iii), the value of each Adjustment Share shall be the current market price (as determined pursuant to Section 11(d) hereof) per share of the Common Stock on the Section 11(a)(ii) Trigger Date and the per share or per unit value of any "common stock equivalent" shall be deemed to equal the current market price per share of the Common Stock on such date.

(b) In case the Company shall fix a record date for the issuance of rights, options or warrants to all holders of Preferred Stock entitling them to subscribe for or purchase (for a period expiring within forty-five (45) calendar days after such record date) Preferred Stock (or shares having the same rights, privileges and preferences as the shares of Preferred Stock ("equivalent preferred stock")) or securities convertible into Preferred Stock or equivalent preferred stock at a price per share of Preferred Stock or per share of equivalent preferred stock (or having a conversion price per share, if a security convertible into Preferred Stock or equivalent preferred stock) less than the current market price (as determined pursuant to Section 11(d) hereof) per share of Preferred Stock on such record date, the Purchase Price to be in effect after such record date shall be determined by multiplying the Purchase Price in effect immediately prior to such record date by a fraction, the numerator of which shall be the number of shares of Preferred Stock outstanding on such record date, plus the number of shares of Preferred Stock which the aggregate offering price of the total number of shares of Preferred Stock and/or equivalent preferred stock so to be offered (and/or the aggregate initial conversion price of the convertible securities so to be offered) would purchase at such current market

price, and the denominator of which shall be the number of shares of Preferred Stock outstanding on such record date, plus the number of additional shares of Preferred Stock and/or equivalent preferred stock to be offered for subscription or purchase (or into which the convertible securities so to be offered are initially convertible). In case such subscription price may be paid by delivery of consideration part or all of which may be in a form other than cash, the value of such consideration shall be as determined in good faith by the Board of Directors of the Company, whose determination shall be described in a statement filed with the Rights Agent and shall be binding on the Rights Agent and the holders of the Rights. Shares of Preferred Stock owned by or held for the account of the Company shall not be deemed outstanding for the purpose of any such computation. Such adjustment shall be made successively whenever such a record date is fixed, and in the event that such rights or warrants are not so issued, the Purchase Price shall be adjusted to be the Purchase Price which would then be in effect if such record date had not been fixed.

(c) In case the Company shall fix a record date for a distribution to all holders of Preferred Stock (including any such distribution made in connection with a consolidation or merger in which the Company is the continuing corporation) of evidences of indebtedness, cash (other than a regular quarterly cash dividend out of the earnings or retained earnings of the Company), assets (other than a dividend payable in Preferred Stock, but including any dividend payable in stock other than Preferred Stock) or subscription rights or warrants (excluding those referred to in Section 11(b) hereof), the Purchase Price to be in effect after such record date shall be determined by multiplying the Purchase Price in effect immediately prior to such record date by a fraction, the numerator of which shall be the current market price (as determined pursuant to Section 11(d) hereof) per share of Preferred Stock on such record date, less the fair market value (as determined in good faith by the Board of Directors of the Company, whose determination shall be described in a statement filed with the Rights Agent) of the portion of the cash, assets or evidences of indebtedness so to be distributed or of such subscription rights or warrants applicable to a share of Preferred Stock and the denominator of which shall be such current market price (as determined pursuant to Section 11(d) hereof) per share of Preferred Stock. Such adjustments shall be made successively whenever such a record date is fixed, and in the event that such distribution is not so made, the Purchase Price shall be adjusted to be the Purchase Price which would have been in effect if such record date had not been fixed.

(d) (i) For the purpose of any computation hereunder, other than computations made pursuant to Section 11(a)(iii) hereof, the "current market price" per share of Common Stock on any date shall be deemed to be the average of the daily Closing Prices per share of such Common Stock for the thirty (30) consecutive Trading Days immediately prior to such date, and for purposes of computations made pursuant to Section 11(a)(iii) hereof, the "current market price" per share of Common Stock on any date shall be deemed to be the average of the daily Closing Prices per share of such Common Stock for the ten (10) consecutive Trading Days immediately following such date; provided, however, that in the event that the current market price per share of the Common Stock is determined during a period following the announcement by the issuer of such Common Stock of (A) a dividend or distribution on such Common Stock payable in shares of such Common Stock or securities convertible into shares of such Common Stock (other than the Rights), or (B) any subdivision, combination or reclassification of such Common Stock, and prior to the expiration of the requisite thirty (30) Trading Day or ten (10) Trading Day period, as set forth above, after the ex-dividend date for such dividend or distribution, or the record date for such subdivision, combination or reclassification, then, and in each such case, the "current market price" shall be properly adjusted to take into account ex-dividend trading.

(ii) For the purpose of any computation hereunder, the "current market price" per share of Preferred Stock shall be determined in the same manner as set forth above for the Common Stock in Section 11(d)(i) hereof. If the current market price per share of Preferred Stock cannot be determined in the manner provided above or if the Preferred Stock is not publicly held or listed or traded in a manner described in subsection (g) of Section 1 hereof, the "current market price" per share of Preferred Stock shall be conclusively deemed to be an amount equal to 300 (as such number may be appropriately adjusted for such events as stock splits, stock dividends and recapitalizations with respect to the Common Stock occurring after the date of this Agreement) multiplied by the current market price per share of the Common Stock. If neither the Common

Stock nor the Preferred Stock is publicly held or so listed or traded, "current market price" per share shall mean the fair value per share as determined in good faith by the Board of Directors of the Company, whose determination shall be described in a statement filed with the Rights Agent and shall be conclusive for all purposes. For all purposes of this Agreement, the "current market price" of one three-hundredth of a share of Preferred Stock shall be equal to the "current market price" of one share of Preferred Stock divided by 300.

(e) Anything herein to the contrary notwithstanding, no adjustment in the Purchase Price shall be required unless such adjustment would require an increase or decrease of at least one percent (1%) in the Purchase Price; provided, however, that any adjustments which by reason of this Section 11(e) are not required to be made shall be carried forward and taken into account in any subsequent adjustment. All calculations under this Section 11 shall be made to the nearest cent or to the nearest ten-thousandth of a share of Common Stock or other share or one-millionth of a share of Preferred Stock, as the case may be. Notwithstanding the first sentence of this Section 11(e), any adjustment required by this Section 11 shall be made no later than the earlier of (i) three (3) years from the date of the transaction which mandates such adjustment, or (ii) the Expiration Date.

(f) If as a result of an adjustment made pursuant to Section 11(a)(ii) or Section 13(a) hereof, the holder of any Right thereafter exercised shall become entitled to receive any shares of capital stock other than Preferred Stock, thereafter the number of such other shares so receivable upon exercise of any Right and the Purchase Price thereof shall be subject to adjustment from time to time in a manner and on terms as nearly equivalent as practicable to the provisions with respect to the Preferred Stock contained in Sections 11(a), (b), (c), (e), (g), (h), (i), (j), (k) and (m), and the provisions of Sections 7, 9, 10, 13 and 14 hereof with respect to the Preferred Stock shall apply on like terms to any such other shares; provided, however, that the Company shall not be liable for its inability to reserve and keep available for issuance upon exercise of the Rights pursuant to Section 11(a)(ii) a number of shares of Common Stock greater than the number then authorized by the Restated Certificate of Incorporation of the Company but not outstanding or reserved for other purposes.

(g) All Rights originally issued by the Company subsequent to any adjustment made to the Purchase Price hereunder shall evidence the right to purchase, at the adjusted Purchase Price, the number of one three-hundredths of a share of Preferred Stock purchasable from time to time hereunder upon exercise of the Rights, all subject to further adjustment as provided herein.

(h) Unless the Company shall have exercised its election as provided in Section 11(i), upon each adjustment of the Purchase Price as a result of the calculations made in Sections 11(b) and (c), each Right outstanding immediately prior to the making of such adjustment shall thereafter evidence the right to purchase, at the adjusted Purchase Price, that number of one three-hundredths of a share of Preferred Stock (calculated to the nearest one-millionth) obtained by (i) multiplying (x) the number of one three-hundredths of a share covered by a Right immediately prior to this adjustment by (y) the Purchase Price in effect immediately prior to such adjustment of the Purchase Price, and (ii) dividing the product so obtained by the Purchase Price in effect immediately after such adjustment of the Purchase Price.

(i) The Company may elect on or after the date of any adjustment of the Purchase Price to adjust the number of Rights, in lieu of any adjustment in the number of one three-hundredths of a share of Preferred Stock purchasable upon the exercise of a Right. Each of the Rights outstanding after the adjustment in the number of Rights shall be exercisable for the number of one three-hundredths of a share of Preferred Stock for which a Right was exercisable immediately prior to such adjustment, at the adjusted Purchase Price. Each Right held of record prior to such adjustment of the number of Rights shall become that number of Rights (calculated to the nearest ten-thousandth) obtained by dividing the Purchase Price in effect immediately prior to adjustment of the Purchase Price by the Purchase Price in effect immediately after adjustment of the Purchase Price. The Company shall make a public announcement of its election to adjust the number of Rights, indicating the record date for the adjustment, and, if known at the time, the amount of the adjustment to be made. This record date may be the date on which the Purchase Price is adjusted or any day thereafter, but, if the Rights Certificates have been issued, shall be at least ten (10) days later than the

date of the public announcement. If Rights Certificates have been issued, upon each adjustment of the number of Rights pursuant to this Section 11(i), the Company shall, as promptly as practicable, cause to be distributed to holders of record of Rights Certificates on such record date Rights Certificates evidencing, subject to Section 14 hereof, the additional Rights to which such holders shall be entitled as a result of such adjustment, or, at the option of the Company, shall cause to be distributed to such holders of record in substitution and replacement for the Rights Certificates held by such holders prior to the date of adjustment, and upon surrender thereof, if required by the Company, new Rights Certificates evidencing all the Rights to which such holders shall be entitled after such adjustment. Rights Certificates to be so distributed shall be issued, executed and countersigned in the manner provided for herein (and may bear, at the option of the Company, the adjusted Purchase Price) and shall be registered in the names of the holders of record of Rights Certificates on the record date specified in the public announcement.

(j) Irrespective of any adjustment or change in the Purchase Price or the number of one three-hundredths of a share of Preferred Stock issuable upon the exercise of the Rights, the Rights Certificates theretofore and thereafter issued may continue to express the Purchase Price per one three-hundredth of a share and the number of one three-hundredths of a share which were expressed in the initial Rights Certificates issued hereunder.

(k) Before taking any action that would cause an adjustment reducing the Purchase Price below the then par value attributable to the number of one three-hundredths of a share of Preferred Stock issuable upon exercise of the Rights, the Company shall take any corporate action which may, in the opinion of its counsel, be necessary in order that the Company may validly and legally issue, fully paid and nonassessable, such number of one three-hundredths of a share of Preferred Stock at such adjusted Purchase Price.

(l) In any case in which this Section 11 shall require that an adjustment in the Purchase Price be made effective as of a record date for a specified event, the Company may elect to defer until the occurrence of such event the issuance to the holder of any Right exercised after such record date of the number of one three-hundredths of a share of Preferred Stock and other capital stock or securities of the Company, if any, issuable upon such exercise over and above the number of one three-hundredths of a share of Preferred Stock and other capital stock or securities of the Company, if any, issuable upon such exercise on the basis of the Purchase Price in effect prior to such adjustment; provided, however, that the Company shall deliver to such holder a due bill or other appropriate instrument evidencing such holder's right to receive such additional shares or securities upon the occurrence of the event requiring such adjustment.

(m) Anything in this Section 11 to the contrary notwithstanding, the Company shall be entitled to make such reductions in the Purchase Price, in addition to those adjustments expressly required by this Section 11, as and to the extent that the Board of Directors of the Company, in its good faith judgment, shall determine to be advisable in order that any (i) consolidation or subdivision of the Preferred Stock, (ii) issuance wholly for cash of any shares of Preferred Stock at less than the current market price, (iii) issuance wholly for cash of shares of Preferred Stock or securities which by their terms are convertible into or exchangeable for shares of Preferred Stock, (iv) stock dividends or (v) issuance of rights, options or warrants referred to in this Section 11, hereafter made by the Company to holders of its Preferred Stock shall not be taxable to such shareholders.

(n) The Company covenants and agrees that it shall not, at any time after the Distribution Date, (i) consolidate with any other Person (other than a consolidation with a Subsidiary of the Company in a transaction which does not violate the provisions of Section 11(o) hereof), (ii) merge with or into any other Person (other than a merger with a Subsidiary of the Company in a transaction which does not violate the provisions of Section 11(o) hereof), or (iii) sell or transfer (or permit any Subsidiary to sell or transfer), in one transaction or a series of related transactions, assets, earning power or cash flow aggregating more than fifty percent (50%) of the assets, earning power or cash flow of the Company and its Subsidiaries (taken as a whole) to any other Person or Persons (other than a sale or transfer to the Company and/or any of its Subsidiaries in one or more transactions each of which does not violate the provisions of Section 11(o) hereof), if (x) at the time of or immediately after such consolidation, merger or sale there are any rights, warrants or other instruments or securities outstanding or agreements in effect which would substantially

diminish or otherwise eliminate the benefits intended to be afforded by the Rights or (y) prior to, simultaneously with or immediately after such consolidation, merger or sale, the shareholders of the Person who constitutes, or would constitute, the "Principal Party" for purposes of Section 13(a) hereof shall have received a distribution of Rights previously owned by such Person or any of its Affiliates and Associates.

(o) The Company covenants and agrees that, after the earlier of the Distribution Date or the Stock Acquisition Date, it will not, except as permitted by Section 23 or Section 27 hereof, take (or permit any Subsidiary to take) any action if at the time such action is taken it is reasonably foreseeable that such action will diminish substantially or otherwise eliminate the benefits intended to be afforded by the Rights.

(p) Anything in this Agreement to the contrary notwithstanding, in the event that the Company shall at any time after the date of this Agreement and prior to the Distribution Date (i) declare a dividend on the outstanding shares of Common Stock payable in shares of Common Stock, (ii) subdivide the outstanding shares of Common Stock, or (iii) combine the outstanding shares of Common Stock into a smaller number of shares, the number of Rights associated with each share of Common Stock then outstanding, or issued or delivered thereafter but prior to the Distribution Date, shall be proportionately adjusted so that the number of Rights thereafter associated with each share of Common Stock following any such event shall equal the result obtained by multiplying the number of Rights associated with each share of Common Stock immediately prior to such event by a fraction, the numerator which shall be the total number of shares of Common Stock outstanding immediately prior to the occurrence of the event and the denominator of which shall be the total number of shares of Common Stock outstanding immediately following the occurrence of such event.

Section 12. Certificate of Adjusted Purchase Price or Number of Shares.

Whenever an adjustment is made as provided in Section 11 or Section 13 hereof, the Company shall (a) promptly prepare a certificate setting forth such adjustment and a brief statement of the facts accounting for such adjustment, (b) promptly file with the Rights Agent and with each transfer agent for the Preferred Stock and the Common Stock a copy of such certificate and (c) if a Distribution Date has occurred, mail a brief summary thereof to each holder of a Rights Certificate in accordance with Section 26 hereof. The Rights Agent shall be fully protected in relying on any such certificate and on any adjustment therein contained.

Section 13. Consolidation, Merger or Sale or Transfer of Assets, Cash Flow or Earning Power.

(a) In the event that, following the Stock Acquisition Date, directly or indirectly, (x) the Company shall consolidate with, or merge with and into, any other Person (other than a Subsidiary of the Company in a transaction which complies with Section 11(o) hereof), and the Company shall not be the continuing or surviving corporation of such consolidation or merger, (y) any Person (other than a Subsidiary of the Company in a transaction which complies with Section 11(o) hereof) shall consolidate with, or merge with or into, the Company, and the Company shall be the continuing or surviving corporation of such consolidation or merger and, in connection with such consolidation or merger, all or part of the outstanding shares of Common Stock shall be changed into or exchanged for stock or other securities of any other Person or cash or any other property, or (z) the Company shall sell, or otherwise transfer (or one or more of its Subsidiaries shall sell or otherwise transfer), in one transaction or a series of related transactions, assets, earning power or cash flow aggregating more than fifty percent (50%) of the assets, earning power or cash flow of the Company and its Subsidiaries (taken as a whole) to any Person or Persons (other than the Company or any Subsidiary of the Company in one or more transactions each of which complies with Section 11(o) hereof), then, and in each such case (except as may be contemplated by Section 13(d) hereof), proper provision shall be made so that: (i) each holder of a Right (other than Rights that heretofore became null and void pursuant to Section 7(e) hereof) shall thereafter have the right to receive, upon the exercise thereof at the then current Purchase Price in accordance with the terms of this Agreement (or, if any Section 11(a)(ii) event has occurred prior to the first occurrence of a Section 13(a) Event, at the Purchase Price in effect immediately prior to the first occurrence of a Section 11(a)(ii) event), such number of validly authorized and issued, fully paid, non-assessable and freely tradeable shares of Common Stock of the Principal Party (as such term is hereinafter defined), free and clear of any liens, encumbrances, rights of first

refusal or other adverse claims, as shall be equal to the result obtained by (1) multiplying the then current Purchase Price by the number of one three-hundredths of a share of Preferred Stock for which a Right is exercisable immediately prior to the first occurrence of a Section 13 Event (or, if a Section 11(a)(ii) Event has occurred prior to the first occurrence of a Section 13 Event, multiplying the number of one three-hundredths of a share of Preferred Stock for which a Right was exercisable immediately prior to the first occurrence of a Section 11(a)(ii) Event by the Purchase Price in effect immediately prior to such first occurrence), and (2) dividing that product (which, following the first occurrence of a Section 13 Event, shall be referred to as the "Purchase Price" for each Right and for all purposes of this Agreement) by fifty percent (50%) of the current market price (determined pursuant to Section 11(d)(i) hereof) per share of the Common Stock of such Principal Party on the date of consummation of such Section 13 Event; (ii) such Principal Party shall thereafter be liable for, and shall assume, by virtue of such Section 13 Event, all the obligations and duties of the Company pursuant to this Agreement; (iii) the term "Company" shall thereafter be deemed to refer to such Principal Party, it being specifically intended that the provisions of Section 11 hereof shall apply only to such Principal Party following the first occurrence of a Section 13 Event; (iv) such Principal Party shall take such steps (including, but not limited to, the reservation of a sufficient number of shares of its Common Stock) in connection with the consummation of any such transaction as may be necessary to assure that the provisions hereof shall thereafter be applicable, as nearly as reasonably may be, in relation to its shares of Common Stock thereafter deliverable upon the exercise of the Rights; and (v) the provisions of Section 11(a) (ii) hereof shall be of no effect following the first occurrence of any Section 13 Event.

(b) "Principal Party" shall mean:

(i) in the case of any transaction described in clause (x) or (y) of the first sentence of Section 13(a) hereof, the Person that is the issuer of any securities into which shares of Common Stock of the Company are converted in such merger or consolidation, and if no securities are so issued, the Person that is the other party to such merger or consolidation; and

(ii) in the case of any transaction described in clause (z) of the first sentence of Section 13(a) hereof, the Person that is the party receiving the greatest portion of the assets, earning power or cash flow transferred pursuant to such transaction or transactions;

provided, however, that in any such case, (1) if the Common Stock of such Person is not, at such time and has not been continuously over the preceding twelve (12) month period, registered under Section 12 of the Exchange Act, and such Person is a direct or indirect Subsidiary of another Person the Common Stock of which is and has been so registered, "Principal Party" shall refer to such other Person; and (2) in case such Person is a Subsidiary, directly or indirectly, of more than one Person, the Common Stock of two or more of which are and have been so registered, "Principal Party" shall refer to whichever of such Persons is the issuer of the Common Stock having the greatest aggregate market value.

(c) The Company shall not consummate any such consolidation, merger, sale or transfer unless the Principal Party shall have sufficient authorized and unissued shares of Common Stock not reserved for other purposes to permit the full exercise of the Rights in accordance with this Section 13, and unless prior thereto the Company and such Principal Party shall have executed and delivered to the Rights Agent a supplemental agreement providing for the terms set forth in paragraphs (a) and (b) of this Section 13 and further providing that, as soon as practicable after the date of any consolidation, merger, sale or transfer of assets mentioned in paragraph (a) of this Section 13, the Principal Party will:

(i) prepare and file a registration statement under the Securities Act with respect to the Rights and the securities purchasable upon exercise of the Rights on an appropriate form, and will use its best efforts to cause such registration statement to (A) become effective as soon as practicable after such filing and (B) remain effective (with a prospectus at all times meeting the requirements of the Securities Act) until the Expiration Date; and

(ii) deliver to holders of the Rights historical financial statements for the Principal Party and each of its Affiliates which comply in all respects with the requirements for registration on Form 10 under the Exchange Act.

The provisions of this Section 13 shall similarly apply to successive mergers or consolidations or sales or other transfers. In the event that a Section 13 Event shall occur at any time after the occurrence of a Section 11(a)(ii) Event, the Rights which have not theretofore been exercised shall thereafter become exercisable in the manner described in Section 13(a) hereof.

(d) Notwithstanding anything in this Agreement to the contrary, this Section 13 shall not be applicable to a transaction described in subparagraphs (x) and (y) of Section 13(a) hereof if (i) such transaction is consummated with a Person or Persons who acquired shares of Common Stock pursuant to a tender offer or exchange offer for all outstanding shares of Common Stock which complies with the provisions of Section 11(a)(ii) hereof (or a wholly owned subsidiary of any such Person or Persons), (ii) the price per share of Common Stock offered in such transaction is not less than the price per share of Common Stock paid to all holders of shares of Common Stock whose shares were purchased pursuant to such tender offer or exchange offer and (iii) the form of consideration being offered to the remaining holders of shares of Common Stock pursuant to such transaction is the same as the form of consideration paid pursuant to such tender offer or exchange offer. Upon consummation of any such transaction contemplated by this Section 13(d), all Rights hereunder shall expire.

Section 14. Fractional Rights and Fractional Shares.

(a) The Company shall not be required to issue fractions of Rights, except prior to the Distribution Date as provided in Section 11(p) hereof, or to distribute Rights Certificates which evidence fractional Rights. In lieu of such fractional Rights, there shall be paid to the registered holders of the Rights Certificates with regard to which such fractional Rights would otherwise be issuable, an amount in cash equal to the same fraction of the current market value of a whole Right. For purposes of this Section 14(a), the current market value of a whole Right shall be the Closing Price of the Rights for the Trading Day immediately prior to the date on which such fractional Rights would have been otherwise issuable. The Closing Price of the Rights for any day shall be the last sale price, or, in case no such sale takes place on such day, the average of the closing bid and asked prices, in either case as reported in the principal consolidated transaction reporting system with respect to securities listed or admitted to trading on the New York Stock Exchange or, if the Rights are not listed or admitted to trading on the New York Stock Exchange, as reported in the principal consolidated transaction reporting system with respect to securities listed on the principal national securities exchange on which the Rights are listed or admitted to trading, or if the Rights are not listed or admitted to trading on any national securities exchange, the last quoted price, or, if not so quoted, the average of the high bid and low asked prices in the over-the-counter market, as reported by NASDAQ or such other system then in use or, if on any such date the Rights are not quoted by any such organization, the average of the closing bid and asked prices as furnished by a professional market maker making a market in the Rights selected by the Board of Directors of the Company. If on any such date no such market maker is making a market in the Rights, the fair value of the Rights on such date as determined in good faith by the Board of Directors of the Company shall be used.

(b) The Company shall not be required to issue fractions of shares of Preferred Stock (other than fractions which are integral multiples of one three-hundredth of a share of Preferred Stock) upon exercise of the Rights or to distribute certificates which evidence fractional shares of Preferred Stock (other than fractions which are integral multiples of one three-hundredth of a share of Preferred Stock). In lieu of fractional shares of Preferred Stock that are not integral multiples of one three-hundredth of a share of Preferred Stock, the Company may pay to the registered holders of Rights Certificates at the time such Rights are exercised as herein provided an amount in cash equal to the same fraction of the current market price of one three-hundredth of a share of Preferred Stock. For purposes of this Section 14(b), the current market price of one three-hundredth of a share of Preferred Stock shall be one three-hundredth of the Closing Price of a share of Preferred Stock (as determined pursuant to Section 11(d)(ii) hereof) for the Trading Day immediately prior to the date of such exercise.

(c) Following the occurrence of a Triggering Event, the Company shall not be required to issue fractions of shares of Common Stock upon exercise of the Rights or to distribute certificates which evidence fractional shares of Common Stock. In lieu of fractional shares of Common Stock, the Company may pay to the registered holders of Rights Certificates at the time such Rights are exercised as herein provided an amount in cash equal to the same fraction of the current market price of one (1) share of Common Stock. For purposes of this Section 14(c), the current market price of one (1) share of Common Stock shall be the Closing Price of one (1) share of Common Stock (as determined pursuant to Section 11(d)(i) hereof) for the Trading Day immediately prior to the date of such exercise.

(d) The holder of a Right, by the acceptance of such Right, expressly waives such holder's right to receive any fractional Rights or any fractional shares (other than, in the case of Preferred Stock, fractions which are integral multiples of one three-hundredths of a share of Preferred Stock) upon exercise of a Right except as permitted by this Section 14.

Section 15. Rights of Action.

All rights of action in respect of this Agreement are vested in the respective registered holders of the Rights Certificates (and, prior to the Distribution Date, the registered holders of the Common Stock); and any registered holder of any Rights Certificate (or, prior to the Distribution Date, the registered holders of the Common Stock), without the consent of the Rights Agent or of the holder of any other Rights Certificate (or, prior to the Distribution Date, the registered holders of the Common Stock), may, in such holder's behalf and for such holder's benefit, enforce, and may institute and maintain any suit, action or proceeding against the Company to enforce, or otherwise act in respect of, such holder's right to exercise the Rights evidenced by such Rights Certificate (or, prior to the Distribution Date, certificates for Common Stock) in the manner provided in such Rights Certificate and in this Agreement. Without limiting the foregoing or any remedies available to the holders of Rights, it is specifically acknowledged that the holders of Rights would not have an adequate remedy at law for any breach of this Agreement and shall be entitled to specific performance of the obligations hereunder and injunctive relief against actual or threatened violations of the obligations hereunder of any Person subject to this Agreement.

Section 16. Agreement of Rights Holders.

Every holder of a Right by accepting the same consents and agrees with the Company and the Rights Agent and with every other holder of a Right that:

(a) prior to the Distribution Date, the Rights will be transferable only in connection with the transfer of Common Stock;

(b) after the Distribution Date, the Rights Certificates are transferable only on the registry books of the Rights Agent if surrendered at the principal office or offices of the Rights Agent designated for such purpose, duly endorsed or accompanied by a proper instrument of transfer and with the appropriate forms and certificates fully executed;

(c) subject to Section 6(a) and Section 7(f) hereof, the Company and the Rights Agent may deem and treat the person in whose name a Rights Certificate (or, prior to the Distribution Date, the associated Common Stock certificate) is registered as the absolute owner thereof and of the Rights evidenced thereby (notwithstanding any notations of ownership or writing on the Rights Certificates or the associated Common Stock certificate made by anyone other than the Company or the Rights Agent) for all purposes whatsoever, and neither the Company nor the Rights Agent, subject to the last sentence of Section 7(e) hereof, shall be required to be affected by any notice to the contrary; and

(d) notwithstanding anything in this Agreement to the contrary, neither the Company nor the Rights Agent shall have any liability to any holder of a Right or other Person as a result of its inability to perform any of its obligations under this Agreement by reason of any preliminary or permanent injunction or other

order, decree or ruling issued by a court of competent jurisdiction or by a governmental, regulatory or administrative agency or commission, or any statute, rule, regulation or executive order promulgated or enacted by any governmental authority, prohibiting or otherwise restraining performance of such obligation; provided, however, the Company must use its best efforts to have any such order, decree or ruling lifted or otherwise overturned as soon as possible.

Section 17. Rights Certificate Holder Not Deemed a Shareholder.

No holder, as such, of any Rights Certificate shall be entitled to vote, receive dividends or be deemed for any purpose the holder of the number of one three-hundredths of a share of Preferred Stock or any other securities of the Company which may at any time be issuable on the exercise of the Rights represented thereby, nor shall anything contained herein or in any Rights Certificate be construed to confer upon the holder of any Rights evidenced by either a certificate for Common Stock or by any Rights Certificate, as such, any of the rights of a shareholder of the Company or any right to vote for the election of directors or upon any matter submitted to shareholders at any meeting thereof, or to give or withhold consent to any corporate action, or to receive notice of meetings or other actions affecting shareholders (except as provided in Section 25 hereof), or to receive dividends or subscription rights, or otherwise, until the Right or Rights evidenced by such certificate for Common Stock or Rights Certificate, as the case may be, shall have been exercised in accordance with the provisions hereof.

Section 18. Concerning the Rights Agent.

(a) The Company agrees to pay to the Rights Agent reasonable compensation for all services rendered by it hereunder and, from time to time, on demand of the Rights Agent, its reasonable expenses and counsel fees and disbursements and other disbursements incurred in the administration and execution of this Agreement and the exercise and performance of its duties hereunder. The Company also agrees to indemnify the Rights Agent for, and to hold it harmless against, any loss, liability, or expense, incurred without gross negligence, bad faith or willful misconduct on the part of the Rights Agent, for anything done or omitted by the Rights Agent in connection with the acceptance and administration of this Agreement, including the costs and expenses of defending against any claim of liability in the premises.

(b) The Rights Agent shall be protected and shall incur no liability for or in respect of any action taken, suffered or omitted by it in connection with its administration of this Agreement in reliance upon any Rights Certificate or certificate for Common Stock or for other securities of the Company, instrument of assignment or transfer, power of attorney, endorsement, affidavit, letter, notice, direction, consent, certificate, statement, or other paper or document reasonably believed by it to be genuine and to be signed, executed and, where necessary, verified or acknowledged, by the proper Person or Persons.

Section 19. Merger or Consolidation or Change of Name of Rights.

(a) Any corporation into which the Rights Agent or any successor Rights Agent may be merged or with which it may be consolidated, or any corporation resulting from any merger or consolidation to which the Rights Agent or any successor Rights Agent shall be a party, or any corporation succeeding to the corporate trust or stock transfer business of the Rights Agent or any successor Rights Agent, shall be the successor to the Rights Agent under this Agreement without the execution or filing of any paper or any further act on the part of any of the parties hereto; provided, however, that such corporation would be eligible for appointment as a successor Rights Agent under the provisions of Section 21 hereof. In case at the time such successor Rights Agent shall succeed to the agency created by this Agreement, any of the Rights Certificates shall have been countersigned but not delivered, any such successor Rights Agent may adopt the countersignature of a predecessor Rights Agent and deliver such Rights Certificates so countersigned; and in case at that time any of the Rights Certificates shall not have been countersigned, any successor Rights Agent may countersign such Rights Certificates either in the name of the predecessor or in the name of the successor Rights Agent; and in all such cases such Rights Certificates shall have the full force provided in the Rights Certificates and in this Agreement.

(b) In case at any time the name of the Rights Agent shall be changed and at such time any of the Rights Certificates shall have been countersigned but not delivered, the Rights Agent may adopt the countersignature under its prior name and deliver Rights Certificates so countersigned; and in case at that time any of the Rights Certificates shall not have been countersigned, the Rights Agent may countersign such Rights Certificates either in its prior name or in its changed name; and in all such cases such Rights Certificates shall have the full force provided in the Rights Certificates and in this Agreement.

Section 20. Duties of Rights Agent.

The Rights Agent undertakes the duties and obligations imposed by this Agreement upon the following terms and conditions, by all of which the Company and the holders of Rights Certificates, by their acceptance thereof, shall be bound:

(a) The Rights Agent may consult with legal counsel (who may be legal counsel for the Company), and the opinion of such counsel shall be full and complete authorization and protection to the Rights Agent as to any action taken or omitted by it in good faith and in accordance with such opinion.

(b) Whenever in the performance of its duties under this Agreement the Rights Agent shall deem it necessary or desirable that any fact or matter (including, without limitation, the identity of any Acquiring Person or any Affiliate or Associate thereof and the determination of "current market price") be proved or established by the Company prior to taking or suffering any action hereunder, such fact or matter (unless other evidence in respect thereof be herein specifically prescribed) may be deemed to be conclusively proved and established by a certificate signed by the Chairman of the Board, the President, the Chairman of the Executive Committee, any Vice President, the Treasurer, any Assistant Treasurer, the Secretary or any Assistant Secretary of the Company and delivered to the Rights Agent; and such certificate shall be full authorization to the Rights Agent for any action taken or suffered in good faith by it under the provisions of this Agreement in reliance upon such certificate.

(c) The Rights Agent shall be liable hereunder only for its own gross negligence, bad faith or willful misconduct.

(d) The Rights Agent shall not be liable for or by reason of any of the statements of fact or recitals contained in this Agreement or in the Rights Certificates or be required to verify the same (except as to its countersignature on such Rights Certificates), but all such statements and recitals are and shall be deemed to have been made by the Company only.

(e) The Rights Agent shall not be under any responsibility in respect of the validity of this Agreement or the execution and delivery hereof (except the due execution hereof by the Rights Agent) or in respect of the validity or execution of any Rights Certificate (except its countersignature thereof); nor shall it be responsible for any breach by the Company of any covenant or condition contained in this Agreement or in any Rights Certificate; nor shall it be responsible for any adjustment required under the provisions of Section 11, Section 13 or Section 24 hereof or responsible for the manner, method or amount of any such adjustment or the ascertaining of the existence of facts that would require any such adjustment (except with respect to the exercise of Rights evidenced by Rights Certificates after actual notice of any such adjustment); nor shall it by any act hereunder be deemed to make any representation or warranty as to the authorization or reservation of any shares of Common Stock or Preferred Stock to be issued pursuant to this Agreement or any Rights Certificate or as to whether any shares of Common Stock or Preferred Stock will, when so issued, be validly authorized and issued, fully paid and nonassessable.

(f) The Company agrees that it will perform, execute, acknowledge and deliver or cause to be performed, executed, acknowledged and delivered all such further and other acts, instruments and assurances as may reasonably be required by the Rights Agent for the carrying out or performing by the Rights Agent of the provisions of this Agreement.

(g) The Rights Agent is hereby authorized and directed to accept instructions with respect to the performance of its duties hereunder from the Chairman of the Board, the President, the Chairman of the

Executive Committee, any Vice President, the Treasurer, any Assistant Treasurer, the Secretary or any Assistant Secretary of the Company, and to apply to such officers for advice or instructions in connection with its duties, and it shall not be liable for any action taken or suffered to be taken by it in good faith in accordance with instructions of any such officer.

(h) The Rights Agent and any shareholder, director, officer or employee of the Rights Agent may buy, sell or deal in any of the Rights or other securities of the Company or become pecuniarily interested in any transaction in which the Company may be interested, or contract with or lend money to the Company or otherwise act as fully and freely as though it were not Rights Agent under this Agreement. Nothing herein shall preclude the Rights Agent from acting in any other capacity for the Company or for any other legal entity.

(i) The Rights Agent may execute and exercise any of the rights or powers hereby vested in it or perform any duty hereunder either itself or by or through its attorneys or agents, and the Rights Agent shall not be answerable or accountable for any act, default, neglect or misconduct of any such attorneys or agents or for any loss to the Company resulting from any such act, default, neglect or misconduct; provided, however, reasonable care was exercised in the selection and continued employment thereof.

(j) No provision of this Agreement shall require the Rights Agent to expend or risk its own funds or otherwise incur any financial liability in the performance of any of its duties hereunder or in the exercise of its rights if there shall be reasonable grounds for believing that repayment of such funds or adequate indemnification against such risk or liability is not reasonably assured to it.

(k) If, with respect to any Rights Certificate surrendered to the Rights Agent for exercise or transfer, split up, combination or exchange, the certificate attached to the form of assignment or form of election to purchase, as the case may be, has either not been completed or indicates an affirmative response to clause 1 and/or 2 thereof, the Rights Agent shall not take any further action with respect to such requested exercise or transfer without first consulting with the Company.

Section 21. Change of Rights Agent.

The Rights Agent or any successor Rights Agent may resign and be discharged from its duties under this Agreement upon thirty (30) days' notice in writing mailed to the Company, and to each transfer agent of the Common Stock and Preferred Stock, by registered or certified mail, and to the holders of the Rights Certificates by first-class mail. The Company may remove the Rights Agent or any successor Rights Agent upon thirty (30) days' notice in writing, mailed to the Rights Agent or successor Rights Agent, as the case may be, and to each transfer agent of the Common Stock and Preferred Stock, by registered or certified mail, and to the holders of the Rights Certificates by first-class mail. If the Rights Agent shall resign or be removed or shall otherwise become incapable of acting, the Company shall appoint a successor to the Rights Agent. If the Company shall fail to make such appointment within a period of thirty (30) days after giving notice of such removal or after it has been notified in writing of such resignation or incapacity by the resigning or incapacitated Rights Agent or by the holder of a Rights Certificate (who shall, with such notice, submit such holder's Rights Certificate for inspection by the Company), then any registered holder of any Rights Certificate may apply to any court of competent jurisdiction for the appointment of a new Rights Agent. Any successor Rights Agent, whether appointed by the Company or by such a court, shall be (a) a corporation or other legal business entity organized and doing business under the laws of the United States or of any State thereof, in good standing, which is authorized under such laws to exercise corporate trust or stock transfer powers and is subject to supervision or examination by federal or state authority and which has at the time of its appointment as Rights Agent a combined capital and surplus of at least \$50,000,000 or (b) an affiliate of a corporation or other legal business entity described in clause (a) of this sentence. After appointment, the successor Rights Agent shall be vested with the same powers, rights, duties and responsibilities as if it had been originally named as Rights Agent without further act or deed; but the predecessor Rights Agent shall deliver and transfer to the successor Rights Agent any property at the time held by it hereunder, and execute and deliver any further assurance, conveyance, act or deed necessary for the purpose. Not later than the effective date of any such appointment, the Company shall file notice thereof in

writing with the predecessor Rights Agent and each transfer agent of the Common Stock and the Preferred Stock, and mail a notice thereof in writing to the registered holders of the Rights Certificates or, if prior to the Distribution Date, to the registered holders of Common Stock. Failure to give any notice provided for in this Section 21, however, or any defect therein, shall not affect the legality or validity of the resignation or removal of the Rights Agent or the appointment of the successor Rights Agent, as the case may be.

Section 22. Issuance of New Rights Certificates.

Notwithstanding any of the provisions of this Agreement or of the Rights Certificates to the contrary, the Company may, at its option, issue new Rights Certificates evidencing Rights in such form as may be approved by the Board of Directors to reflect any adjustment or change in the Purchase Price and the number or kind or class of shares or other securities or property purchasable under the Rights Certificates made in accordance with the provisions of this Agreement. In addition, in connection with the issuance or sale of shares of Common Stock following the Distribution Date and prior to the redemption or expiration of the Rights, the Company (a) shall, with respect to shares of Common Stock so issued or sold pursuant to the exercise of stock options or under any employee plan or arrangement, granted or awarded as of the Distribution Date, or upon the exercise, conversion or exchange of securities issued by the Company hereinafter but prior to the Distribution Date, and (b) may, in any other case, if deemed necessary or appropriate by the Board of Directors of the Company, issue Rights Certificates representing the appropriate number of Rights in connection with such issuance or sale; provided, however, that (i) no such Rights Certificate shall be issued if, and to the extent that, the Company shall be advised by counsel that such issuance would create a significant risk of material adverse tax consequences to the Company or the Person to whom such Rights Certificate would be issued, and (ii) no such Rights Certificate shall be issued if, and to the extent that, appropriate adjustment shall otherwise have been made in lieu of the issuance thereof.

Section 23. Redemption and Termination.

(a) Subject to Section 27 hereof, the Board of Directors of the Company may, at its option, at any time on or before the earlier of (i) the close of business on the tenth business day following the Stock Acquisition Date (or, if the Stock Acquisition Date shall have occurred prior to the Record Date, the close of business on the tenth business day following the Record Date), or (ii) the Final Expiration Date, redeem all but not less than all the then outstanding Rights at a redemption price of \$.01 per Right, as such amount may be appropriately adjusted to reflect any stock split, stock dividend or similar transaction occurring after the date hereof (such redemption price being hereinafter referred to as the "Redemption Price"). Notwithstanding anything contained in this Agreement to the contrary, the Rights shall not be exercisable after the first occurrence of a Section 11(a)(ii) Event until such time as the Company's right of redemption hereunder has expired. The Company may, at its option, pay the Redemption Price in cash, shares of Common Stock (based on the "current market price," as defined in Section 11(d)(i) hereof, of the Common Stock at the time of redemption) or any other form of consideration, or any combination of any of the foregoing, deemed appropriate by the Board of Directors of the Company.

(b) Immediately upon the action of the Board of Directors of the Company ordering the redemption of the Rights, evidence of which shall have been filed with the Rights Agent and without any further action and without any notice, the right to exercise the Rights will terminate and the only right thereafter of the holders of Rights shall be to receive the Redemption Price for each Right so held. Promptly after the action of the Board of Directors ordering the redemption of the Rights, the Company shall give notice of such redemption to the Rights Agent and the holders of the then outstanding Rights by mailing such notice to all such holders at each holder's last address as it appears upon the registry books of the Rights Agent or, prior to the Distribution Date, on the registry books of the transfer agent for the Common Stock. Any notice which is mailed in the manner herein provided shall be deemed given, whether or not the holder receives the notice. Each such notice of redemption will state the method by which the payment of the Redemption Price will be made.

Section 24. Exchange.

(a) The Board of Directors of the Company may, at its option, at any time after any Person becomes an Acquiring Person, exchange all or part of the then outstanding and exercisable Rights (which shall not include Rights that have become void pursuant to the provisions of Section 7(e) hereof) for Common Stock at an exchange ratio of one share of Common Stock per Right, appropriately adjusted to reflect any stock split, stock dividend or similar transaction occurring after the date hereof (such exchange ratio being hereinafter referred to as the "Exchange Ratio"). Notwithstanding the foregoing, the Board of Directors of the Company shall not be empowered to effect such exchange at any time after any Person (other than the Company, any Subsidiary of the Company, any employee benefit plan of the Company or any such Subsidiary, or any entity holding Common Stock for or pursuant to the terms of any such plan), together with all Affiliates and Associates of such Person, becomes the Beneficial Owner of fifty percent (50%) or more of the Common Stock then outstanding.

(b) Immediately upon the action of the Board of Directors of the Company ordering the exchange of any Rights pursuant to subsection (a) of this Section 24 and without any further action and without any notice, the right to exercise such Rights shall terminate and the only right thereafter of a holder of such Rights shall be to receive that number of shares of Common Stock equal to the number of such Rights held by such holder multiplied by the Exchange Ratio. The Company shall promptly give public notice of any such exchange; provided, however, that the failure to give, or any defect in, such notice shall not affect the validity of such exchange. The Company promptly shall mail a notice of any such exchange to all of the holders of such Rights at their last addresses as they appear upon the registry books of the Company. Any notice which is mailed in the manner herein provided shall be deemed given, whether or not the holder receives the notice. Each such notice of exchange will state the method by which the exchange of the Common Stock for Rights will be effected and, in the event of any partial exchange, the number of Rights which will be exchanged. Any partial exchange shall be effected pro rata based on the number of Rights (other than Rights which have become void pursuant to the provisions of Section 7(e) hereof) held by each holder of Rights.

(c) In any exchange pursuant to this Section 24, the Company, at its option, may substitute Preferred Stock (or equivalent preferred stock, as such term is defined in paragraph (b) of Section 11 hereof) for Common Stock exchangeable for Rights, at the initial rate of one three-hundredths of a share of Preferred Stock (or equivalent preferred stock) for each share of Common Stock, as appropriately adjusted to reflect stock splits, stock dividends or other similar transactions effected after the date hereof.

(d) In the event that there shall not be sufficient Common Stock issued but not outstanding or authorized but unissued to permit any exchange of Rights as contemplated in accordance with this Section 24, the Company shall take all such action as may be necessary to authorize additional shares of Common Stock for issuance upon exchange of the Rights.

(e) The Company shall not be required to issue fractions of shares of Common Stock or to distribute certificates which evidence fractional shares of Common Stock. In lieu of such fractional shares of Common Stock, there shall be paid to the registered holders of the Right Certificates with regard to which such fractional shares of Common Stock would otherwise be issuable, an amount in cash equal to the same fraction of the current market value of a whole share of Common Stock. For the purposes of this subsection (e), the current market value of a whole share of Common Stock shall be the closing price of a share of Common Stock (as determined pursuant to Section 11(d)(i) hereof) for the Trading Day immediately prior to the date of exchange pursuant to this Section 24.

Section 25. Notice of Certain Events.

(a) In case the Company shall propose, at any time after the Distribution Date, (i) to pay any dividend payable in stock of any class to the holders of Preferred Stock or to make any other distribution to the holders of Preferred Stock (other than a regular quarterly cash dividend out of earnings or retained earnings of the Company), or (ii) to offer to the holders of Preferred Stock rights or warrants to subscribe for or to purchase any

additional shares of Preferred Stock or shares of stock of any class or any other securities, rights or options, or (iii) to effect any reclassification of its Preferred Stock (other than a reclassification involving only the subdivision of outstanding shares of Preferred Stock), or (iv) to effect any consolidation or merger into or with any other Person (other than a Subsidiary of the Company in a transaction which complies with Section 11(o) hereof), or to effect any sale or other transfer (or to permit one or more of its Subsidiaries to effect any sale or other transfer), in one transaction or a series of related transactions, of more than fifty percent (50%) of the assets, earning power or cash flow of the Company and its Subsidiaries (taken as a whole) to any other Person or Persons (other than the Company and/or any of its Subsidiaries in one or more transactions each of which complies with Section 11(o) hereof), or (v) to effect the liquidation, dissolution or winding up of the Company, then, in each such case, the Company shall give to each holder of a Rights Certificate, to the extent feasible and in accordance with Section 26 hereof, a notice of such proposed action, which shall specify the record date for the purposes of such stock dividend, distribution of rights or warrants, or the date on which such reclassification, consolidation, merger, sale, transfer, liquidation, dissolution, or winding up is to take place and the date of participation therein by the holders of the shares of Preferred Stock, if any such date is to be fixed, and such notice shall be so given in the case of any action covered by clause (i) or (ii) above at least twenty (20) days prior to the record date for determining holders of the shares of Preferred Stock for purposes of such action, and in the case of any such other action, at least twenty (20) days prior to the date of the taking of such proposed action or the date of participation therein by the holders of the shares of Preferred Stock whichever shall be the earlier.

(b) In case any Section 11(a)(ii) Event shall occur, then, in any such case, (i) the Company shall as soon as practicable thereafter give to each holder of a Rights Certificate, to the extent feasible and in accordance with Section 26 hereof, a notice of the occurrence of such event, which shall specify the event and the consequences of the event to holders of Rights under Section 11(a)(ii) hereof, and (ii) all references in the preceding paragraph to Preferred Stock shall be deemed thereafter to refer to Common Stock and/or, if appropriate, other securities issuable upon exercise of the Rights.

Section 26. Notices.

Notices or demands authorized by this Agreement to be given or made by the Rights Agent or by the holder of any Rights Certificates to or on the Company shall be sufficiently given or made if sent by first-class mail, postage prepaid, addressed (until another address is filed in writing with the Rights Agent) as follows:

Xerox Corporation
P.O. Box 1600
Stamford, Connecticut 06904
Attention: Secretary

Subject to the provisions of Section 21 hereof, any notice or demand authorized by this Agreement to be given or made by the Company or by the holder of any Rights Certificates to or on the Rights Agent shall be sufficiently given or made if sent by first-class mail, postage prepaid, addressed (until another address is filed in writing with the Company) as follows:

The First National Bank of Boston
c/o Boston EquiServe, Limited Partnership
150 Royall Street
Canton, Massachusetts 02021
Attention: Client Administration

Notices or demands authorized by this Agreement to be given or made by the Company or the Rights Agent to the holder of any Rights Certificate (or, if prior to the Distribution Date, to the holder of certificates representing shares of Common Stock) shall be sufficiently given or made if sent by first-class mail, postage prepaid, addressed to such holder at the address of such holder as shown on the registry books of the Company.

Section 27. Supplements and Amendments.

Prior to the Distribution Date, the Company and the Rights Agent shall, if the Company so directs, supplement or amend any provision of this Agreement without the approval of any holders of certificates representing shares of Common Stock. From and after the Distribution Date, the Company and the Rights Agent shall, if the Company so directs, supplement or amend this Agreement without the approval of any holders of Rights Certificates in order (i) to cure any ambiguity, (ii) to correct or supplement any provision contained herein which may be defective or inconsistent with any other provisions herein, (iii) to shorten or lengthen any time period hereunder or (iv) to change or supplement the provisions hereunder in any manner which the Company may deem necessary or desirable and which shall not adversely affect the interests of the holders of Rights Certificates; provided, from and after the Distribution Date, this Agreement may not be supplemented or amended to lengthen any time period hereunder pursuant to clause (iii) of this sentence unless such lengthening is for the purpose of protecting, enhancing or clarifying the rights of, and/or the benefits to, the holders of Rights. Upon the delivery of a certificate from an appropriate officer of the Company which states that the proposed supplement or amendment is in compliance with the terms of this Section 27, the Rights Agent shall execute such supplement or amendment. Prior to the Distribution Date, the interests of the holders of Rights shall be deemed coincident with the interests of the holders of Common Stock. Notwithstanding anything contained herein to the contrary, this Agreement may not be amended at a time when the Rights are not redeemable.

Section 28. Successors.

All the covenants and provisions of this Agreement by or for the benefit of the Company or the Rights Agent shall bind and inure to the benefit of their respective successors and assigns hereunder.

Section 29. Determinations and Actions by the Board of Directors, etc.

For all purposes of this Agreement, any calculation of the number of shares of Common Stock outstanding at any particular time, including for purposes of determining the particular percentage of such outstanding shares of Common Stock of which any Person is the Beneficial Owner, shall be made in accordance with Section 912 of the NYBCL. The Board of Directors of the Company shall have the exclusive power and authority to administer this Agreement and to exercise all rights and powers specifically granted to the Board of Directors of the Company, or the Company, or as may be necessary or advisable in the administration of this Agreement, including, without limitation, the right and power to (i) interpret the provisions of this Agreement, and (ii) make all determinations deemed necessary or advisable for the administration of this Agreement (including a determination to redeem or not redeem the Rights or to amend the Agreement). All such actions, calculations, interpretations and determinations (including, for purposes of clause (ii) below, all omissions with respect to the foregoing) which are done or made by the Board of Directors of the Company in good faith, shall (i) be final, conclusive and binding on the Company, the Rights Agent, the holders of the Rights and all other parties, and (ii) not subject the Board of Directors of the Company to any liability to the holders of the Rights.

Section 30. Benefits of this Agreement.

Nothing in this Agreement shall be construed to give to any Person other than the Company, the Rights Agent and the registered holders of the Rights Certificates (and, prior to the Distribution Date, registered holders of the Common Stock) any legal or equitable right, remedy or claim under this Agreement; but this Agreement shall be for the sole and exclusive benefit of the Company, the Rights Agent and the registered holders of the Rights Certificates (and, prior to the Distribution Date, registered holders of the Common Stock).

Section 31. Severability.

If any term, provision, covenant or restriction of this Agreement is held by a court of competent jurisdiction or other authority to be invalid, void or unenforceable, the remainder of the terms, provisions, covenants and restrictions of this Agreement shall remain in full force and effect and shall in no way be affected, impaired or

invalidated; provided, however, that notwithstanding anything in this Agreement to the contrary, if any such term, provision, covenant or restriction is held by such court or authority to be invalid, void or unenforceable and the Board of Directors of the Company determines in its good faith judgment that severing the invalid, void or unenforceable language from this Agreement would adversely affect the purpose or effect of this Agreement, the right of redemption set forth in Section 23 hereof shall be reinstated and shall not expire until the close of business on the tenth day following the date of such determination by the Board of Directors of the Company.

Without limiting the foregoing, if any provision of this Agreement requiring that a determination be made by less than the entire Board of Directors is held by a court of competent jurisdiction or other authority to be invalid, void or unenforceable, such determination shall then be made by the entire Board of Directors.

Section 32. Governing Law.

This Agreement, each Right and each Rights Certificate issued hereunder shall be deemed to be a contract made under the laws of the State of New York and for all purposes shall be governed by and construed in accordance with the laws of such State applicable to contracts made and to be performed entirely within such State.

Section 33. Counterparts.

This Agreement may be executed in any number of counterparts and each of such counterparts shall for all purposes be deemed to be an original, and all such counterparts shall together constitute but one and the same instrument.

Section 34. Descriptive Headings.

Descriptive headings of the several Sections of this Agreement are inserted for convenience only and shall not control or affect the meaning or construction of any of the provisions hereof.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed and their respective corporate seals to be hereunto affixed and attested, all as of the day and year first above written.

XEROX CORPORATION

By _____

Name:
Title:

Attest: _____

Name:
Title:

THE FIRST NATIONAL BANK OF BOSTON

By _____

Name:
Title:

Attest: _____

Name:
Title:

[Form of Rights Certificate]

Certificate No. R-

Rights

NOT EXERCISABLE AFTER APRIL 16, 2007 OR EARLIER IF REDEEMED OR EXCHANGED BY THE COMPANY. THE RIGHTS ARE SUBJECT TO REDEMPTION, AT THE OPTION OF THE COMPANY, AT \$.01 PER RIGHT ON THE TERMS SET FORTH IN THE RIGHTS AGREEMENT. UNDER CERTAIN CIRCUMSTANCES, RIGHTS BENEFICIALLY OWNED BY AN ACQUIRING PERSON OR ANY AFFILIATE OR ASSOCIATE THEREOF (AS SUCH TERMS ARE DEFINED IN THE RIGHTS AGREEMENT) AND ANY SUBSEQUENT HOLDER OF SUCH RIGHTS SHALL BECOME NULL AND VOID. [THE RIGHTS REPRESENTED BY THIS RIGHTS CERTIFICATE ARE OR WERE BENEFICIALLY OWNED BY A PERSON WHO WAS OR BECAME AN ACQUIRING PERSON OR AN AFFILIATE OR ASSOCIATE OF AN ACQUIRING PERSON (AS SUCH TERMS ARE DEFINED IN THE RIGHTS AGREEMENT). ACCORDINGLY, THIS RIGHTS CERTIFICATE AND THE RIGHTS REPRESENTED HEREBY SHALL BECOME NULL AND VOID IN THE CIRCUMSTANCES SPECIFIED IN SECTION 7(e) OF SUCH AGREEMENT.]*

Rights Certificate
XEROX CORPORATION

This certifies that _____, or registered assigns, is the registered owner of the number of Rights set forth above, each of which entitles the owner thereof, subject to the terms, provisions and conditions of the Rights Agreement, dated as of April 7, 1997 (as from time to time amended or supplemented, the "Rights Agreement"), between Xerox Corporation, a New York corporation (the "Company"), and The First National Bank of Boston (the "Rights Agent"), to purchase from the Company at any time prior to 5:00 P.M. (New York City time) on April 16, 2007 (the "Final Expiration Date"), unless earlier redeemed or exchanged by the Company, at the office or offices of the Rights Agent designated for such purpose, or its successors as Rights Agent, one three-hundredth of a fully paid, non-assessable share of Series A Cumulative Preferred Stock (the "Preferred Stock") of the Company, at a purchase price of \$[] per one three-hundredth of a share (the "Purchase Price"), upon presentation and surrender of this Rights Certificate with the Form of Election to Purchase and related Certificate duly executed. The number of Rights evidenced by this Rights Certificate (and the number of shares which may be purchased upon exercise thereof) set forth above, and the Purchase Price per share set forth above, are the number and Purchase Price as of April 16, 1997, based on the Preferred Stock as constituted at such date and may be adjusted in accordance with the provisions of the Rights Agreement. The Company reserves the right to require, prior to the occurrence of a Triggering Event (as such term is defined in the Rights Agreement) that a number of Rights be exercised so that only whole shares of Preferred Stock will be issued.

Upon the occurrence of a Section 11(a)(ii) Event (as such term is defined in the Rights Agreement), if the Rights evidenced by this Rights Certificate are beneficially owned by (i) an Acquiring Person or an Affiliate or Associate of any such Acquiring Person (as such terms are defined in the Rights Agreement), (ii) a transferee of any such Acquiring Person, Affiliate or Associate or (iii) under certain circumstances specified in the Rights Agreement, a transferee of a person who, after such transfer, became an Acquiring Person, or an Affiliate or Associate of an Acquiring Person, such Rights shall become null and void and no holder hereof shall have any right with respect to such Rights from and after the occurrence of such Section 11(a)(ii) Event.

* The portion of the legend in brackets shall be inserted only if applicable and shall replace the preceding sentences.

As provided in the Rights Agreement, the Purchase Price and the number and kind of shares of Preferred Stock or other securities which may be purchased upon the exercise of the Rights evidenced by this Rights Certificate are subject to modification and adjustment upon the happening of certain events, including Triggering Events.

This Rights Certificate is subject to all of the terms, provisions and conditions of the Rights Agreement, which terms, provisions and conditions are hereby incorporated herein by reference and made a part hereof and to which Rights Agreement reference is hereby made for a full description of the rights, limitations of rights, obligations, duties and immunities hereunder of the Rights Agent, the Company and the holders of the Rights Certificates, which limitations of rights include the temporary suspension of the exercisability of such Rights under the specific circumstances set forth in the Rights Agreement. Copies of the Rights Agreement are on file at the above-mentioned office of the Rights Agent and are also available upon written request to the Rights Agent.

This Rights Certificate, with or without other Rights Certificates, upon surrender at the principal office or offices of the Rights Agent designated for such purpose, may be exchanged for another Rights Certificate or Rights Certificates of like tenor and date evidencing Rights entitling the holder to purchase a like aggregate number of one three-hundredths of a share of Preferred Stock as the Rights evidenced by the Rights Certificate or Rights Certificates surrendered shall have entitled such holder to purchase. The Rights evidenced by this Rights Certificate may be transferred, in whole or in part, upon surrender of this Rights Certificate at the principal office or offices of the Rights Agent designated for such purpose, with the Form of Assignment and related Certificate duly executed. If the Rights evidenced by this Rights Certificate shall be transferred or exercised in part, the holder shall be entitled to receive upon surrender hereof another Rights Certificate or Rights Certificates for the number of whole Rights not transferred or exercised.

Subject to the provisions of the Rights Agreement, the Rights evidenced by this Certificate may generally be redeemed by the Company at its option at a redemption price of \$.01 per Right at any time on or before the earlier of the close of business on (i) the tenth business day following the Stock Acquisition Date (as such time period may be extended pursuant to the Rights Agreement) and (ii) the Final Expiration Date.

No fractional shares of Preferred Stock will be issued upon the exercise of any Right or Rights evidenced hereby (other than fractions which are integral multiples of one three-hundredth of a share of Preferred Stock, which may, at the election of the Company, be evidenced by depositary receipts), but in lieu thereof a cash payment will be made, as provided in the Rights Agreement.

No holder of this Rights Certificate shall be entitled to vote or receive dividends or be deemed for any purpose the holder of shares of Preferred Stock or of any other securities of the Company which may at any time be issuable on the exercise hereof, nor shall anything contained in the Rights Agreement or herein be construed to confer upon the holder hereof, as such, any of the rights of a shareholder of the Company or any right to vote for the election of directors or upon any matter submitted to shareholders at any meeting thereof, or to give or withhold consent to any corporate action, or to receive notice of meetings or other actions affecting shareholders (except as provided in the Rights Agreement), or to receive dividends or subscription rights, or otherwise, until the Right or Rights evidenced by this Rights Certificate shall have been exercised as provided in the Rights Agreement.

This Rights Certificate shall not be valid or obligatory for any purpose until it shall have been countersigned by the Rights Agent.

WITNESS the facsimile signature of the proper officers of the Company and its corporate seal.

Dated as of _____, __

ATTEST:

XEROX CORPORATION

Secretary

By _____
Title

Countersigned:

THE FIRST NATIONAL BANK OF BOSTON

By _____
Authorized Signature

[Form of Reverse Side of Rights Certificate]

FORM OF ASSIGNMENT

(To be executed by the registered holder if such holder desires to transfer the Rights Certificate.)

FOR VALUE RECEIVED _____ hereby sells, assigns and transfers unto

(Please print name and address of transferee)

this Rights Certificate, together with all right, title and interest therein, and does hereby irrevocably constitute and appoint _____ Attorney, to transfer the within Rights Certificate on the books of the within-named Company, with full power of substitution.

Dated: _____, __

Signature

Signature Guaranteed:

Signatures must be guaranteed by a member firm of a registered national stock exchange, a member of the National Association of Securities Dealers, Inc. or a commercial bank or trust company having an office or correspondent in the United States.

Certificate

The undersigned hereby certifies by checking the appropriate boxes that:

(1) this Rights Certificate [] is [] is not being sold, assigned and transferred by or on behalf of a Person who is or was an Acquiring Person or an Affiliate or Associate of any such Acquiring Person (as such terms are defined pursuant to the Rights Agreement);

(2) after due inquiry and to the best knowledge of the undersigned, it [] did [] did not acquire the Rights evidenced by this Rights Certificate from any Person who is, was or subsequently became an Acquiring Person or an Affiliate or Associate of an Acquiring Person.

Dated: _____, __

Signature

Signature Guaranteed:

Signatures must be guaranteed by a member firm of a registered national stock exchange, a member of the National Association of Securities Dealers, Inc. or a commercial bank or trust company having an office or correspondent in the United States.

NOTICE

The signature to the foregoing Assignment and Certificate must correspond to the name as written upon the face of this Rights Certificate in every particular, without alteration or enlargement or any change whatsoever.

FORM OF ELECTION TO PURCHASE

(To be executed if holder desires to exercise Rights represented by the Rights Certificate.)

To: XEROX CORPORATION:

The undersigned hereby irrevocably elects to exercise _____ Rights represented by this Rights Certificate to purchase the shares of Preferred Stock issuable upon the exercise of the Rights (or such other securities of the Company or of any other person which may be issuable upon the exercise of the Rights) and requests that certificates for such shares be issued in the name of and deliverable to:

Please insert social security or other identifying number

(Please print name and address)

If such number of Rights shall not be all the Rights evidenced by this Rights Certificate, a new Rights Certificate for the balance of such Rights shall be registered in the name of and delivered to:

Please insert social security or other identifying number

(Please print name and address)

Dated: _____, ____

Signature

Signature Guaranteed:

Signatures must be guaranteed by a member firm of a registered national stock exchange, a member of the National Association of Securities Dealers, Inc. or a commercial bank or trust company having an office or correspondent in the United States.

Certificate

The undersigned hereby certifies by checking the appropriate boxes that:

- (1) the Rights evidenced by this Rights Certificate [] are [] are not being exercised by or on behalf of a Person who is or was an Acquiring Person or an Affiliate or Associate of any such Acquiring Person (as such terms are defined pursuant to the Rights Agreement);
- (2) after due inquiry and to the best knowledge of the undersigned, it [] did [] did not acquire the Rights evidenced by this Rights Certificate from any Person who is, was or became an Acquiring Person or an Affiliate or Associate of an Acquiring Person.

Dated: _____, ____

 Signature

Signature Guaranteed:

Signatures must be guaranteed by a member firm of a registered national stock exchange, a member of the National Association of Securities Dealers, Inc. or a commercial bank or trust company having an office or correspondent in the United States.

NOTICE

The signature to the foregoing Election to Purchase and Certificate must correspond to the name as written upon the face of this Rights Certificate in every particular, without alteration or enlargement or any change whatsoever.

**SUMMARY OF RIGHTS TO PURCHASE
PREFERRED STOCK**

Dividend of Rights to Purchase Preferred Stock

On April 7, 1997, the Board of Directors of Xerox Corporation (the "Company") declared a dividend distribution of one Right for each outstanding share of common stock, par value \$1.00 per share, of the Company (the "Common Stock") to shareholders of record at the close of business on April 16, 1997 (the "Record Date"). Each Right entitles the registered holder to purchase from the Company one three-hundredth of a share of a series of cumulative preferred stock of the Company designated Series A Cumulative Preferred Stock (the "Preferred Stock"), at a price of \$[] (the "Purchase Price"), subject to adjustment. The description and terms of the Rights are set forth in a Rights Agreement (the "Rights Agreement") between the Company and The First National Bank of Boston, as Rights Agent (the "Rights Agent").

Distribution of the Rights; Rights Certificates

Until the Distribution Date (or earlier redemption or expiration of the Rights), which is defined below, the Rights will be evidenced, with respect to any of the Common Stock certificates outstanding prior to the Distribution Date, by such Common Stock certificates. Until the Distribution Date, (or earlier redemption or expiration of the Rights), (i) the Rights will be transferred with and only with the Common Stock, (ii) new Common Stock certificates issued after the Record Date upon transfer, replacement or new issuance of Common Stock will be deemed to be issued with Rights and will contain a notation incorporating the Rights Agreement by reference and (iii) the surrender for transfer of any certificate for Common Stock will also constitute the transfer of the Rights associated with the Common Stock represented by such certificate.

As soon as practicable following the Distribution Date, separate certificates evidencing the Rights ("Rights Certificates") will be mailed to holders of record of the Common Stock as of the close of business on the Distribution Date. From and after the Distribution Date, such separate Rights Certificates alone will evidence the Rights. Except as otherwise determined by the Board of Directors, and except in connection with the exercise of employee stock options, any other issuance of Common Stock with respect to awards outstanding under employee benefit plans outstanding on the Distribution Date and in connection with the conversion of convertible securities issued after April 7, 1997, only Common Stock issued prior to the Distribution Date will be issued with Rights.

Definition of Distribution Date

"Distribution Date" shall mean the earlier to occur of (i) 10 business days following the date of a public announcement that a person, together with persons affiliated or associated with it, has acquired beneficial ownership of 20% or more of the outstanding Common Stock or (ii) 10 business days following the earlier of the commencement of, or the first public announcement of the intent to commence, a tender offer or exchange offer by a person other than the Company if, upon consummation of the offer, such person, together with persons affiliated or associated with it, would be the beneficial owner of 20% or more of the outstanding Common Stock.

Exercise and Expiration of the Rights

The Rights are not exercisable until the Distribution Date. The Rights will expire at the close of business on April 16, 2007 (the "Final Expiration Date"), unless earlier redeemed or exchanged by the Company as described below.

Adjustment of the Purchase Price

The Purchase Price payable and the number of and kind of shares of Preferred Stock or other securities or property issuable upon exercise of the Rights are subject to adjustment from time to time to prevent dilution (i) in

the event of a stock dividend on, or a subdivision, combination or reclassification of, the Preferred Stock, (ii) upon the grant to holders of the Preferred Stock of certain rights, options or warrants to subscribe for Preferred Stock (or shares having the same rights, privileges and preferences as the shares of Preferred Stock) at less than the current market price of the Preferred Stock or (iii) upon the distribution to holders of the Preferred Stock of evidences of indebtedness, securities, cash or assets (excluding regular periodic dividends out of earnings or retained earnings) or of subscription rights or warrants (other than those referred to above). With certain exceptions, no adjustment in the Purchase Price will be required until cumulative adjustments require an adjustment of at least 1% in the Purchase Price. No fractional shares of Preferred Stock will be issued upon the exercise of any Right or Rights (other than fractions which are integral multiples of one three-hundredth of a share of Preferred Stock), and in lieu thereof an adjustment in cash will be made based on the current market price of the Preferred Stock on the last trading day prior to the date of exercise.

Effect of a Triggering Event

Any of the events described in the succeeding second and fourth paragraphs are defined as a “Triggering Event.”

“Acquiring Person” shall mean any person who constitutes an “Interested Shareholder” as defined in Section 912 of the New York Business Corporation Law, in effect from time to time, (generally defined to include any person who or which, together with all persons affiliated or associated with it, shall be the beneficial owner of 20% or more of the shares of Common Stock then outstanding), but shall not include the Company, any subsidiary of the Company, any employee benefit plan of the Company or of any subsidiary of the Company, or any person or entity organized, appointed or established by the Company for or pursuant to the terms of any such plan.

In the event that a person, together with persons affiliated or associated with it, becomes an Acquiring Person (except pursuant to an offer for all outstanding shares of Common Stock that the independent directors determine to be fair and adequate to shareholders and otherwise in the best interests of the Company and its shareholders or as a result of repurchases of stock by the Company or certain inadvertent actions by institutional or certain other shareholders), proper provision shall be made so that each holder of a Right, except as provided below, shall thereafter have the right to receive, upon exercise thereof, Common Stock (or, in certain circumstances as determined by the Company, other securities, cash, or other property) having a value of two times the Purchase Price. Notwithstanding any of the foregoing, following the occurrence of the event set forth in this paragraph, all Rights that are, or (under certain circumstances set forth in the Rights Agreement) were, beneficially owned by any Acquiring Person (or by certain related parties and transferees) will be null and void. Rights are not exercisable following the occurrence of the event set forth above until such time as the Rights are no longer redeemable by the Company, as set forth below.

For example, at an exercise price of \$[X] per Right, each Right not owned by an Acquiring Person (or by certain related parties and transferees) following an event set forth in the preceding paragraph would entitle its holder to purchase \$[2X] worth of Common Stock (or other consideration, as noted above) for \$[X]. Assuming that the Common Stock had a per share value of \$[X/3] at such time, the holder of each valid Right would be entitled to purchase 6 shares of Common Stock for \$[X].

In the event that, at any time following the Stock Acquisition Date, which is defined below, (i) the Company is acquired in a merger or other business combination transaction in which the Company is not the surviving corporation (other than a merger which follows an offer described in the second preceding paragraph), or (ii) fifty percent (50%) or more of the Company’s assets, cash flow or earning power is sold or transferred, proper provision shall be made so that each holder of a Right (other than Rights that theretofore become null and void as described in the second preceding paragraph) shall thereafter have the right to receive, upon exercise thereof, common stock of the acquiring company having a value equal to two times the exercise price of the Right.

Redemption of the Rights

At any time until the close of business on the tenth business day following the date of a public announcement that a person has become an Acquiring Person (the "Stock Acquisition Date"), the Company may redeem all, but not less than all, the then outstanding Rights at a redemption price of \$.01 per Right (the "Redemption Price"). Immediately upon the action of the Board of Directors of the Company ordering redemption of the Rights, the Rights will terminate and the only right of the holder of Rights will be to receive the Redemption Price.

Exchange of the Rights

At any time after the acquisition by a person or group of affiliated or associated persons of beneficial ownership of 20% or more of the outstanding shares of Common Stock and prior to the acquisition by such person or group of 50% or more of the outstanding shares of Common Stock, the Board of Directors may exchange the Rights (other than Rights owned by such person or group which have become void), in whole or in part, at an exchange ratio of one share of Common Stock, or one three-hundredth of a share of Preferred Stock (or of a share of a class or series of the Company's preferred stock having equivalent rights, preferences and privileges), per Right (subject to adjustment).

Amendment of the Rights Agreement

Any of the provisions of the Rights Agreement may be amended by the Board of Directors of the Company prior to the Distribution Date. Thereafter, the provisions of the Rights Agreement may be amended by the Board of Directors of the Company in order to (i) cure any ambiguity, (ii) shorten or lengthen any time period under the Rights Agreement, or (iii) make changes that will not adversely affect the interests of the holders of Rights; provided such lengthening is for the purpose of protecting, enhancing or clarifying the rights of, and/or the benefits to, the holders of Rights, and further; provided, that no amendment may be made at such time as the Rights are not redeemable.

Exercise of the Right entitles the Right holder to the rights of a shareholder

Until a Right is exercised, the holder thereof, as such, will have no rights as a shareholder of the Company, including, without limitation, the right to vote or to receive dividends. While the distribution of the Rights will not be taxable to shareholders or to the Company, shareholders may, depending on the circumstances, recognize taxable income in the event that the Rights become exercisable for Common Stock (or other consideration) of the Company or for common stock of the acquiring company as set forth above.

Copy of the Rights Agreement available

A copy of the Rights Agreement has been filed with the Securities and Exchange Commission as an Exhibit to a Current Report on Form 8-K. A copy of the Rights Agreement will be available free of charge from the Company. This summary description of the Rights does not purport to be complete and is qualified in its entirety by reference to the Rights Agreement, which is incorporated herein by reference.

**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 Compensation Committee. To the extent that performance measures are achieved at or between threshold and maximum levels (as shall be determined by the Compensation 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 for any reason (including Disability), other than death or for Cause, 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. *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.

14. *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.

15. *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.

16. *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.

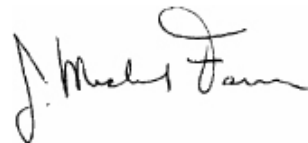
17. *Separability.* In case any provision in the Agreement, or in any other instrument referred to herein, shall become invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions in the Agreement, or in any other instrument referred to herein, shall not in any way be affected or impaired thereby.

18. *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



Award Summary

Executive Long-Term Incentive Program Grant (Officers)

«First_Name» «Last_Name»
Date of Agreement and Award: **January 1, 2005**

Value on Date of Grant:

«Approved_Value_»

Performance Shares

Number of Performance Shares:

«Performance_Shares_»

Vesting Date of All Performance Shares Earned:

- on or after Compensation Committee approval following the first earnings release after 1/1/08

Performance Shares Earned if Annual Target Performance is Achieved:

- 1/3 of grant on or after Compensation Committee approval following the first earnings release after each of the following dates: 1/1/06, 1/1/07 and 1/1/08

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 or after Compensation Committee approval following the first earnings release after 1/1/08

An example of performance share vesting can be found in the 2005 E-LTIP communication materials.

* Notwithstanding the above at the Company's discretion, Employee may irrevocably elect, on or before June 30, 2005, 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

Annual Performance Incentive Plan for 2004 ("2004 APIP")

Under the 2004 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 2004, 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 2004 APIP. The performance measures and weightings for 2004 were total revenue (30%), earnings per share (40%), cash flow from operations (15%) and accounts receivable (15%).

For 2004, the performance against the 2004 APIP goals for all factors except total revenue exceeded target. Accordingly, the Committee approved an average payout for officers of 120% of target, in light of the overall results delivered by the Company in 2004.

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 are total revenue (30%), earnings per share (40%) and cash flow from operations (30%).

Individual payments will be subject to the review and approval of the Committee following the completion of the 2005 fiscal year.

2005 Executive Long-Term Incentive Program (“2005 E-LTIP”)

Under the 2005 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 2005 E-LTIP are: (i) (60%) Diluted Earnings Per Share (EPS) 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 in excess of \$50 million pre-tax on an individual basis): legal and regulatory matters; loss (gain) on early extinguishment of debt; business divestitures and asset sale losses (gains); impairment of long-lived assets; impairment of goodwill and other intangibles; restructuring charges resulting from a strategically-named corporate initiative and/or annual cumulative restructuring charges in excess of \$50 million, exclusive of previously identified initiatives. In addition, any adjustment greater than \$50 million of the annual tax provision resulting from a change in tax law shall be excluded from the compilation of EPS; and (ii) (40%) Net Cash provided by (used for) Operating Activities as reported in the Company’s audited financial statements, as adjusted for the cash flow impacts (inflows and outflows) resulting from those items as identified within the definition of Diluted EPS. In addition, any individual special discretionary pension funding greater than \$50 million shall be excluded.

Earning of the shares will be based on achievement of the performance targets as defined above, subject to the review and certification of the Committee following the completion of each of the next three fiscal years.

2004 Restatement
of
XEROX CORPORATION
UNFUNDED RETIREMENT INCOME GUARANTEE PLAN

XEROX CORPORATION, a New York corporation having its principal executive office in the City of Stamford, County of Fairfield and State of Connecticut, hereby adopts the XEROX CORPORATION UNFUNDED RETIREMENT INCOME GUARANTEE PLAN effective on the Effective Date as follows:

Restatement Effective April 2, 2004

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**2004 RESTATEMENT
OF
XEROX CORPORATION
UNFUNDED RETIREMENT INCOME GUARANTEE PLAN**

ARTICLE 1

Definitions

When used herein, the words and phrases defined hereinafter shall have the following meaning unless a different meaning is clearly required by the context of the Plan. Terms used herein which are defined in Article 1 of the Funded Plan shall have the meanings assigned to them in the Funded Plan.

Section 1.1. Administrator. The Administrator appointed by the Vice President, Human Resources of the Company

Section 1.2. Average Monthly Compensation shall be determined under Article 1 of the Funded Plan, without regard to the dollar limitation contained therein, and, notwithstanding the above, shall also include any compensation provided under the Xerox Corporation CEO Challenge Bonus Program.

Section 1.3. Board. The Board of Directors of the Company.

Section 1.4. Code. The Internal Revenue Code of 1986 as amended, or as it may be amended from time to time.

Section 1.5. Company. Xerox Corporation.

Section 1.6. Effective Date. The original effective date of the Plan was July 1, 1977. This Restatement is effective as of April 2, 2004.

Section 1.7. Employee. A Member in the Funded Plan.

Section 1.8. Funded Plan. The Xerox Corporation Retirement Income Guarantee Plan.

Section 1.9. Plan. The "Xerox Corporation Unfunded Retirement Income Guarantee Plan", as set forth herein or in any amendment hereto.

ARTICLE 2

Purpose of Plan

Section 2.1. Purpose. The Plan is designed to provide retirement benefits payable out of the general assets of the Company as provided in Section 4.1.

ARTICLE 3

Eligibility

Section 3.1. Eligibility. All Employees and beneficiaries of Employees eligible to receive benefits from the Funded Plan shall be eligible to receive benefits under this Plan in accordance with Section 4.1 regardless of when the Employees may have retired.

ARTICLE 4

Benefits

Section 4.1. Amount of Benefits. The amount of the benefit payable under the Plan shall be equal to the monthly benefit which would be payable to or on behalf of an Employee under the Funded Plan as a Life Annuity if Section 9.5 of the Funded Plan were inapplicable and if the amount of any compensation deferred by the Employee was included in the calculation of Average Monthly Compensation (except the increase in compensation which became payable under the Company's policy of increasing compensation by the amount which cannot be added to an Employee's accounts under the Profit Sharing Plan by reason of the limitation contained in Section 415 of the Code), less the following:

(a) The monthly benefit actually payable as a Life Annuity to or on behalf of the Employee under the Funded Plan other than the RIGP Plus Benefit payable under Article 17 thereof.

(b) The monthly benefit which could be purchased as a Life Annuity with the balance, if any, in the Employee's deferred compensation account under the Xerox Corporation Deferred Compensation Plan For Executives arising from the Retirement Account portion of the Profit Sharing Adjustment under Section 4 thereof.

(c) Any amount paid to the Employee from which FICA taxes are withheld related to nonqualified retirement benefits from a plan sponsored by the Company which have not been previously withheld (or deemed to be withheld because the maximum tax had already been paid) and are payable upon retirement but cannot be withheld from any single sum payment of compensation or other nonqualified plan benefits translated to an annuity (single life or joint and survivor as appropriate) payable commencing on the date of retirement.

(d) The amount of that certain provisional supplement provided to certain high-paid Employees in RIGP effective in 1989 when the RIGP benefit was modified payable to Employees in a lump sum translated to an annuity (single life or joint and survivor as appropriate) payable commencing on the date of retirement.

Section 4.1A Additional Benefit. In addition to the benefit provided by the foregoing provisions of Section 4.1, there shall be an additional benefit equal to the excess of (a) over (b) where (a) is the RIGP Plus Benefit which would be payable under Article 17 of the Funded Plan as if "Annual Pay", as defined in Article 17 of the Funded Plan, had been calculated without regard to the applicable limitations of the "Code" as defined in the Funded Plan and to include deferred compensation to the extent not already included and (b) is the RIGP Plus Benefit calculated under Article 17 of the Funded Plan subject to such Code limitations. Notwithstanding any provision of this Plan to the contrary, the benefit under this Section 4.1A shall be payable in cash in a lump sum. Such benefit shall be paid at the time specified in Section 4.4. If payment is not made at or about termination of employment, the Administrator may, in his or her discretion, determine to increase the amount of the additional benefit at the CBRA interest rate (within the meaning of the Funded Plan) for the period between termination and payout hereunder.

Section 4.2. Form of Benefit Payments. The forms of benefit available under the Plan shall be for single Employees a 10-Year certain and life annuity or a life annuity and for married Employees a 50% or 100% joint and survivor annuity option, all as shall have been elected by Employee on forms provided by the Administrator. The benefit payable to a single Employee who has failed to make such an election shall be a life annuity and for any such married Employee a 50% joint and survivor annuity. The 10-year certain and life annuity is the actuarial equivalent of the life annuity and the 100% joint and survivor annuity is the actuarial equivalent of the 50% joint and survivor annuity. Except as otherwise provided in Section 5.1 in no event is the benefit payable in a lump sum.

Notwithstanding the above, the lump sum actuarial equivalent of any benefit otherwise payable as a monthly amount of one hundred dollars (\$100.00) or less, shall be distributed in accordance with Section 4.3. The interest rate used in computing the lump sum actuarial equivalent amount shall be the interest rate described in the section entitled "Optional Forms of Benefit Payment" of the Funded Plan.

Section 4.3. Death Prior to Benefit Commencement. The spouse of a Participant who dies before commencement of benefits under the Plan shall be entitled to a survivor benefit calculated in accordance with Article 7 of the Funded Plan in an amount equal to the amount determined under (a) or (b) below.

(a) In the case of a Participant who is eligible to retire under the Funded Plan on the date of his or her death, one-half of the retirement benefit to which the Participant would have been entitled under the Plan if he or she had retired on the last day of the month coincident with or next following the date of the Participant's death; or

(b) In the case of a Participant who is not eligible to retire under the Funded Plan on the date of his or her death, one-half of the retirement benefit to which the Participant would have been entitled under the Plan if he or she had terminated on his or her date of death and survived to the date of payment of benefits as determined under Section 4.4 below.

Section 4.4. Time of Benefit Payments. Benefits due under the Plan shall be paid coincident with the payment date of benefits under the Funded Plan or at such other time or times as the Administrator in his discretion determines.

Section 4.5. Employee's Rights Unsecured. The benefits payable under this Plan shall be unfunded. Consequently, no assets shall be segregated for purposes of this Plan and placed beyond the reach of the Company's general creditors. The right of any Employee to receive benefits under the provisions of the Plan shall be an unsecured claim against the general assets of the Company.

ARTICLE 5

Change in Control

Section 5.1 Change In Control. Notwithstanding anything to the contrary in this Plan, in the event of a change in control of the Company, as hereinafter defined, each Employee, including retired Employees, shall be entitled to a benefit hereunder without regard to his or her age or Years of Service at the time of such change in control. Upon the occurrence of a change in control of the Company, the benefit of each Employee shall be payable in a lump sum within 30 days of such change in control equal in amount to the then present value of a benefit expressed in the form provided in Section 4.1 hereof, commencing on the later of (i) the date of such change in control and (ii) the date the Employee would be eligible for a benefit under the Funded Plan, and based upon such Employee's Average Monthly Compensation and Years of Participation as of the date of such change in control. A "change in control of the Company" shall have the meaning set forth in the Xerox Corporation Retirement Income Guarantee Plan, as may be amended or restated from time to time.

Section 5.2. Termination of Employment Following Change in Control. Upon the termination of employment of a Employee following a change in control of the Company, such Employee, if he or she has otherwise satisfied the requirements of the Funded Plan for a benefit, shall be entitled to a benefit equal to the benefit to which he or she would have been entitled without application of Section 5.1, reduced (but not below zero) to reflect the value of the benefit he or she received pursuant to Section 5.1.

Section 5.3. Calculation of Present Value. For purposes of Section 5.1 hereof, the present value of a benefit shall be calculated based upon the interest rate which would be used by the Pension Benefit Guaranty Corporation for purposes of determining lump sums for benefits payable as immediate annuities with respect to plans terminating on the date on which the change in control of the Company occurs and the 1983 GAM mortality table, *provided, however*, that effective upon the date that the applicable interest rate as specified in Section 417(e)(3)(A) of the Code is adopted for use in the Funded Plan, the present value hereunder shall thereafter be determined under such applicable interest rate and the applicable mortality table as defined in Section 417(e)(3)(A)(ii)(I) of the Code. For purposes of the Funded Plan, each Employee shall be treated as if they terminated employment upon the change in control and had their benefits determined as if they were to begin receiving benefits on the commencement date used in developing the present value of the benefit in Section 5.1.

ARTICLE 6

Plan Administration

Section 6.1. Duties of the Administrator. The Plan shall be administered by the Administrator in accordance with its terms and purposes. The Administrator shall determine the amount and manner of payment of the benefits due to or on behalf of each Participant from the Plan and shall cause them to be paid by the Company accordingly.

Section 6.2. Authority of the Administrator. The Administrator may

(i) Construe and interpret the provisions of the Plan, determine all questions of fact, and make rules and regulations under the Plan to the extent deemed advisable or helpful by the Administrator;

(ii) Should any defect, omission, ambiguity or inconsistency in the Plan be discovered at any time, the Administrator shall be empowered to take such action as may be necessary to correct such defect, rectify such omission, resolve such ambiguity or reconcile such inconsistency.

Section 6.3. Claims and Appeals. Claims and appeals regarding benefits under the Plan shall be determined pursuant to section 503 of ERISA.

Section 6.4. Finality of Decisions. The decisions made by and the actions taken by the Administrator in the administration of the Plan shall be final and conclusive on all persons, and the Administrator shall not be subject to individual liability with respect to the Plan.

Section 6.5. Limitations of Actions. Any action brought in state or federal court for the alleged wrongful denial of Plan benefits or for the alleged intentional interference with any Plan rights to which a person is or may become entitled under ERISA must be commenced within one year after the cause of action accrued.

ARTICLE 7

Amendment and Termination

Section 7.1. Amendment and Termination. It is the intention of the Company to continue the Plan indefinitely. The Company expressly reserves the right to amend the Plan at any time and in any particular manner, provided that any such amendment shall be made in accordance with ERISA. Such amendments, other than amendments relating to termination of the Plan or relating to benefit levels under Section 4.1 of the Plan, may be effected by (i) the Board of Directors, (ii) a duly constituted committee of the Board of Directors, or (iii) the Vice President of the Company responsible for human resources or a representative thereof. In the event such office is vacant at the time the amendment is to be made, the Chief Executive Officer of the Company shall approve such amendment or appoint a representative. Amendments relating to termination of the Plan or relating to benefit levels under Section 4.1 of the Plan shall be effected pursuant to a resolution duly adopted by the Board of Directors of the Company, or a duly constituted committee of the Board of Directors of the Company, in accordance with the Business Corporation Law of the State of New York.

Any amendment, alteration, modification or suspension under subsection (iii) of the preceding paragraph shall be set forth in a written instrument executed by any Vice President of the Company and by the Secretary or an Assistant Secretary of the Company.

Section 7.2. Contractual Obligation. Notwithstanding Section 7.1, the Company hereby makes a contractual commitment to pay the benefits accrued under the Plan to the extent it is financially capable of meeting such obligations.

ARTICLE 8

Miscellaneous

Section 8.1. No Employment Rights. Nothing contained in the Plan shall be construed as a contract of employment between the Company and an Employee, or as a right of any Employee to be continued in the employment of the Company, or as a limitation of the right of the Company to discharge any of its Employees, with or without cause.

Section 8.2. Assignment. The benefits payable under this Plan may not be assigned or alienated except as may otherwise be required by law or pursuant to the terms of a domestic relations order that has been approved by the Plan Administrator.

Section 8.3. Law Applicable. This Plan shall be governed by the laws of the State of New York.

Section 8.4. Section 409A of the Internal Revenue Code. Notwithstanding any other provision of the Plan, no election by any participant or beneficiary, and no payment to any individual, shall be permitted under the Plan if such election or payment would cause any amount to be taxable under section 409A of the Internal Revenue Code with respect to any individual.

2004 Restatement
of
XEROX CORPORATION
UNFUNDED SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN

XEROX CORPORATION, a New York corporation having its principal executive office in the City of Stamford, County of Fairfield and State of Connecticut, hereby adopts the XEROX CORPORATION UNFUNDED SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN effective on the Effective Date as follows:

Restatement Effective April 2, 2004

UNFUNDED SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN

Section 1. *Plan Name*

The plan name is the Xerox Corporation Unfunded Supplemental Executive Retirement Plan (referred to herein as the "Plan" or "SERP").

Section 2. *Effective Date*

The original effective date of the Plan is June 30, 1982. The Plan was restated on five previous occasions, effective February 4, 1985, January 1, 1990, December 6, 1993, December 9, 1996 and October 13, 1997. This Restatement is effective as of April 2, 2004.

Section 3. *Purpose of the Plan*

The Plan is designed to address special circumstances involved in the retirement of executives.

Section 4. *Covered Employees*

The following employees of Xerox Corporation (the "Company") are covered by the Plan:

(A) All employees who were corporate officers of the Company at grade level 25 and above on the original effective date of the Plan (the "Grandfathered Officers").

(B) All employees who were corporate officers at grades 23 or 24 on the original effective date of the Plan or who first become corporate officers of the Company at grade level 23 and above after the original effective date of the Plan and do not fall within categories (D) through (G) below (the "Officers").

(C) Certain employees who received a letter dated September 2, 1982 from David T. Kearns regarding Executive Retirement Guidelines (the "Guideline Employees").

(D) All employees who were corporate officers of the Company on the date of the 1996 Restatement who first commenced employment with the Company on or after attainment of age 40 and whose names appeared on a list presented at the meeting of the Executive Compensation and Benefits Committee held December 9, 1996 and made part of the records of that meeting which list is incorporated herein by reference and made a part of the Plan ("Grandfathered Mid-Career Officers").

(E) All employees who after the date of the 1996 Restatement first commence employment with the Company on or after attainment of age 40 who are elected corporate officers and whose names were added to the list referred to in Section 4(D) above upon selection by the Chief Executive Officer of the Company as maintained with the records of the Executive Compensation Department of the Company which list as so modified from time to time is incorporated herein by reference and made a part hereof ("Mid-Career Officer Hires").

(F) All employees who after the date of the 1996 Restatement are elected officers of the Company and are authorized by the Compensation Committee of the Board of Directors to receive benefits under this Plan.

(G) All employees who were in payroll Band A of the Company on the date of the 1996 Restatement who first commenced employment with the Company on or after attainment of age 40 and whose names are set forth on a list which has been approved by the Vice President responsible for Human Resources and placed with the records of the Executive Compensation Department of the Company which list is incorporated herein by reference and made a part of the Plan ("Grandfathered Mid-Career Band A Employees").

(H) All employees who after the date of the 1996 Restatement first commence employment with the Company on or after attainment of age 40 who are hired into payroll Band A selected by the Vice President of the Company responsible for Human Resources, or his or her designee, such selection to be evidenced by the placement of the

employee's name on a list to be maintained from time to time by such Vice President or his or her designee, which list is incorporated herein by reference and made a part of the Plan ("Mid-Career Band A Hires").

(I) Grandfathered Mid-Career Officers, Mid-Career Officer Hires, Grandfathered Mid-Career Band A Employees and Mid-Career Band A Hires are sometimes together referred to as "Mid-Career Executives".

(J) The employees referred to in paragraphs A through H above are together referred to herein as "Participants".

Section 5. *Eligibility for Benefits*

Participants must have attained the following age and completed the following Years of Service to be eligible for benefits under the Plan:

(A) Grandfathered Officers and Guideline Employees—age 55, Years of Service—5.

(B) Officers— age 60, Years of Service—10.

(C) Grandfathered Mid-Career Officers—the age set forth opposite their respective names on Schedule A, Years of Service—5.

(D) Mid-Career Officer Hires—the age determined by the Chief Executive Officer of the Company as reflected in Schedule A, Years of Service—5.

(E) Grandfathered Mid-Career Band A Employees—the age set forth opposite their respective names on the Schedule B, Years of Service—5.

(F) Mid-Career Band A Hires—the age determined by the Vice President responsible for Human Resources or his or her delegate as set forth on Schedule C referred to above, Years of Service 5.

Section 6. *Supplemental Retirement Benefit*

(A) The benefit payable under the Plan shall be a monthly retirement benefit equal to:

One and two-thirds percent of Average Monthly Compensation of the Participant multiplied by the number of full and fractional Years of Participation up to thirty less

(a) One and two-thirds percent of the Social Security Benefit multiplied by the number of full and fractional Years of Participation up to thirty; and

(b) The monthly retirement benefit payable under the Company's Retirement Income Guarantee Plan ("RIGP") (stated as a Life Annuity)* as it is in effect as of and from time to time after January 1, 1990;

subject to the "Adjustments" set forth in subsections (B) through (F) below.

"Average Monthly Compensation" shall be determined under RIGP without regard to the dollar limitation contained in the Plan as required by Section 401(a)(17) of the Internal Revenue Code of 1986, as amended, or any successor thereto; and, notwithstanding the above, shall also include any compensation provided under the Xerox Corporation CEO Challenge Bonus Program.

"Social Security Benefit" shall mean the monthly benefit which a retired Participant or a terminated Participant receives or would be entitled to receive at the age at which unreduced retirement benefits are then paid under the U.S. Social Security Act (or at his sixty-second birthday, in the case of a retired Participant who has at least thirty Years of Service or who, on such Participant's retirement, is the pilot of an airplane operated by

* Defined terms in RIGP shall have the same meanings in the Plan, except as otherwise noted herein.

the Company), as a primary insurance amount under the U.S. Social Security Act, as amended, whether he or she applies for such benefit or not, and even though he or she may lose part or all of such benefit for any reason.

The amount of such Social Security Benefit to which the retired or terminated Participant is or would be entitled shall be computed by the Administrator for the purposes of the Plan as of the January 1 of the calendar year of retirement or termination. In computing such amount, the Administrator shall use estimated benefit tables developed by the Plan's actuary, the five-year average compensation of the Participant and the assumption that the Participant's compensation prior to the fifth year preceding the year of termination grew in accordance with average national wages.

(B) Grandfathered Officers—Adjustments shall be

(1) The monthly benefit and the Social Security Benefit shall be calculated at the rate of 3 1/3% of Average Monthly Compensation and of the Social Security Benefit, respectively, for each full or fractional Year of Participation up to a maximum of 15 Years of Participation.

(2) There shall be no reduction in the benefit payable upon retirement on or after attainment of age 55 on account of payment commencing prior to attainment of age 65.

(3) Amounts included in the Participant's Executive Expense Allowance shall be included in determining Average Monthly Compensation.

(C) Officers—Adjustments shall be that there shall be no reduction in the benefit payable upon retirement on or after attainment of age 60 on account of payment commencing prior to attainment of age 65 and no part of the Executive Expense Allowance shall be included in determining Average Monthly Compensation.

(D) Guideline Employees—An adjustment shall be that there shall be no reduction in the benefit payable upon retirement on or after attainment of age 55.

(E) Mid-Career Executives—Adjustments shall be

(1) The monthly benefit and the Social Security Benefit shall be calculated at the rate of 2.5% of the Average Monthly Compensation and of the Social Security Benefit, respectively, for each full or fractional Year of Participation up to a maximum of 20 Years of Participation.

(2) There shall be no reduction in the benefit payable upon retirement on or after attainment of age 60 on account of payment commencing prior to attainment of age 65 and no part of the Executive Expense Allowance, if any, shall be included in determining Average Monthly Compensation.

(F) All Participants—Adjustments shall be

(1) Average Monthly Compensation shall be calculated including any compensation deferred by the Participant during the period used in calculating Average Monthly Compensation (except that there shall not be included any increase in Participant's compensation which became payable under the Company's policy of increasing compensation by the amount which cannot be added to the Participant's accounts under the Company's Savings Plan ("Savings Plan") by reason of the limitation contained in Section 415 of the Internal Revenue Code of 1986, as amended, hereinafter the "Code").

(2) The following additional amounts shall be deducted from the hypothetical monthly benefit:

(a) The value of the portion of the Participant's Account under the Company's Deferred Compensation Plan For Executives, if any, resulting from the Retirement Account portion of the Profit Sharing Adjustment (as defined in such Deferred Compensation Plan) translated into an annuity (single life or joint and survivor, as appropriate) payable commencing on the date of retirement; and

(b) The benefit payable under the Company's Unfunded Retirement Income Guarantee Plan ("Unfunded RIGP").

(c) Any amount paid to the participant from which FICA taxes are withheld related to nonqualified retirement benefits from a plan sponsored by the Company which have not been previously withheld (or deemed to have been withheld because the maximum tax had already been paid) and are payable upon retirement but cannot be withheld from any single sum payment of compensation or other nonqualified plan benefits translated to an annuity (single or joint and survivor as appropriate) payable commencing on the date of retirement.

(d) The amount of that certain supplement provided to certain high-paid participants in RIGP effective in 1989 when the RIGP benefit was modified payable to the Participant in a lump sum translated to an annuity (single life or joint and survivor as appropriate) payable commencing on the date of retirement.

(e) The amount of any pension, retirement or other post-retirement income benefits paid or payable to a Participant under plans or arrangements provided by the Company or any subsidiary of the Company, whether incorporated or organized in the United States or in any other country of the world.

Section 7. *Change In Control.*

(A) Notwithstanding anything to the contrary in this Plan, in the event of a change in control of the Company, as hereinafter defined, each Participant, including retired Participants, shall be entitled to a benefit hereunder without regard to his or her age or Years of Service at the time of such change in control (including, without limitation, the benefit provided under Section 8 hereof, if applicable). Upon the occurrence of a change in control of the Company, the benefit of each Participant shall be payable in a lump sum within five days of such change in control equal in amount to the then present value of a benefit expressed in the form provided in Section 10 hereof, commencing on the later of (i) the date of such change in control, (ii) the date Guideline Employee or Grandfathered Officer attains age 55, (iii) the date the Officers attain age 60 or (iv) in the case of a Mid-Career Executive, the date such Participant attains the age specified in Schedule A, B or C, and based upon such Participant's Average Monthly Compensation and Years of Participation as of the date of such change in control. A "change in control of the Company" 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.

(B) Upon the termination of employment of a Participant following a change in control of the Company, such Participant, if he or she has otherwise satisfied the requirements of Section 5 hereof, shall be entitled to a benefit equal to the benefit to which he or she would have been entitled without application of Section 7(A), reduced (but not below zero) to reflect the value of the benefit he or she received pursuant to Section 7(A).

(C) For purposes of Section 7(A) hereof, the present value of a benefit shall be calculated based upon the interest rate which would be used by the Pension Benefit Guaranty Corporation for purposes of determining lump sums for benefits payable as immediate annuities with respect to plans terminating on the date on which the change in control of the Company occurs and the 1983 GAM mortality table, *provided, however*, that effective upon the date that the applicable interest rate as specified in Section 417(e)(3)(A) of the Code is adopted for use in RIGP, the present value hereunder shall thereafter be determined under the applicable interest rate and mortality table as defined in Section 417(e)(3)(A)(ii)(I) of the Code. For purposes of RIGP, each Participant shall

be treated as if he or she terminated employment upon the change in control and had his or her benefits determined as if he or she were to begin receiving benefits on the commencement date used in developing the present value of the benefit in Section 7(A).

Section 8. *Minimum Benefit*

In no event shall the monthly retirement benefit payable to any Participant other than Mid-Career Executives under the Plan be less than an amount which, when added to the benefits payable under RIGP, 25% of the amount of the Social Security Benefit and the amounts described in Section 6(F)(2) above, is equal to 25% of such Participant's Average Monthly Compensation as adjusted in Section 6(F)(1) for Participants and Section 6(B)(3) for Grandfathered Officers.

Section 9. *Pre-Retirement Spouse's Benefit*

For purposes of this Plan, the term "spouse" shall have the same meaning as "Spouse" under Section 1.36 of RIGP.

The benefit determined under (A) or (B) below whichever is applicable:

(A) The spouse of a Participant who dies after completing the appropriate age and number of Years of Service pursuant to Section 5 (but in no case less than 10) while still employed by the Company shall be entitled to a survivor benefit, commencing on the death of the Participant, in an amount equal to one-half of the retirement benefit to which the Participant would have been entitled under the Plan if the Participant had retired on the last day of the month coincident with or next following the date of the Participant's death.

(B) The spouse of a Participant who dies while still employed by the Company, but after completing the number of Years of Service that when added to his age upon his death is greater than or equal to 70 but less than the requisite age and number of Years of Service under Section 9(A) above, shall be entitled to an adjusted survivor benefit. Such adjusted survivor benefit shall be calculated by first reducing the benefit under Section 6(A) before applying the offset for Section 6(A)(b) by 5% per year from the appropriate age pursuant to Section 5, applying the offset in Section 6(A)(b), and then converting the result to an actuarially equivalent 50% joint and survivor annuity. The adjusted survivor benefit is 50% of this annuity amount, commencing on the death of the Participant.

Section 10. *Form of Benefit*

The forms of benefit available under the Plan shall be for single Participants a 10-year certain and life annuity or life annuity and for married Participants a 50% or 100% joint and survivor annuity option, all as shall have been elected by Participant on forms provided by the Administrator. The benefit payable to single Participant who has failed to make such an election shall be a life annuity and for a married Participant a 50% joint and survivor annuity. The 10-year certain and life annuity is the actuarial equivalent of the life annuity and the 100% joint and survivor annuity is the actuarial equivalent of the 50% joint and survivor annuity. Except as otherwise provided in Section 7(A) in no event is the benefit payable in a lump sum. Notwithstanding anything herein to the contrary, any marriages that occur subsequent to a Participant's retirement shall not entitle Participant to the forms of benefit available to married Participants described herein.

Section 11. *Participant's Rights Unsecured*

The benefits payable under this Plan shall be unfunded. Consequently, no assets shall be segregated for purposes of the Plan and placed beyond the reach of the Company's general creditors. The right of any Participant to receive benefits under the provisions of the Plan shall be an unsecured claim against the general assets of the Company.

Section 12. *Section 409A of the Internal Revenue Code.* Notwithstanding any other provision of the Plan, no election by any participant or beneficiary, and no payment to any individual, shall be permitted under the Plan if such election or payment would cause any amount to be taxable under section 409A of the Internal Revenue Code with respect to any individual.

Section 12. *Other Plan Provisions*

Other Plan provisions necessary to determine any benefit under the Plan shall be the same as those described in RIGP.

Section 13. *Plan Administration*

(a) *Duties of the Administrator.* The Plan shall be administered by the Administrator in accordance with its terms and purposes. The Administrator shall determine the amount and manner of payment of the benefits due to or on behalf of each Participant from the Plan and shall cause them to be paid by the Company accordingly. The Administrator shall be the Vice President, Human Resources of the Company.

(b) *Authority of the Administrator.* The Administrator may

(i) Construe and interpret the provisions of the Plan, determine all questions of fact, and make rules and regulations under the Plan to the extent deemed advisable or helpful by the Administrator;

(ii) Should any defect, omission, ambiguity or inconsistency in the Plan be discovered at any time, the Administrator shall be empowered to take such action as may be necessary to correct such defect, rectify such omission, resolve such ambiguity or reconcile such inconsistency.

(c) *Claims and Appeals.* Claims and appeals regarding benefits under the Plan shall be determined pursuant to section 503 of ERISA.

(d) *Finality of Decisions.* The decisions made by and the actions taken by the Administrator in the administration of the Plan shall be final and conclusive on all persons, and the Administrator shall not be subject to individual liability with respect to the Plan.

Section 14. *Limitations of Actions*

Any action brought in state or federal court for the alleged wrongful denial of Plan benefits or for the alleged intentional interference with any Plan rights to which a person is or may become entitled under ERISA must be commenced within one year after the cause of action accrued.

Section 15. *Amendment and Termination*

It is the intention of the Company to continue the Plan indefinitely. The Company expressly reserves the right to amend the Plan at any time and in any particular manner, provided that any such amendment shall be made in accordance with ERISA. Such amendments, other than amendments relating to termination of the Plan or relating to benefit levels under Section 6 of the Plan, may be effected by (i) the Board of Directors, (ii) a duly constituted committee of the Board of Directors, or (iii) the Vice President of the Company responsible for Human Resources or a representative thereof. In the event such office is vacant at the time the amendment is to be made, the Chief Executive Officer of the Company shall approve such amendment or appoint a representative. Amendments relating to termination of the Plan or relating to benefit levels under Section 6 of the Plan shall be effected pursuant to a resolution duly adopted by the Board of Directors of the Company, or a duly constituted committee of the Board of Directors of the Company, in accordance with the Business Corporation Law of the State of New York.

Any amendment, alteration, modification or suspension under subsection (iii) of the preceding paragraph shall be set forth in a written instrument executed by any Vice President of the Company and by the Secretary or an Assistant Secretary of the Company.

Section 16. *No Employment Rights*

Nothing contained in the Plan shall be construed as a contract of employment between the Company and a Participant, or as a right of any Participant to be continued in the employment of the Company, or as a limitation of the right of the Company to discharge any of its employees, with or without cause.

Section 17. *Assignment*

The benefits payable under this Plan may not be assigned or alienated except as may otherwise be required by law or pursuant to the terms of a domestic relations order that has been approved by the Plan Administrator.

Section 18. *Law Applicable*

This Plan shall be governed by the laws of the State of New York.

Section 19.. *Restriction of Venue. Any action in connection with the Plan by a covered employee or beneficiary may only be brought in Federal District Court in Monroe County, New York.*

Restatement adopted and approved as of May 12, 2004.

XEROX CORPORATION
RESTRICTED STOCK PLAN FOR DIRECTORS
1996 AMENDMENT AND RESTATEMENT

1. **NAME OF PLAN.** This plan shall be known as the "Xerox Corporation Restricted Stock Plan For Directors" and is hereinafter referred to as the "Plan".

2. **EFFECTIVE DATE AND TERM.** The Plan was originally effective as of January 1, 1988. This amendment and restatement is effective July 1, 1996. The Plan shall remain in effect until amended or terminated by action of the Board of Directors (the "Board") of Xerox Corporation, a New York corporation (the "Company").

3. **ELIGIBLE PARTICIPANTS.** Each member of the Board from time to time who is not a full time employee of the Company or any of its subsidiaries shall be eligible participants in the Plan (the "Participants").

4. **AUTOMATIC RECEIPT OF RESTRICTED SHARES.** In accordance with Section 14 of Article II of the By-Laws of the Company, until further action by the Board commencing with the calendar quarter beginning on July 1, 1996 in addition to any cash compensation established by the Board of Directors, each Participant shall be paid annual fees at the rate of \$25,000 for service on the Board payable in shares of Common Stock, par value \$1 per share, of the Company (the "Common Stock") subject to the restrictions set forth in Section 6 hereof. Such fee shall be payable in equal quarterly installments on the first day of the month next following the end of each calendar quarter for services on the Board and any Committee(s) thereof in such calendar quarter. The number of shares of Common Stock to be issued to each Participant on each payment date shall be determined by dividing such quarterly installment by the Fair Market Value of such shares as hereinafter defined. The Board shall have the authority to change the amount of annual fees for service on the Board payable in shares of Common Stock under this Section 4 not more frequently than annually.

5. **ELECTION TO RECEIVE ADDITIONAL RESTRICTED SHARES.** Each Participant shall have the right to elect, on forms provided by the Company, to receive up to one hundred percent of their annual fee for services on the Board which would otherwise be payable in cash (other than fees which have been deferred under the Company's 1981 Deferred Compensation Plan For Directors), in the form of shares of Common Stock. Any part of the fee elected to be paid in shares shall be payable in equal quarterly installments on the first day of the month next following the end of each calendar quarter for services on the Board in such calendar quarter. The number of shares to be issued at the time of payment shall be determined by dividing the amount elected to be taken in the form of shares by the Fair Market Value of such shares. Such election must be made prior to the calendar year the fees for which are to be paid in shares but not less than six months prior to the date any shares are to be distributed in accordance with such election. The shares receivable under this Section may be made subject to the restrictions set forth in Section 6 at the election of the Participant made at the same time the Participant elects to receive shares under this Section. Elections under this Section shall remain in effect from year to year until changed by the Participant. New elections or changes to existing elections under this Section must be made on or before December 31 of any year for amounts to be earned in a subsequent calendar year or years.

6. **RESTRICTIONS ON SHARES.** The shares issued under Section 4, and those issued under Section 5 which are elected to be covered by this Section, shall be restricted and may not be sold, hypothecated or transferred (including, without limitation, transfer by gift or donation) except that such restrictions shall lapse upon:

(a) Death of the Participant;

(b) Disability of the Participant preventing continued service on the Board;

(c) Retirement of the Participant from service as a Director of the Company in accordance with the policy on retirement of non-employee Directors then in effect;

(d) Termination of service as a Director with the consent of a majority of the members of the Board other than the Participant; or

(e) A Change in Control as hereinafter defined.

If a Participant ceases to be a Director of the Company for any other reason, the shares issued to such Director subject to this Section shall be forfeited and revert to the Company.

The certificates for shares which are subject to this Section shall be held by the Company until lapse of restrictions as provided in this Section, provided, however, the Participant shall be entitled to all voting, dividend and distribution rights for such shares.

Participants shall have the right to direct in writing, on forms provided by the Company, that upon lapse of restrictions in accordance with subsections (a) through (e) above, the shares held by such Participant under the Plan shall be transferred and delivered by the Company to the individuals or entities as specified by the Participant in such form.

7. FAIR MARKET VALUE. The term "Fair Market Value" shall mean the closing price of the Common Stock in consolidated trading on the last trading day preceding the relevant payment date as reported in the Wall Street Journal.

8. FRACTIONS OF SHARES. Whenever under the terms of the Plan a fractional share would be required to be issued, the number of shares shall be rounded up to the next highest whole number of shares.

9. CHANGE IN CONTROL. "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.

10. WITHHOLDING TAXES. Whenever under the Plan shares are to be issued, the Company shall have the right to require the recipient to remit to the Company an amount sufficient to satisfy federal, state and local withholding tax requirements prior to the issuance or delivery of any certificate or certificates for such shares.

11. GENERAL RESTRICTION. The issuance of shares or the delivery of certificates for such shares to recipients hereunder shall be subject to the requirement that, if at any time the Chief Financial Officer of the Company shall reasonably determine, in his discretion, that the listing, registration or qualification of such shares 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, such issuance or delivery thereunder, such issuance or delivery shall not take place unless such listing, registration, qualification, consent or approval shall have been effected or obtained free of any conditions not reasonably acceptable to the Chief Financial Officer.

12. AUTHORIZED OR TREASURY SHARES. Shares issuable under the Plan may be authorized but unissued shares or may be treasury shares as shall be determined from time to time by the Chief Financial Officer of the Company.

13. RULE 16B-3. It is the intention that the Plan and the operation thereof qualify for the exemption provisions contained in Rule 16b-3 adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, as in effect from time to time or any successor rule ("Rule"). To the extent that the implementation or operation of any provision hereof does not comply with the requirements of the Rule as applicable to the Plan, such provision shall be inoperative or shall be interpreted, to the extent practicable, to apply in a manner not inconsistent with the requirements of the Rule.

XEROX UNIVERSAL LIFE PLAN**Effective July 1, 2003****Article I
Definitions**

For the purposes hereof, unless otherwise required by the context, the following phrases or terms shall have the following meanings:

1.1 "Actively at Work" shall mean a Participant's employment at a scheduled or actual rate of 30 hours or more per week with the Company.

1.2 "Administrator" shall mean the Vice President of the Company having responsibility for human resource matters, or his or her designee. The Administrator will manage and administer the Plan in accordance with the provisions of Article VII of this Plan.

1.3 "Beneficiary" shall mean the person(s), trust(s), or the estate of a Participant, entitled to receive any benefits under this Plan upon the death of a Participant.

1.4 "Beneficiary Designation" shall mean the designation of a Beneficiary by the Participant on a form and in the manner acceptable to the Insurer and Administrator. A Beneficiary under the Plan shall be the Beneficiary named on the last valid designation on file with the Company or Insurer.

1.5 "Cash Surrender Value" shall be credited each year in accordance with the amount allocated under the contract as provided under the Insurance Policy with interest, appreciation and loss, as applicable, in connection with the funds selected and made available under the Insurance Policy.

1.6 "Change of Beneficiary" shall mean the act of changing a Beneficiary on a Change of Beneficiary Designation form to another individual, trust or estate of the Participant using a form acceptable to the Insurer and Administrator. The consent of a Beneficiary to change a Beneficiary shall not be required. The proper designation of a Beneficiary shall be the Beneficiary as designated on the last Change of Beneficiary Designation form on file with the Insurer or the Company.

1.7 "CLIP" shall mean the Xerox Corporation Contributory Life Insurance Program.

1.8 "Company" shall mean Xerox Corporation.

1.9 "Death Benefit" shall mean the Face Amount of life insurance provided by the Plan on the life of each Participant and any accumulated Cash Surrender Value less any outstanding loan balance.

1.10 "Disabled" or "Disability" shall mean those Employees who have been determined under procedures established under the Xerox Corporation Long-Term Disability Income Plan and the HR Policy defining Short-Term Disability to be disabled as that term is defined in such Plan or HR Policy, respectively.

1.11 "Effective Date of Coverage" shall mean the date, determined under Article II, that a Participant becomes covered under an Insurance Policy.

1.12 "Eligible Employee" shall mean each Employee who was an active Participant of the CLIP and who was Actively at Work on July 1, 2003, and each additional classification of Eligible Employees that are designated by the Administrator as participants under the Plan and are listed as Participants in Schedule A.

1.13 "Employee" shall mean any person who is an employee of the Company, as determined by the personnel policies of the Company, and is designated as such in the books and records of the Company. Any individual who was excluded under the Plan because the Company or its personnel policies classified such individual as an independent contractor, leased employee, temporary employee, supplemental contract worker, consultant, agent or self-employed shall remain excluded even if such individual is later determined to be a common law employee (unless the Plan is amended to provide coverage for such individual). Only individuals who are United States citizens may participate in this Plan. Ex-patriates and foreign nationals may participate subject to the approval of the Insurer.

1.14 "Face Amount" shall mean the total amount of life insurance protection provided by the Plan on the life of each Participant.

1.15 "Guaranteed Issue Amount" shall mean the maximum Face Amount of coverage provided under the Insurance Policy before the Insurer would require a Participant to complete a health questionnaire with respect to the Participant's current health condition.

1.16 "Insurer" shall mean the insurance company selected by the Administrator to provide the Insurance Policy under the Plan.

1.17 "Insurance Policy" shall mean the Group Variable Universal Life insurance policy that shall be automatically renewable at the beginning of each Plan Year and that provides the insured benefit under this Plan.

1.18 "Participant" shall mean an Employee who is eligible to participate in this Plan as provided in Article II.

1.19 "Participation Agreement" shall mean the agreement(s) attached hereto as Schedule B between the Eligible Employee and the Company setting forth the particular terms, rights and obligations that apply only to the Eligible Employee with whom the Participation Agreement is made.

1.20 "Plan" shall mean this Xerox Universal Life Plan, which shall be evidenced by this instrument and by each Participation Agreement.

1.21 "Salary" shall mean the annual rate of pay as of July 1 paid to the Participant for services to the Company and shall include any voluntary pre-tax deferrals under a plan sponsored by the Company including amounts under Internal Revenue Code Sections 125, 132(f), and 4.02(g)(3).

Article II

Eligibility and Effective Date of Coverage

2.1 Each Eligible Employee shall become covered under an Insurance Policy on an Effective Date of Coverage as determined below:

(a) Each Eligible Employee, who was a participant in the CLIP and who was Actively at Work on July 1, 2003, shall become covered under an Insurance Policy on August 1, provided the premium and a properly completed application are received by the Insurer in connection with the Insurance Policy no later than August 1, 2003. In the event of the Employee's death during the month of July 2003, such Employee shall receive a benefit equal to his or her current level of CLIP coverage.

(b) For each Employee who becomes an Eligible Employee, coverage under an Insurance Policy shall begin on the first day of the month following the date such individual is designated as an Eligible Employee once the premium and a properly completed application are received by the Insurer in connection with the Insurance Policy (provided such application is received within the 60-day period following the date an Employee was initially eligible for the Plan).

(c) For each Eligible Employee who is hired as an Eligible Employee, coverage under an Insurance Policy shall begin on the first of the month coincident with or next following such Eligible Employee's date of hire once the premium and a properly completed application are received by the Insurer (provided such application is received within the 60-day period following the date an Employee was initially eligible for the Plan).

2.2 Each Eligible Employee must be Actively at Work on the date an application is signed by the Participant. If an Eligible Employee is not Actively at Work on the date an application is signed, then the Effective Date of Coverage (as determined under Section 2.1) may not begin until the Eligible Employee is Actively at Work.

2.3 If a Participant has met the requirements for eligibility under the Plan and thereafter becomes ineligible under the terms of the Plan and Insurance Policy, then such Participant will no longer be covered by the Plan or Insurance Policy subject to the discretion of the Plan Administrator. Nothing in the Plan shall be interpreted to limit, in any way, the right of the Participant to continue coverage if such continuation is provided for under the Insurance Policy where such continuation is unrelated to the individual's employment or eligibility with the Company.

2.4 As a condition of participation, each eligible individual shall complete, execute, and return to the Administrator a signed and executed Participation Agreement in the form approved by the Administrator and will comply with such further conditions as may be established by and in the sole discretion of the Administrator. A copy of the Agreement for each Participant under the Plan shall be attached to and become a part of this Plan.

2.5 In the event the Insurer or Administrator classifies, in error, an individual as being eligible for the Plan, or in the event an individual has not been approved for coverage under the Plan, or in the event coverage is extended to an individual based on incorrect information, premiums which have been paid on behalf of such individual shall be refunded and coverage will not have been nor will be effective and in force.

2.6 An Eligible Employee shall only be provided with an application to participate in the Plan at the time of initial eligibility. If the Employee declines coverage or does not complete an application within the time required by Section 2.1, such Employee shall be deemed to have irrevocably elected not to participate in the Plan and shall have no further opportunity to do so.

2.7 In the event that coverage will be delayed because the Insurer has not approved the coverage under the Insurance Policy in excess of the Guaranteed Issue Amount, an amount of coverage up to the Guaranteed Issue Amount will be effective for such Eligible Employee provided the Insurer is in receipt of the application.

2.8 In the event an Eligible Employee who was an active Participant in the CLIP is Disabled on July 1, 2003, and such Employee has not completed an application for coverage under the Plan, the Guaranteed Issue Amount shall be equal to the value of the Employee's coverage under the CLIP. In the event an Eligible Employee who was an active Participant in the CLIP has become disabled during the application period (the 60-day period beginning on the Employee's initial date of eligibility) after signing the application, the Guaranteed Issue Amount shall be equal to the coverage as provided in 3.1(a).

Article III

Procurement of Insurance Policy

3.1 The Company, on behalf of the Participant, shall provide the Participant with the opportunity to apply to the Insurer for an Insurance Policy, in which the Participant shall have ownership rights and with the following provisions:

(a) *Pre-retirement Coverage* shall be the greater of (i) or (ii).

In the event a Participant dies while in active service of the Company, and prior to the date of retirement within the meaning provided under the Xerox Corporation Retirement Income Guarantee Plan, the amount of

Pre-retirement Coverage under the Insurance Policy and payable to a Beneficiary shall equal the greater of (i) the Death Benefit payable to the Employee's Beneficiary under the CLIP as of July 1, 2003 or (ii) Salary multiplied by 3 plus the amount of Cash Surrender Value under the Insurance Policy.

(b) Post-retirement Target Coverage

Participants will have the option to continue coverage after termination of employment as provided in the Insurance Policy by paying premiums or using the Cash Surrender Value to cover the cost of insurance. For Participants who were in the CLIP, the Company will make additional investment contributions as provided in the Participation Agreement. The additional investment contributions will provide sufficient Cash Surrender Value at retirement age 65 or 10 years from the Xerox Universal Life Plan issue date, which ever is later, based on stated assumptions, to continue the Participant's share of the CLIP death benefit after retirement. The length of time the actual Face Amount can be supported will depend on the performance of the underlying investment vehicle(s).

(c) Increasing Coverage Amounts; Maximum Amount of Plan Coverage

The Amounts described in (a) above are the amounts of coverage provided by the Company subject to the Insurer's coverage limits and underwriting requirements. In addition, if the Salary of any Participant increases, the coverage under the Plan shall increase on July 1 subject to the Insurer's coverage limits and underwriting requirements. The Insurer may require that the Participant answer medical inquiries about his current health condition. The Plan shall not provide for an increase in coverage due to increases in Salary if the Participant fails to cooperate with the Insurer or the Insurer does not approve the increase.

(d) Cessation of Company Contributions

The Company shall make premium contributions to cover the premium on behalf of each Participant as may be required in the Insurance Policy to provide the amount of coverage described in this Article. Contributions will be made until the earlier of termination of employment or retirement under the Xerox Corporation Retirement Income Guarantee Plan. For Participants who were in the CLIP and are retirement eligible upon termination, premium investment contributions will continue until retirement age 65 or 10 years from the Xerox Universal Life Plan issue date, whichever is later.

3.2 If a Participant does not cooperate in the securing of such insurance, or if he or she is for any reason unable to obtain insurance in the specified amount on his or her life, the Company shall have no further obligation to Participant under the Plan and such Participant's Participation Agreement shall terminate.

3.3 The Participant shall have full ownership rights in any Insurance Policy acquired on Participant's life.

Article IV

Beneficiary

4.1 The Participant shall designate his or her Beneficiary to receive benefits under the Plan on a Beneficiary Designation form approved by the Insurer. If more than one Beneficiary is named, the shares and the preference of each shall be distributed as indicated or on a pro rata basis if not otherwise instructed.

4.2 The Participant may terminate, alter or amend the Beneficiary Designation form as provided in the Insurance Policy. No change in Beneficiary shall be effective until received and acknowledged in writing by the Insurer.

4.3 Any payment made by the Insurer in accordance with the most recent Beneficiary Designation form filed with the Company and the Insurer shall fully discharge the Insurer from all further obligations with respect to such payment.

4.4 The Beneficiary may elect any settlement option that is offered under the Insurance Policies with respect to his or her portion of the Death Benefit proceeds.

Article V

Other Policy Provisions

5.1 To the extent provided in the Insurance Policy, a Participant may elect a loan or withdrawal of amounts under the Insurance Policy that is subject to a loan or withdrawal. The Insurer shall be obligated to provide sufficient communication regarding these rights to Participants.

5.2 A Participant may decline coverage under this Plan by filing a written notice to the Company and Insurer at any time declining such coverage. Such notice shall be irrevocable.

5.3 Nothing contained in this Plan or the Participation Agreement or Insurance Policy shall be construed as a contract of employment between the Company and a Participant, or as a right of any Participant to be continued in the employment of the Company, or as a limitation of the right of the Company to discharge any of its employees, with or without cause.

5.4 The Insurer shall be responsible for adjudicating all claims under the Plan arising out of the Insurance Policy. The Company shall not administer or review any claim that is the jurisdiction of the Insurer.

Article VI

Termination Amendment Modification or Supplement of Plan

6.1 The Company reserves the right to totally or partially amend, modify or supplement this Plan or any Participation Agreement at any time and for any reason. Any amendment, modification or supplement shall be in writing and signed by the Vice President of the Company having responsibility for Human Resources. Changes to the Insurance Policy shall be subject to the terms of the Policy and no such amendment or change may occur to the Policy unless the amendment, modification or change is written and signed by the Insurer 30 days prior to the effective date of said change.

6.2 The Company reserves the right to terminate the Plan and any Participation Agreement in whole or in part, provided, however, and subject to the terms of the Insurance Policy no such termination shall adversely impact a Participant's right to continue insurance coverage at the Participant's own expense in accordance with the terms of the Insurance Policy.

6.3 If a termination of the Plan occurs, the obligation of the Company or a Participant to make any premium payments shall, subject to the Insurance Policy, cease and the rights of the Company and the Participant shall be controlled by this Article VI and the Insurance Policy. Participant rights under the Insurance Policy shall be determined with reference to such Policy and may include notice and contract rights.

Article VII

Administration of the Plan

7.1 The sole right of construction, interpretation and general administration of the Plan shall be vested in the Administrator. The sole right of construction, interpretation, and general administration of the Insurance Policy shall be vested in the Insurer.

7.2 The Insurer shall establish rules, forms and procedures for the administration of the Policy from time to time, and the Administrator shall establish rules, forms and procedures for the administration of the Plan from time to time. The Administrator may employ agents to carry out non-fiduciary as well as fiduciary responsibilities with respect to the Plan. The Administrator shall have the exclusive right to interpret the Plan, determine all questions of fact and determine eligibility under the Plan, and to decide any and all matters arising there under or in connection with the administration of the Plan. The Insurer shall be responsible for establishing a claims procedure for claims under the Insurance Policy. The Insurer shall be solely responsible for interpreting the Insurance Policy and administering such Policy under applicable law.

Article VIII
Indemnification

To the extent permitted by law, the Company shall indemnify and hold harmless the Administrator and any designee of the Administrator but only if employed by the Company, against any and all claims, losses, damages, expenses and liabilities arising from any act or failure to act that constitutes or is alleged to constitute a breach of such person's responsibilities in connection with the Plan under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") or any other law, unless the same is determined to be due to gross negligence, willful misconduct, or willful failure to act.

Article IX
Miscellaneous

9.1 Any notice which shall or may be given under this Plan or an assignment shall be in writing and shall be mailed by United States Mail, postage prepaid. If notice is to be given to the Company, such notice shall be addressed to the Company at its general offices:

Xerox Corporation
800 Long Ridge Road
Stamford CT 06904-1600

marked for the attention of the Administrator, Xerox Universal Life Plan; or if notice to a Participant, addressed to the most recent address shown on the Company's personnel records.

9.2 Any party may change the address to which notices shall be mailed from time to time by giving written notice of such new address.

9.3 The Plan shall be binding upon the Company and its successors and assigns, and upon a Participant, his or her beneficiary, heirs, executors and administrators.

9.4 This Plan shall be construed and governed in all respects under and by the laws of the State of Connecticut, except to the extent preempted by federal law. If any provision of this Plan shall be held by a court of competent jurisdiction to be invalid or unenforceable, the remaining provisions hereof shall continue to be fully effective.

9.5 Headings and subheadings in this Plan are inserted for convenience and reference only and do not constitute any part of this Plan.

9.6 Neither the Plan, the Insurer, the Administrator nor the Company is responsible for any tax that may become due and payable with respect to any benefit provided under the Plan. The sole responsibility for paying a tax on benefits provided herein belongs to the Participant regardless of whether tax was withheld on income or reported as taxable to the Participant.

Schedule A
XEROX UNIVERSAL LIFE PLAN

Plan Participants

- Active CLIP Participants as of July 1, 2003
- Other active Band X and Band A U.S. employees as of July 1, 2003 and thereafter
- Any other employee designated as a Participant by the Administrator and approved by the Insurer

Schedule B
XEROX UNIVERSAL LIFE PLAN
PARTICIPATION AGREEMENT
(for Participants in CLIP)

Section I Personal Information

Please type or print clearly.
First Name, M.I., Last Name

Street Address (Including Apt., Suite, etc.)

Business Telephone

City, State, Zip

Social Security Number

Section II Acknowledgement & Agreement

Complete this Section II only if you were a participant in the Xerox Corporation Contributory Life Insurance Program.

_____ Yes, I acknowledge that I have received and reviewed a copy of the Xerox Universal Life Plan as may be amended from time to time, and I hereby agree to participate under the terms thereof. I also elect to receive the “additional contributions” referenced in Section 3.1(b) of the Xerox Universal Life Plan. I understand that the additional contribution will be an annual premium (payable monthly) in the amount of \$ _____ payable until the later of age 65 or 10 years from the Xerox Universal Life Plan issue date, provided that no premiums will be paid after my termination of employment unless I am retirement eligible as defined in the Xerox Corporation Retirement Income Guarantee Plan. I understand that the “additional contributions” are targeted to provide the post-retirement coverage to which I was entitled under the CLIP based on a 5.6% interest credit rate, the Insurer’s current cost of insurance rates and policy expense charges but that the length of time before the policy lapses will vary based on the policy performance. By electing coverage under this Plan, I am also waiving Company-paid coverage under the Xerox Corporation Life Insurance Plan.

_____ Yes, I acknowledge that I have received and reviewed a copy of the Xerox Universal Life Plan, and I hereby agree to participate under the terms thereof. By electing coverage under this Plan, I am also waiving Company-paid coverage under the Xerox Corporation Life Insurance Plan. I elect, however, *not* to receive the additional contributions referenced in Section 3.1(b) of the Xerox Universal Life Plan

_____ No, I elect not to participate in the Xerox Universal Life Plan.

Section III Employee Signature

I understand that my election to decline coverage under the Xerox Universal Life Plan shall be irrevocable. I also understand that coverage under this Plan is subject to the Insurer's coverage limits and underwriting requirements and that the Insurer may require me to answer medical inquiries to receive coverage or increases in coverage. I understand that if I do not cooperate or am otherwise unable to obtain insurance in the specified amount from the Insurer that Xerox shall have no further obligation under the Plan.

I understand that any premiums paid by Xerox will be added to my taxable income and that it is my sole responsibility to pay the taxes on such amounts.

I understand that Xerox intends this Plan to be permanent but can and does reserve the right to amend or terminate the Plan at any time and for any reason.

Signature of Employee

Month / Day / Year

Schedule B
XEROX UNIVERSAL LIFE PLAN
PARTICIPATION AGREEMENT
(for non-CLIP Participants)

Section I Personal Information

Please type or print clearly.
First Name, M.I., Last Name

Street Address (Including Apt., Suite, etc.)

Business Telephone

City, State, Zip

Social Security Number

Section II Acknowledgement & Agreement

_____ Yes, I acknowledge that I have received and reviewed a copy of the Xerox Universal Life Plan as may be amended from time to time, and I hereby agree to participate under the terms thereof. By electing coverage under this Plan, I am also waiving Company-paid coverage under the Xerox Corporation Life Insurance Plan.

_____ No, I elect not to participate in the Xerox Universal Life Plan.

Section III Employee Signature

I understand that my election to decline coverage under the Xerox Universal Life Plan shall be irrevocable. I also understand that coverage under this Plan is subject to the Insurer's coverage limits and underwriting requirements and that the Insurer may require me to answer medical inquiries to receive coverage or increases in coverage. I understand that if I do not cooperate or am otherwise unable to obtain insurance in the specified amount from the Insurer that Xerox shall have no further obligation under the Plan.

I understand that any premiums paid by Xerox will be added to my taxable income and that it is my sole responsibility to pay the taxes on such amounts.

I understand that Xerox intends this Plan to be permanent but can and does reserve the right to amend or terminate the Plan at any time and for any reason.

Signature of Employee

Month / Day / Year

XEROX CORPORATION
DEFERRED COMPENSATION PLAN FOR DIRECTORS
(Formerly 1989 Deferred Compensation Plan For Directors)

1997 AMENDMENT AND RESTATEMENT

Preamble. This Plan is a private unfunded nonqualified deferred compensation arrangement for Directors and all rights shall be governed by and construed in accordance with the laws of New York, except where preempted by federal law. It is intended to provide a vehicle for setting aside funds for retirement.

Section 1. Effective Date. The original effective date of the Plan is January 1, 1989. The effective date of this amendment and restatement is October 9, 2000.

Section 2. Eligibility. Any Director of Xerox Corporation (the "Company") who is not an officer or employee of the Company or a subsidiary of the Company is eligible to participate in the Plan (a Director who has so elected to participate is hereinafter referred to as a "Participant"). A Participant who terminates an election to defer receipt of compensation is not eligible to participate again in the Plan until twelve months after the effective date of such termination.

Section 3. Deferred Compensation Accounts. There shall be established for each Participant one or more deferred compensation Accounts (as hereinafter defined).

Section 4. Amount of Deferral.

(a) A Participant may elect to defer receipt of all or a specified part, expressed as a percentage of the cash compensation otherwise payable to the Participant for serving on the Company's Board of Directors or committees of the Board of Directors. Any amount deferred is credited to the Participant's Accounts on the date such amount is otherwise payable.

(b) In addition to the foregoing, there shall be credited to the deferred compensation accounts of each person who is serving as a Director on May 17, 1996 a sum computed by the Company as the present value of his or her accrued benefit under the Company's Retirement Income Plan For Directors, if any, as of such date and each such Director shall be given notice of such amount. The amount so computed shall be final and binding on the Company and each such Director. Within 30 days of the giving of such notice, each such Director shall make an election on a form provided by the Company as to the hypothetical investment of such amount and the payment methods as permitted under Sections 6 and 8 hereof as in effect on such date under the administrative rules adopted by the Administrator.

Section 5. Time of Election to Defer. The election to defer will be made prior to the individual's commencement of services as a Director for amounts to be earned for the remainder of the calendar year. In the case of an individual currently serving as a Director, the election to defer must be made prior to December 31, of any year for amounts to be earned in a subsequent calendar year or years. An election to totally terminate deferrals may be made at any time prior to the relevant payment date.

Section 6. Hypothetical Investment. Deferred compensation is assumed to be invested, without charge, in the (a) Balanced Fund, Income Fund, U.S. Stock Fund, International Stock Fund, Small Company Stock Fund or Xerox Stock Fund (or the successors thereto) (the "Funds") established from time to time under the Xerox Corporation Profit Sharing and Savings Plan (the "Profit Sharing Plan") (b) a fund with a variable fixed rate of return based upon the prime or base rate charged by one or more banks ("Prime Rate Investment") and (c) such other fixed income return investments ("Fixed Return Investment"), all as shall be made available from time to time by the Administrator in his or her administrative discretion ("Investments") as elected by the participant

It is anticipated that the Administrator will substitute the Prime Rate Investment for the Income Fund effective January 1, 1998. Amounts deferred prior to January 1, 1998 shall have a rate of return at the Income Fund or the Prime Rate Investment as elected by Participants on forms provided by the Administrator in connection with the implementation of the Prime Investment Rate.

Elections to make hypothetical investments in any one or more of the Investments shall be subject to administrative rules adopted by the Administrator from time to time.

No shares of Xerox stock will ever actually be issued to a Participant under the Plan.

Section 7. Value of Deferred Compensation Accounts and Installment Payments. The value of each Participant's Accounts shall reflect all amounts deferred, gains, losses and rates of return from the Investments, and shall be determined at the close of business on each day on which securities are traded on the New York Stock Exchange. Hypothetical investments in the Profit Sharing Plan shall be valued on each business day based upon the value of such hypothetical investment as determined under such Plan on the valuation date under such Plan coincident with or last preceding such business day. The value of Investments not made under the Profit Sharing Plan shall be determined from such available source or sources as the Administrator in his or her sole discretion shall from time to time determine. The date as of which investments are valued pursuant to the foregoing sentences are referred to herein as a Valuation Date.

Section 8. Manner of Electing Deferral. A Participant may elect to defer compensation by giving written notice to the Administrator on a form provided by the Company, which notice shall include (1) the percentage to be deferred; (2) if more than one is offered under the Plan, the hypothetical investment applicable to the amount deferred; and (3) the payment method that will apply to the deferred compensation. A Participant may elect to a maximum of four separate payment methods during his or her participation in the Plan ("Accounts"). Such payment methods once made may never be changed. Each election to defer compensation under the Plan shall specify an Account from which payment will be made. The Accounts available under the Plan shall be:

Account 1 which shall be payable beginning the July 15 of a calendar year that follows the calendar year of retirement by the number of years elected by the Participant (0, 1, 2, 3, 4, or 5 years). The last payment shall be on the July 15 of the year in which the Participant attains a certain age elected by the Participant.

Account 2 which shall be payable beginning the July 15 of a calendar year that follows the calendar year of retirement by the number of years elected by the Participant (0, 1, 2, 3, 4, or 5 years) and is payable on each subsequent July 15 until the number of payments elected by the Participant have been made.

Account 3 which shall be payable on the July 15 of a calendar year that follows the calendar year of retirement by the number of years elected by the Participant (0, 1, 2, 3, 4, or 5 years) and is payable as a single sum.

Account 4 shall be available with respect to amounts deferred during 1998 and later years. This account is payable beginning on the July 15 of a specified year whether before or after retirement. In addition to this payment date, the Participant must elect the number of payments that are to commence on this date. The payment(s) from this account can be as a single sum or payable in up to four annual installments. Once Account 4 is established (an election is made to defer and the payment date is defined), deferrals to Account 4 shall cease for any calendar year in which a payment is scheduled to be made from this Account. The full account balance shall be distributed by the end of the installment period. Once the final payment is made from this Account, the Participant may elect to create a new Account 4. The initial election or any subsequent election to use this Account must be made by December 31 of the year preceding the calendar year in which deferrals will be allocated to this Account. The first payment date that can be elected is the July 15 of the calendar year that follows the calendar year of election (calendar year containing the December 31 due date for election) by three years.

Not later than December 31, 1997, Participants who are currently serving as Directors of the Company may change their payment elections previously made under the Plan which specified payment dates relating to termination, retirement, death, or disability, by selecting payments pursuant to the methods described in Accounts 1 through 3 above. Such change shall be effected by the Participant filing with the Administrator a change of election on a form or forms established by the Administrator for such purpose. Such change shall be effective only with respect to payments in 1999 or later for Participants who are serving on the Company's Board of Directors as of December 31, 1998.

The Administrator may adopt rules of general applicability for administration of payments under the Plan which may be elected by Participants, including without limitation, fixing the maximum age selected for payments to terminate and the maximum number of payments.

Section 9. Payment of Deferred Compensation.

(a) No withdrawal may be made from the Participant's Account, except as provided under this Section and Sections 10 and 11.

(b) Payments from a Participant's Account are made in cash in accordance with the elections made under Section 8 of the Plan based on the value of the Participant's deferred compensation Accounts as of the Valuation Date immediately preceding the date of payment.

(c) Unless otherwise elected by a Participant with the written approval of the Administrator, payments of deferred compensation shall be made pursuant to the following formula: the amount of the first payment shall be a fraction of the value of the Participant's deferred compensation account on the preceding Valuation Date, the numerator of which is one and the denominator of which is the total number of installments elected, and the amount of each subsequent payment shall be a fraction of the value on the Valuation Date preceding each subsequent payment date, the numerator of which is one and the denominator of which is the total number of installments elected minus the number of installments previously paid. Any other payment method selected with the written approval of the Administrator must in all events provide for payments in substantially equal installments.

(d) Upon termination of service on the Board of Directors, other than termination resulting from death, prior to retirement, the total value of the Participant's Accounts under the Plan shall be paid to the Participant as soon as administratively possible after his or her date of termination.

(e) Upon the death of a Participant either before or after retirement the total value of the Participant's Accounts under the Plan shall be paid in accordance with an election made by such Participant in a lump sum or in installments, as appropriate, from the Accounts established under Section 8 to the beneficiary(ies) designated by the Participant.

(f) If a Participant dies either before or after retirement without having made such an election, the total value of his or her Accounts under the Plan shall be paid in a single payment to the Participant's estate as soon as administratively possible after notice of his or her date of death has been received by the Administrator.

Section 10. Acceleration of Payment for Hardship.

(a) *For Hardship.* Upon written approval from the Board of Directors (with the Participant requesting the withdrawal not participating) a Participant may be permitted to receive all or part of his accumulated benefits if, in the discretion of such Board of Directors, it is determined that an emergency event beyond the Participant's control exists and which would cause such Participant severe financial hardship if the payment of his benefits were not approved. Any such distribution for hardship shall be limited to the amount needed to meet such emergency. A Participant who makes a hardship withdrawal cannot reenter the Plan for twelve months after the date of withdrawal.

(b) *Upon a Change in Control.* Within 5 days following the occurrence of a change in control of the Company (as hereinafter defined), each Participant shall receive a lump sum payment equal to the value of his or her Account. For purposes hereof, a “change in control of the Company” 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 (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 (C) 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; (B) the following individuals cease for any reason to constitute a majority of the directors then serving: individuals who, on October 9, 2000 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 October 9, 2000 or whose appointment, election or nomination for election was previously so approved or recommended; (C) 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% of more of the combined voting power of the Company’s then outstanding securities; or (D) 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.

Section 11. Other Penalized Withdrawals. Notwithstanding the provisions of Sections 9 and 10, a Participant may be permitted to receive all or part of his accumulated benefits at any time provided that (A) the Administrator approves such distribution in his or her sole discretion, and (B) the Participant forfeits a portion of his account balance equal to a percentage of the amount distributed. The percentage reduction shall be the greater of (A) six percent, or (B) a percentage equal to one-half of the prime interest rate, as determined by the Administrator.

Section 12. Time Of Investment. Amounts deferred under the Plan shall begin to be credited with gains, losses and rates of return from Investments commencing on the date credited to the Participant’s Accounts.

Section 13. Participant’s Rights Unsecured. The benefits payable under this Plan shall be unfunded. Consequently, no assets shall be segregated for purposes of this Plan and placed beyond the reach of the Company’s general creditors. The right of any Participant to receive future installments under the provisions of the Plan shall be an unsecured claim against the general assets of the Company.

Section 14. Statement of Account. Statements will be sent to each Participant by February and August and more frequently if the Administrator so determines as to the value of their deferred compensation accounts as of the end of December and June, respectively.

Section 15. Assignability. No right to receive payments hereunder shall be transferable or assignable by a Participant, except by will or by the laws of descent and distribution or except as provided under Section 9.

Section 16. Business Days. In the event any date specified herein falls on a Saturday, Sunday or legal holiday, such date shall be deemed to refer to the next business day thereafter.

Section 17. Administration. The Plan shall be administered by the Vice President of the Company having responsibility for human resources (the "Administrator"). The Administrator shall have the authority to adopt rules and regulations for carrying out the plan, and interpret, construe and implement the provisions of the Plan.

Section 18. Amendment. The Company expressly reserves the right to amend the Plan at any time and in any particular manner. Such amendments, other than amendments relating to termination of the Plan or relating to Investments under Section 6 of the Plan, may be effected by (i) the Board of Directors, (ii) a duly constituted committee of the Board of Directors ("Committee"), or (iii) the Vice President of the Company responsible for human resources or a representative thereof. In the event such office is vacant at the time the amendment is to be made, the Chief Executive Officer of the Company shall approve such amendment or appoint a representative. Amendments relating to termination of the Plan or relating to Investments under Section 6 of the Plan shall be effected pursuant to a resolution duly adopted by the Board of Directors of the Company, or a duly constituted committee of the Board of Directors of the Company, in accordance with the Business Corporation Law of the State of New York.

Any amendment, alteration, modification or suspension under subsection (iii) of the preceding paragraph shall be set forth in a written instrument executed by any Vice President of the Company and by the Secretary or an Assistant Secretary of the Company.

Upon termination the Administrator in his or her sole discretion may pay out account balances to participants. No amendment, modification or termination shall, without the consent of a Participant, adversely affect such Participant's accruals in his/her Accounts.

Section 19. Section 409A of the Internal Revenue Code. Notwithstanding any other provision of the Plan, no election by any participant or beneficiary, and no payment to any individual, shall be permitted under the Plan if such election or payment would cause any amount to be taxable under section 409A of the Internal Revenue Code with respect to any individual.

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, as well as any deficiency of earnings 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 will be no future dividends beyond such date.

(In millions)	Year Ended December 31,				
	2004	2003	2002	2001	2000
Fixed charges:					
Interest expense	\$ 708	\$ 884	\$ 896	\$1,001	\$1,146
Portion of rental expense which represents interest factor	105	77	82	111	115
Total fixed charges before capitalized interest	813	961	978	1,112	1,261
Capitalized interest	—	—	—	—	3
Total fixed charges	\$ 813	\$ 961	\$ 978	\$ 1,112	\$ 1,264
Earnings available for fixed charges:					
Earnings	\$1,116	\$ 494	\$ 158	\$ 381	\$ (365)
Less: Undistributed equity in income of affiliated companies	(89)	(37)	(23)	(20)	(25)
Add: fixed charges before capitalized interest	813	961	978	1,112	1,261
Total earnings available for fixed charges	\$1,840	\$1,418	\$1,113	\$1,473	\$ 871
Ratio of earnings to fixed charges	2.26	1.48	1.14	1.32	*

* Earnings for the year ended December 31, 2000 were inadequate to cover fixed charges by \$393 million.

Xerox Corporation

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

(In millions)	Year Ended December 31,				
	2004	2003	2002	2001	2000
Fixed charges:					
Interest expense	\$ 708	\$ 884	\$ 896	\$1,001	\$1,146
Portion of rental expense which represents interest factor	105	77	82	111	115
Total fixed charges before capitalized interest and preferred stock dividends pre-tax income requirement	813	961	978	1,112	1,261
Capitalized interest	—	—	—	—	3
Preferred stock dividends pre-tax income requirement	110	90	78	13	53
Total combined fixed charges and preferred stock dividends	\$ 923	\$1,051	\$1,056	\$1,125	\$1,317
Earnings available for fixed charges:					
Earnings	\$1,116	\$ 494	\$ 158	\$ 381	\$ (365)
Less: Undistributed equity in income of affiliated companies	(89)	(37)	(23)	(20)	(25)
Add: fixed charges before capitalized interest and preferred stock dividends	813	961	978	1,112	1,261
Total earnings available for fixed charges and preferred stock dividends	\$1,840	\$1,418	\$1,113	\$1,473	\$ 871
Ratio of earnings to combined fixed charges and preferred stock dividends	1.99	1.35	1.05	1.31	*

* Earnings for the year ended December 31, 2000 were inadequate to cover combined fixed charges and preferred stock dividends by \$446 million.

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

Throughout this document, references to "we," "our" or "us" 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 transformation from older technology light lens devices to digital systems, the transition from black and white to color, as well as an increased reliance on electronic documents. We believe we are well positioned as this transformation plays 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. We deliver advanced technology through focused investment in research and development and offset lower prices through continuous improvement of our cost base. Our 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 installation and equipment sales growth to stabilize and grow our installed base of equipment at customer locations. In addition to our installed base, the key factors in delivering growth in our recurring revenue streams (supplies, service, paper, outsourcing and rental, which we collectively refer to as post sale revenue) are page volume growth and higher revenue per page. Connected multifunction devices and 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 2004, we made significant progress in positioning ourselves for revenue growth and earnings expansion while significantly improving our overall financial condition and liquidity. Our continued focus on investment in the growing areas of digital production and office systems contributed to revenue growth as the majority of our equipment sales were generated from products launched in the last two years. Total revenue increased modestly, as equipment sales growth was essentially offset by declines in post sale and other.

We maintained our focus on cost management throughout 2004. While gross margins were slightly below our targeted level, we continued to offset lower prices with productivity improvements. Gross margins were impacted by a change in overall product mix, as well as performance in our Developing Markets Operations. We reduced selling, administrative and general ("SAG") expenses as a result of expense efficiencies and reductions in bad debt expense. 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 \$1 billion during the year.

Our 2004 balance sheet strategy focused on reducing our total debt, optimizing operating cash flows and utilizing long-term funding agreements to support our customer financing operations. The successful implementation of this strategy in 2004 enabled us to significantly improve our liquidity and finish the year with a cash balance of \$3.2 billion. Our prospective balance sheet strategy includes: returning our credit rating to investment grade; optimizing operating cash flows; reducing total debt and leverage; achieving an optimal cost of capital; rebalancing secured and unsecured debt; and effectively deploying cash to deliver and maximize long-term shareholder value.

Revenues for the three years ended December 31, 2004 were as follows:

(\$ in millions)	Year Ended December 31,			Percent Change	
	2004	2003	2002	2004	2003
Equipment sales	\$ 4,480	\$ 4,250	\$ 3,970	5%	7%
Post sale and other revenue	10,308	10,454	10,879	(1)%	(4)%
Finance income	934	997	1,000	(6)%	—
Total revenues	\$15,722	\$15,701	\$15,849	—	(1)%
Total color revenue included in total revenues	\$ 3,903	\$ 3,267	\$ 2,781	19%	17%

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

(\$ in millions)	Year Ended December 31,		
	2004	2003	2002
Sales	\$ 7,259	\$ 6,970	\$ 6,752
Less: Supplies, paper and other sales	(2,779)	(2,720)	(2,782)
Equipment Sales	\$ 4,480	\$ 4,250	\$ 3,970
Service, outsourcing and rentals	\$ 7,529	\$ 7,734	\$ 8,097
Add: Supplies, paper and other sales	2,779	2,720	2,782
Post sale and other revenue	\$10,308	\$10,454	\$10,879

Total 2004 revenues of \$15.7 billion increased modestly as compared to 2003 including a 3-percentage point benefit from currency. Equipment sales increased 5 percent reflecting the success of our color and digital light production products and a 3-percentage point benefit from currency. Post sale and other revenues declined 1 percent as 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. Finance income, which reflects a decrease in equipment lease originations over the past several years, declined 6 percent, including a 4-percentage point benefit from currency.

Total 2003 revenues of \$15.7 billion declined one percent from 2002, reflecting moderating year-over-year revenue declines, as well as a 5-percentage point benefit from currency. Equipment sales increased 7 percent in 2003, reflecting a 6-percentage point benefit from currency, as well as the success of our numerous color multifunction and production color products and growth in our Developing Markets Operations (DMO) segment. 2003 Post sale and other revenue declined 4 percent from 2002, primarily due to declines in older technology light lens revenues, DMO and the Small Office / Home Office (SOHO) business which we exited in the second half of 2001. These declines were partially offset by growth in our digital revenues and a 5-percentage point benefit from currency. Post sale and other revenue declines reflect the reduction in our equipment at customer locations and related page volume declines. 2003 Finance income approximated that of 2002, including a 5-percentage point benefit from currency.

Net income and diluted earnings per share for the three years ended December 31, 2004 were as follows:

(\$ in millions, except share amounts)	Year Ended December 31,		
	2004	2003	2002
Net income	\$ 859	\$ 360	\$ 91
Preferred stock dividends	(73)	(71)	(73)
Income available to common shareholders	\$ 786	\$ 289	\$ 18
Diluted earnings per share	\$ 0.86	\$ 0.36	\$ 0.02

2004 Net income of \$859 million, or 86 cents per diluted share, included an after-tax gain of \$83 million (\$109 million pre-tax) related to the sale of substantially all of our investment in ContentGuard Holdings, Inc. ("ContentGuard"), an after-tax \$38 million pension settlement benefit from Fuji Xerox, an after-tax gain of \$30 million (\$38 million pre-tax) from the sale of our investment in ScanSoft, Inc. ("ScanSoft") and after-tax restructuring charges of \$57 million (\$86 million pre-tax).

2003 Net income of \$360 million, or 36 cents per diluted share, included after-tax restructuring charges of \$111 million (\$176 million pre-tax), an after-tax charge of \$146 million (\$239 million pre-tax) related to the court approved settlement of the Berger v. RIGP litigation, a \$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.

2002 Net income of \$91 million, or 2 cents per diluted share, included after-tax asset impairment and restructuring charges of \$471 million (\$670 million pre-tax), a pre-tax and after-tax charge of \$63 million for impaired goodwill and an after-tax charge of \$72 million (\$106 million pre-tax) for permanently impaired internal-use capitalized software, partially offset by \$105 million of tax benefits arising from the favorable resolution of a foreign tax audit and tax law changes, as well as a favorable adjustment to compensation expense of \$31 million (\$33 million pre-tax), that was previously accrued in 2001, associated with the reinstatement of dividends for our Employee Stock Ownership Plan ("ESOP").

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, see 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: As discussed more fully in Note 1 to the Consolidated Financial Statements, 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: As more fully discussed in Note 1 to the Consolidated Financial Statements, 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 \$110 million, \$224 million, and \$332 million in selling, administrative and general expenses in our Consolidated Statements of Income for the years ended December 31, 2004, 2003 and 2002, 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, 2004, 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, 2004, our allowance for doubtful accounts ranged from 4.2 to 5.5 percent of gross receivables. Holding all other assumptions constant, a one percentage point increase or decrease in the allowance from the December 31, 2004 rate of 4.2 percent would change the 2004 provision by approximately \$110 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.

Provisions for Excess and Obsolete Inventory Losses: We value our inventories 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, including equipment to be leased to customers, which is included as part of finished goods inventory, and record a provision for excess and/or obsolete inventory based primarily on our estimated forecast of product demand and production requirements. Several factors may influence the realizability of our inventories, including our decision to exit a product line, technological changes and new product development. These factors could result in an increase in the amount of excess or obsolete inventory quantities. Additionally, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventories. Although we make every effort to ensure the accuracy of our forecasts of future product demand, including the impact of future product launches and changes in remanufacturing strategies, significant unanticipated changes in demand or technological developments could materially impact the value of our inventory and our reported operating results if our estimates prove to be inaccurate. We recorded \$73 million, \$78 million, and \$115 million in inventory write-down charges for the years ended December 31, 2004, 2003 and 2002, respectively. The decline in inventory write-down charges is due to the absence of business exiting activities, stabilization of our product lines, manufacturing outsourcing related improvements and a lower level of inventories.

As discussed above, in preparing our financial statements for the three years ended December 31, 2004, we estimated our provision for excess and obsolete inventories based primarily on forecasts of production and service requirements. This methodology has been consistently applied for all periods presented. During the three year period ended December 31, 2004, inventory reserves for net realizable value adjustments as a percentage of gross inventory varied by approximately one percentage point. Holding all other assumptions constant, a one percentage point increase or decrease in our net realizable value adjustments would change the 2004 provision by approximately \$13 million.

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 and declining interest rates, 2005 net periodic pension cost will increase. The total unrecognized actuarial loss as of December 31, 2004 was \$1.99 billion, as compared to \$1.87 billion at December 31, 2003. The change from December 31, 2003 relates to a decline in the discount rate, partially offset by improved asset returns as compared to expected returns. 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 8.1 percent for 2004 expense, 8.3 percent for 2003 expense and 8.8 percent for 2002 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 rate we will utilize to calculate our 2005 expense will be 8 percent. 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. In estimating this rate, we consider rates of return on high quality fixed-income investments over the period to expected payment of the pension and other benefits. The weighted average rate we will utilize to measure our pension obligation as of December 31, 2004 and calculate our 2005 expense will be 5.6 percent, which is a decrease from 5.8 percent used in determining 2004 expense. As a result of the reduction in the discount rate, the lower cumulative actual return on plan assets during the prior three years and certain other factors, our 2005 net periodic pension cost is expected to be \$40 million higher than 2004.

On a consolidated basis, we recognized net periodic pension cost of \$350 million, \$364 million, and \$168 million for the years ended December 31, 2004, 2003 and 2002, 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 12 to the Consolidated Financial Statements. Holding all other assumptions constant, a 0.25 percent increase or decrease in the discount rate would change the 2005 projected net periodic pension cost by approximately \$34 million. Likewise, a 0.25 percent increase or decrease in the expected return on plan assets would change the 2005 projected net periodic pension cost by approximately \$14 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 charges (credits) to income tax expense, were \$12 million, \$(16) million, and \$15 million for the years ended December 31, 2004, 2003 and 2002, respectively. Gross deferred tax assets of \$3.5 billion and \$3.7 billion had valuation allowances of \$567 million and \$577 million at December 31, 2004 and 2003, respectively.

We are subject to ongoing tax examinations and assessments in various jurisdictions. Accordingly, we incur additional 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 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 14 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 2003 and 2002 has been restated to reflect changes in operating segment structure made during 2004. 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 and color products over 40 pages per minute. Products include the Xerox iGen3[®] digital color production press, DocuColor family, Xerox Nuvera[™], DocuTech, DocuPrint, and Xerox 2101, as well as older technology light-lens products. The Office segment includes black and white products which operate at speeds up to 90 pages per minute and color devices which operate at speeds up to 40 pages per minute. 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. 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 Production and Office 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 includes Xerox Supplies Business Group (predominantly paper), 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 and other corporate costs.

The changes made in 2004 relate to the reclassification of the operations of our Central and Eastern European entities to DMO to align our segment reporting with how we manage our business. Operating profit was reclassified for this change, as well as for certain other expense allocations. The adjustments (decreased) increased full year 2003 revenues as follows: Production—\$(40) million, Office—\$(61) million, DMO—\$147 million and Other—\$(46) million. The full year 2003 segment profit was (decreased) increased as follows: Production—\$(21) million, Office—\$(11) million, DMO—\$21 million, and Other—\$11 million. The adjustments (decreased) increased full year 2002 revenues as follows: Production—\$(40) million, Office—\$(54) million, DMO—\$127 million, and Other—\$(33) million. The full year 2002 segment profit was (decreased) increased as follows: Production—\$(14) million, Office—\$(9) million, DMO—\$29 million, and Other—\$(6) million.

Revenues by segment for the years ended 2004, 2003 and 2002 were as follows:

(in millions)	Production	Office	DMO	Other	Total
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
2002					
Equipment sales	\$ 1,084	\$2,312	\$ 374	\$ 200	\$ 3,970
Post sale and other revenue	3,005	4,576	1,492	1,806	10,879
Finance income	393	599	19	(11)	1,000
Total Revenue	\$ 4,482	\$7,487	\$1,885	\$1,995	\$15,849

Equipment Sales

2004 Equipment sales of \$4.5 billion increased 5 percent from 2003 reflecting a 3-percentage point benefit from currency as well as the success of our color and digital light production products. Additionally, continued equipment sales growth reflects the success of numerous products launched in the past two years, as the majority of 2004 equipment sales were generated from these products. Color equipment sales continued to grow rapidly in 2004 and represented approximately one-third of total equipment sales.

2003 Equipment sales of \$4.3 billion increased 7 percent from 2002, reflecting significant growth in DMO, the success of numerous new product introductions and a 6-percentage point benefit from currency. In 2003, approximately 50 percent of equipment sales were generated from products launched in the previous two years. Color equipment sales represented 28 percent of total equipment sales compared with 24 percent in 2002.

Production: 2004 equipment sales increased 14 percent from 2003, as improved product mix, installation growth and favorable currency of 4-percentage points more than offset price declines of approximately 3 percent. Strong 2004 production color equipment sales growth reflected stronger product mix and increased installations driven by the DocuColor 5252 and Xerox iGen3 digital color production press products. The Xerox iGen3 digital color production press utilizes next generation color technology which we expect will expand the digital color print on demand market. 2004 production monochrome equipment sales grew as light-production installations,

driven by the success of the Xerox 2101 copier/printer and strong demand for the Xerox Nuvera 100 and 120 copier/printers, as well as favorable currency, more than offset declines in production publishing, printing and older technology light lens products.

2003 Production equipment sales grew 10 percent from 2002, as improved product mix, installation growth and favorable currency of 7 percentage points more than offset price declines of approximately 5 percent. Strong 2003 production color equipment sales growth reflected increased installations and stronger product mix driven by the DocuColor 6060 and Xerox iGen3 digital color production press products. 2003 production monochrome equipment sales grew modestly as light production installations, driven by the success of the new Xerox 2101 copier/printer, and favorable currency more than offset declines in production publishing, printing and older technology light lens.

Office: 2004 equipment sales were essentially unchanged from 2003, as installation growth of approximately 20 percent and favorable currency of 3-percentage points were offset by moderating price declines of approximately 6 percent and the impact of weaker product mix. Product mix reflected an increased proportion of low-end equipment due to very strong growth in office monochrome ("Segments 1 and 2") as well as monochrome and color printers. Color printer growth 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.

2003 Office equipment sales increased 5 percent from 2002, as favorable currency of 7 percentage points and installation increases more than offset price declines of approximately 10 percent and the impact of weaker product mix. Equipment installation growth of approximately 20 percent reflects growth in all monochrome digital and color businesses, particularly office color printing and monochrome multifunction/copier systems. The CopyCentre, WorkCentre and WorkCentre Pro systems, which were launched in the second quarter 2003, expand our market reach and include new entry-level configurations at more competitive prices.

DMO: Equipment sales in DMO consist primarily of segment 1 devices and office printers. Equipment sales in 2004 increased 8 percent from 2003, primarily reflecting growth in geographies where we operate an indirect distribution model such as Russia and Central and Eastern Europe. This growth was partially offset by declines in Latin America, primarily driven by Brazil, and product mix to lower segments. During 2004, we accelerated our transition to indirect distribution channels in Latin America to expand market coverage in that region. DMO 2003 equipment sales grew 25 percent from 2002, reflecting volume growth of over 40 percent, partially offset by price declines of approximately 10 percent and unfavorable mix.

Other: 2004 equipment sales grew 11 percent from 2003, primarily due to growth in equipment sales associated with our Value-added Services business and a 2-percentage point currency benefit. Other 2003 equipment sales declined 15 percent from 2002 due to general sales declines, none of which were individually significant.

Post Sale and Other Revenue

2004 post sale and other revenues of \$10.3 billion declined 1 percent 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, 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 percent 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 percent 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.

2003 post sale and other revenues of \$10.5 billion declined 4 percent from 2002, including a 5-percentage point benefit from currency, primarily reflecting lower equipment populations. 2003 supplies, paper and other sales of \$2.7 billion (included within post sale and other revenue) declined 2 percent from 2002 primarily due to declines in supplies sales resulting from reduced usage in the lower installed base of equipment and declines in our SOHO business. 2003 service, outsourcing and rental revenue of \$7.7 billion declined 4 percent from 2002, reflecting declines in rental and facilities management revenues.

Production: 2004 post sale and other revenue declined 2 percent from 2003, as monochrome declines, driven primarily by lower page volumes, offset favorable mix from color page growth of approximately 40 percent as well as favorable currency. Production 2003 post sale and other revenue declined 2 percent from 2002, as favorable currency and improved mix, driven largely by an increased volume of color pages, were offset by the impact of monochrome page volume declines, primarily in older technology light lens products.

Office: 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. Office 2003 post sale and other revenue grew 1 percent from 2002, as favorable currency and strong digital page growth more than offset declines in older technology light lens products.

DMO: 2004 post sale and other revenue declined 7 percent from 2003, primarily reflecting Latin America's rental equipment population declines. 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. DMO 2003 post sale and other revenue declined 14 percent from 2002, due largely to a lower rental equipment population at customer locations and related page volume declines.

Other: 2004 post sale and other revenue declined 1 percent from 2003, as declines in SOHO were essentially offset by currency benefits and growth in Value-added Services as well as other activity. Other 2003 post sale and other revenue declined 11 percent from 2002, reflecting supply sale declines in SOHO of \$82 million as well as the absence of \$50 million of third-party licensing revenue recognized in 2002.

2005 Projected Revenues

We expect 2005 equipment sales will continue to grow, as we anticipate that new platforms and products launched in 2003, 2004 and those planned in 2005 will enable us to further strengthen our market position. Compared to 2004, we expect 2005 post sale and other revenue declines to continue to moderate throughout the year and ultimately transition to growth before year-end. Growth in post sale and other revenue 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. We expect 2005 total revenues to increase approximately 3 percent from 2004 levels.

Segment Operating Profit

Segment operating profit and operating margin for the three years ended December 31, 2004 were as follows (\$ in millions):

	<u>Production</u>	<u>Office</u>	<u>DMO</u>	<u>Other</u>	<u>Total</u>
2004					
Operating Profit	\$ 388	\$ 798	\$ 43	\$ (29)	\$ 1,200
Operating Margin	8.5%	10.5%	2.5%	(1.6)%	7.6%
2003					
Operating Profit	\$ 401	\$ 742	\$ 172	\$ (327)	\$ 988
Operating Margin	8.9%	9.7%	9.8%	(18.3)%	6.3%
2002					
Operating Profit	\$ 436	\$ 612	\$ 120	\$ (335)	\$ 833
Operating Margin	9.7%	8.2%	6.4%	(16.8)%	5.3%

Production: 2004 operating profit declined \$13 million and operating margin declined 0.4 percentage points from 2003. The declines primarily reflect lower gross margin and investments in selling and marketing expenses, which were partially offset by R&D efficiencies and lower bad debt expenses. Production 2003 operating profit declined \$35 million from 2002, reflecting lower gross margins related to initial installations of the Xerox iGen3 digital color production press and Xerox 2101. The decrease in gross margins was only partially offset by lower R&D and SAG expenses.

Office: 2004 operating profit improved \$56 million and operating margin improved 0.8 percentage points from 2003. The improvements primarily reflect modest improvement in gross margins, general and administrative expense productivity, and lower bad debt expense. Office 2003 operating profit improved \$130 million from 2002, reflecting improved gross margins driven primarily by improved manufacturing and service productivity, as well as lower R&D and SAG expenses.

DMO: 2004 operating profit declined \$129 million from 2003 primarily reflecting results in Latin America where the pace of revenue declines have exceeded cost and expense reductions. DMO 2003 operating profit improved \$52 million from 2002 due to significantly lower SAG spending resulting from our cost saving initiatives, lower bad debts and gains on currency exposures compared to currency exposure losses in 2002. These improvements were partially offset by lower gross margins as a result of declining post sale revenue.

Other: 2004 Other segment operating loss of \$29 million improved by \$298 million as compared to 2003, principally due to reduced non-financing interest expense of \$159 million, an increase in equity income from Fuji Xerox of \$93 million and the gain on sale of our interest in ScanSoft of \$38 million. 2003 Other segment operating loss of \$327 million decreased by \$8 million from 2002.

Employee Stock Ownership Plan (ESOP): In 2002, our Board of Directors reinstated the dividend on our ESOP, which resulted in a reversal of previously recorded compensation expense. The reversal of compensation expense corresponded to the line item in the Consolidated Statement of Income for 2002 where the charge was originally recorded and included \$28 million in both Cost of Sales and Selling, administrative and general expenses and \$11 million in Research and Development expenses. Of the total compensation expense originally recorded, \$34 million and \$33 million was recognized in 2002 and 2001, respectively. As such, 2002 benefited by the reversal of \$33 million of excess compensation expense that was originally recorded in 2001. There is no corresponding earnings per share improvement in 2002 since the EPS calculation requires deduction of dividends declared from reported net income in arriving at net income available to common shareholders. See Note 12 to the Consolidated Financial Statements for a more complete discussion of the ESOP.

Gross Margin: Gross margins by revenue classification were as follows:

	Year Ended December 31,		
	2004	2003	2002
Total gross margin	40.6%	42.0%	42.4%
Sales	35.4%	36.4%	37.3%
Service, outsourcing and rentals	42.8%	44.3%	44.5%
Finance income	63.1%	63.7%	59.9%

2004 gross margin of 40.6 percent declined 1.4 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 from DMO results. The declines in DMO relate to Brazil's revenue, which has declined faster than declines in its cost levels and product mix to lower gross margin products in various DMO geographies. Lower prices were approximately offset by productivity improvements.

2004 sales gross margin of 35.4 percent declined 1 percentage point 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.

2004 service, outsourcing, and rentals gross margin of 42.8 percent declined 1.5 percentage points from 2003. The majority of the decline is attributed to product mix in the Office and Production segments as well as DMO results. Productivity and cost improvements offset lower prices for the year.

The 2003 gross margin of 42.0 percent declined 0.4 percentage points from 2002. During 2003, we completed the R&D phase of the Xerox iGen3 digital color production press development and, therefore, beginning in July 2003 ongoing engineering costs associated with initial commercial production were included in cost of sales. Xerox iGen3 digital color production press ongoing engineering costs of \$30 million, the absence of the \$28 million prior year favorable ESOP adjustment and the absence of \$50 million in prior year licensing revenue each contributed 0.2 percentage points to the 2003 gross margin decline. During 2003, manufacturing and service productivity improvements more than offset the impact of lower prices, higher pension and other employee benefit costs and product mix.

2003 sales gross margin declined 0.9 percentage points from 2002, with over half of the decline due to Xerox iGen3 digital color production press ongoing engineering costs and the remainder due to product mix as we increased our penetration of the digital light production market. In 2003, manufacturing productivity more than offset the impact of planned lower prices. 2003 service, outsourcing and rentals margin declined 0.2 percentage points from 2002. Improved productivity and product mix more than offset lower prices and higher pension and other employee expenses. 2002 also included a 0.4 percentage point benefit from a \$50 million licensing agreement and a 0.3 percentage point benefit due to favorable ESOP adjustments.

2004 Finance income gross margins decreased 0.6 percentage points from 2003 due to interest costs specific to equipment financing. Equipment financing interest expense is determined based on a combination of actual interest expense incurred on financing debt, as well as our estimated cost of funds, applied against the estimated level of debt required to support our finance receivables. The estimate is based on an assumed ratio which ranges from 80-90% of our average finance receivables. This methodology has been consistently applied for all periods presented. 2003 Finance income gross margins increased 3.8 percentage points from 2002, in line with declining interest costs specific to equipment financing.

Research and Development: 2004 R&D expense of \$760 million was \$108 million lower than the prior year, primarily due to improved efficiencies as we capture benefits from our platform development strategy as well as the commercial launch of the Xerox iGen3. We continue to invest in technological development, particularly in color, and believe that our R&D spending is at an adequate level to remain technologically competitive. We expect 2005 R&D spending to approximate 5 percent of total revenue. Our R&D is strategically coordinated with that of Fuji Xerox, which invested \$704 million and \$724 million in R&D in 2004 and 2003, respectively.

2003 R&D spending of \$868 million was \$49 million lower than 2002, primarily due to a \$30 million reduction associated with the commercial launch of the Xerox iGen3 digital color production press and improved R&D productivity, partially offset by higher pension and other employee benefit expenses.

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

	Year Ended December 31,		
	2004	2003	2002
Total Selling, administrative and general expenses	\$4,203	\$4,249	\$4,437
SAG as a percentage of revenue	26.7%	27.1%	28.0%

2004 SAG expense of \$4.2 billion declined \$46 million from 2003 as bad debt expense reductions of approximately \$115 million and G&A efficiencies were partially offset by increased selling and marketing

expenses as well as unfavorable currency impacts of \$141 million. 2003 SAG expense of \$4.2 billion declined \$188 million from 2002 including adverse currency impacts of \$172 million and \$70 million of higher pension and other employee benefit costs. 2003 SAG reductions reflect improved productivity and employment reductions associated with our cost base restructuring and lower bad debt expenses of \$109 million.

Bad debt expense included in SAG was \$110 million, \$224 million and \$332 million in 2004, 2003 and 2002, respectively. The 2004 reduction reflects improved collections performance, receivables aging and write-off trends. Bad debt expense as a percent of total revenue was 0.7 percent, 1.4 percent and 2.1 percent for 2004, 2003 and 2002, respectively.

Restructuring Programs: For the three years ended December 31, 2004, we have engaged in a series of restructuring programs, resulting in \$932 million in charges related to downsizing our employee base, exiting certain activities, outsourcing some internal functions and engaging in other actions designed to reduce our cost structure. In 2004, we recorded restructuring charges of \$86 million, primarily consisting of ongoing restructuring actions. These ongoing initiatives included downsizing our employee base and the outsourcing of certain internal functions. The initiatives are not individually significant and primarily include severance actions and impact all geographies and segments. We expect prospective annual savings associated with 2004 actions to be approximately \$88 million. Restructuring and asset impairment charges of \$176 million and \$670 million in 2003 and 2002, respectively, primarily related to severance and employee benefits related to worldwide severance actions as well as certain costs related to the consolidation of excess facilities. The remaining restructuring reserve balance at December 31, 2004 for all programs was \$117 million. The reserve balance for Ongoing Programs as of December 31, 2004 was \$93 million, the majority of which will be spent in 2005. The reserve balance for the Legacy programs as of December 31, 2004 was \$24 million and the majority of this balance relates to our exit from facilities in Europe and the United States, which are currently leased beyond 2008.

Worldwide employment declined by approximately 3,000 in 2004, to approximately 58,100, primarily reflecting reductions as part of our restructuring programs. Worldwide employment was approximately 61,100 and 67,800 at December 31, 2003 and 2002, 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 18 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, 2004 consisted of the following (\$ in millions):

	Year Ended December 31,		
	2004	2003	2002
Non-financing interest expense	\$ 363	\$ 522	\$ 495
Interest income	(75)	(65)	(77)
Net currency losses	73	11	77
Legal and regulatory matters	9	242	37
Amortization of intangible assets	37	36	36
Loss (gain) on early extinguishment of debt	—	73	(1)
Business divestiture and asset sale (gains) losses	(61)	13	(1)
Minorities' interests in earnings of subsidiaries	8	6	3
All other, net	15	38	24
	<u>\$ 369</u>	<u>\$ 876</u>	<u>\$ 593</u>

Non-financing interest expense: 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. 2003 non-financing interest expense was \$27 million higher than 2002, primarily reflecting 2003 net losses of \$13 million from the mark-to-market valuation of our interest rate swaps compared to gains of \$12 million in 2002. 2003 non-financing interest expense also included higher interest rates and borrowing costs in the first half of the year associated with the terms of the 2002 Credit Facility. These increased expenses were offset by lower borrowing costs in the second half of 2003 following the June 2003 Recapitalization.

Interest income: Interest income is derived primarily from our invested cash and cash equivalent balances and interest resulting from periodic tax settlements. 2004 interest income was \$10 million higher than 2003 reflecting interest income 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. 2003 interest income was \$12 million lower than 2002 reflecting declining interest rates and lower average cash balances, partially offset by the \$13 million of interest income related to the Brazilian tax credits.

Net currency losses: Net currency losses primarily result from the spot/forward premiums on foreign exchange forward contracts, the re-measurement of unhedged foreign currency-denominated assets and liabilities and the mark-to-market impact of economic hedges of anticipated transactions for which we do not qualify for cash flow hedge accounting treatment. In 2004, the majority of the exchange losses of \$73 million related to spot/forward premiums on foreign exchange forward contracts as well as the mark-to-market of derivatives economically hedging the cost of future inventory purchases. The increase from 2003 was primarily due to the weakening of the U.S. Dollar against the Euro and the Yen. In 2003, exchange losses of \$11 million were due largely to spot/forward premiums on foreign exchange forward contracts and unfavorable currency movements on economic hedges of anticipated transactions not qualifying for hedge accounting treatment. In the first half of 2002, we incurred \$57 million of exchange losses, primarily in Brazil and Argentina due to the devaluation of the underlying currencies. In the latter half of 2002, we were able to restore hedging capability in the majority of our key markets. Therefore, the \$20 million of currency losses in the second half of 2002 primarily represented the spot/forward premiums on foreign exchange forward contracts and unfavorable currency movements on economic hedges of anticipated transactions not qualifying for hedge accounting treatment.

Legal and regulatory matters: Legal and regulatory matters for 2004 reflect expenses associated with the resolution of various legal matters, none of which was individually material, partially offset by the adjustment of an estimate associated with a previously recorded litigation accrual. See Note 14 to the Consolidated Financial Statements for additional information regarding litigation against the Company. Legal and regulatory matters for 2003 primarily reflects a \$239 million provision for litigation relating to the court approved settlement of the Berger v. Retirement Income Guarantee Plan (RIGP) litigation. Legal and regulatory matters for 2002 includes \$27 million of expenses related to certain litigation, indemnifications and associated claims, as well as the \$10 million penalty incurred in connection with our settlement with the SEC.

Loss (gain) on early extinguishment of debt: In 2003, we recorded a \$73 million loss on early extinguishment of debt reflecting the write-off of the remaining unamortized fees associated with the 2002 Credit Facility. The 2002 Credit Facility was repaid upon completion of the June 2003 Recapitalization.

Business divestiture and asset sale losses (gains): Business divestitures and asset sales in all years included miscellaneous land, buildings and equipment sales. The 2004 amount primarily reflects the \$38 million gain from the sale of our interest in ScanSoft, gains of \$14 million primarily related to the sale of certain excess land and buildings in Europe and Mexico and a \$7 million favorable purchase price adjustment associated with a prior year business sale. The 2003 amount primarily included losses related to the sale of XES subsidiaries in France and Germany, which were partially offset by a gain on the sale of our investment in Xerox South Africa.

Income Taxes: The following table summarizes our consolidated income taxes and the related effective tax rate for each respective period (\$ in millions):

	Year Ended December 31,		
	2004	2003	2002
Pre-tax income	\$ 965	\$ 436	\$104
Income taxes	340	134	4
Effective tax rate ⁽¹⁾	35.2%	30.7%	3.8%

⁽¹⁾ A detailed reconciliation of the consolidated effective tax rate to the U.S. federal statutory income tax rate is included in Note 13.

The 2004 consolidated effective income tax rate of 35.2 percent was comparable to the U.S. federal statutory income tax rate. The effective income tax rate reflects the impact of nondeductible expenses and \$20 million of unrecognized tax benefits primarily related to recurring losses in certain jurisdictions where we continue to maintain deferred tax asset valuation allowances. This tax expense was 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 difference between the 2003 consolidated effective tax rate of 30.7 percent and the U.S. federal statutory income tax rate of 35 percent relates primarily to \$35 million of tax benefits arising 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. Such benefits were 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 continue to maintain deferred tax asset valuation allowances.

The difference between the 2002 consolidated effective tax rate of 3.8 percent and the U.S. federal statutory income tax rate of 35 percent relates primarily to the recognition of tax benefits resulting from the favorable resolution of a foreign tax audit of approximately \$79 million, tax law changes of approximately \$26 million and the impact of Series B Convertible Preferred Stock dividends. Such benefits were offset, in part, by tax expense recorded for the on-going examination in India, the sale of our interest in Katun Corporation, as well as recurring losses in certain jurisdictions where we are not providing tax benefits and continue to maintain deferred tax asset valuation allowances.

Our consolidated effective income tax rate will change based on discrete events (such as audit settlements) as well as other factors including the geographical mix of income before taxes and the related tax rates in those jurisdictions. We anticipate that our 2005 annual consolidated effective tax rate will approximate 38 percent.

Equity in Net Income of Unconsolidated Affiliates: Equity in net income of unconsolidated affiliates increased \$93 million in 2004 as compared to 2003. This account is principally related to our 25 percent share of Fuji Xerox income. As discussed in Note 6 to the Consolidated Financial Statements, equity income for 2004 included \$38 million related to our share of a pension settlement gain recorded by Fuji Xerox due to a non-recurring opportunity given to Japanese companies by the Japanese government in accordance with the Japan Welfare Pension Insurance Law. This law allowed Japanese companies to transfer a portion of their pension obligations to the Japanese government. The remainder of the 2004 increase is primarily due to the improved operational performance of Fuji Xerox. Our 2003 equity in net income of \$58 million was comparable with the 2002 result of \$54 million.

In 2004, we recorded a *Gain on sale of ContentGuard* relating to the sale of all but 2 percent of our 75 percent ownership interest in ContentGuard. The sale, which is disclosed in Note 18 to the Consolidated Financial Statements, resulted in an after-tax gain of approximately \$83 million (\$109 million pre-tax).

Recent Accounting Pronouncements: See Note 1 of the Consolidated Financial Statements for a full 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, 2004, as reported in our Consolidated Statements of Cash Flows in the accompanying Consolidated Financial Statements (\$ in millions):

	2004	2003	2002
Net cash provided by operating activities	\$ 1,750	\$ 1,879	\$ 1,980
Net cash provided by investing activities	203	49	93
Net cash used in financing activities	(1,293)	(2,470)	(3,292)
Effect of exchange rate changes on cash	81	132	116
	<u>741</u>	<u>(410)</u>	<u>(1,103)</u>
Increase (decrease) in cash and cash equivalents			
Cash and cash equivalents at beginning of year	2,477	2,887	3,990
	<u>\$ 3,218</u>	<u>\$ 2,477</u>	<u>\$ 2,887</u>

Operating: For the year ended December 31, 2004, operating cash flows were \$1.8 billion, a decrease of \$129 million over the same period in 2003. The decrease primarily results from 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 product launches and increased tax payments of \$46 million due to increased income. In addition, there was lower cash generation from the early termination of interest rate swaps of \$62 million. These cash outflows were partially offset by lower pension plan contributions of \$263 million.

For the year ended December 31, 2003, operating cash flows were \$1.9 billion, a decrease of \$101 million over the same period in 2002. The decrease primarily reflects increased pension plan contributions of \$534 million, lower finance receivable reductions of \$258 million reflecting the increase in equipment sale revenue in 2003 and an increased on-lease equipment investment of \$39 million. These items were partially offset by increased pre-tax income of \$332 million, lower tax payments of \$235 million and increased cash proceeds from the early termination of interest rate swaps of \$80 million. The lower tax payments reflect the absence of the \$346 million tax payment associated with the 2001 sale of a portion of our ownership interest in Fuji Xerox.

We expect operating cash flows to be between \$1.0 billion and \$1.5 billion in 2005, as compared to \$1.8 billion in 2004. The reduction includes the expected change in finance receivables consistent with expected equipment sales expansion, along with expected on-lease equipment growth as well as the absence of early derivative contract termination cash flow.

Investing: Investing cash flows for the year ended December 31, 2004 of \$203 million included \$191 million proceeds from the sale of businesses and investments, primarily consisting of \$66 million from the ContentGuard sale, \$79 million from the ScanSoft sale and \$36 million from a preferred stock investment. In addition, \$223 million was released from restricted cash during the period primarily related to the renegotiation of certain secured borrowing arrangements and scheduled releases from an escrow account supporting interest payments on our liability to a trust issuing preferred securities. We also received \$53 million of proceeds from the sale of certain excess land and buildings. These aggregate proceeds were partially offset by capital and internal use software spending of \$252 million. We expect 2005 capital expenditures to approximate \$250 million.

Investing cash flows for the year ended December 31, 2003 of \$49 million consisted primarily of \$235 million released from restricted cash related to former reinsurance obligations associated with our discontinued

operations, \$35 million of aggregate cash proceeds from the divestiture of our investment in Xerox South Africa, XES France and Germany and other minor investments, partially offset by capital and internal use software spending of \$250 million.

Financing: Cash usage from financing activities for the year ended December 31, 2004 of \$1.3 billion included payments of scheduled maturities on Euro and Dollar denominated term debt of \$2.1 billion, net payments of other debt totaling \$101 million and preferred stock dividends of \$83 million. These net payments were partially offset by net proceeds of \$750 million from the issuance of the 2011 Senior Notes, net proceeds from secured borrowing activity of \$155 million and proceeds from stock options exercises of \$73 million.

Cash usage from financing activities for the year ended December 31, 2003 of \$2.5 billion included net payments on our 2002 credit facility of \$3.5 billion, net payments on term and other debt of \$2.0 billion and preferred stock dividends of \$57 million. These payments were partially offset by net proceeds from secured borrowing activity of \$269 million and the following activity related to the completion of our June 2003 recapitalization plan—net proceeds from the convertible preferred stock offering of \$889 million, net proceeds from the common stock offering of \$451 million, net proceeds from the 2010 and 2013 Senior Notes of \$1.2 billion and net proceeds from the 2003 Credit Facility of \$271 million.

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. We have funded a significant portion of our finance receivables through third-party secured funding arrangements. Under these arrangements, debt is secured by the finance receivables it supports, which eliminates certain significant refinancing, pricing and duration risks associated with our debt. In addition to these third party arrangements, we support our customer finance leasing with cash generated from operations and through capital markets offerings.

During the years ended December 31, 2004 and 2003, we borrowed \$2.1 billion and \$2.5 billion, respectively, under third-party secured funding arrangements. Approximately 60 percent of our total finance receivable portfolio has been pledged to secure funding at both December 31, 2004 and December 31, 2003. The following table compares finance receivables to financing-related debt as of December 31, 2004 and 2003 (\$ in millions):

	December 31, 2004		December 31, 2003	
	Finance Receivables, Net	Secured Debt	Finance Receivables, Net	Secured Debt
GE secured loans:				
United States	\$ 2,711	\$2,486	\$ 2,939	\$2,598
Canada	486	426	528	440
United Kingdom	771	685	719	570
Germany	—	—	114	84
Total GE encumbered finance receivables, net	3,968	3,597	4,300	3,692
Merrill Lynch Loan—France	368	287	138	92
Asset-backed notes—France	225	148	429	364
DLL—Netherlands, Spain, and Belgium	436	404	335	277
Total encumbered finance receivables, net ⁽¹⁾	4,997	\$4,436	5,202	\$4,425
Unencumbered finance receivables, net	3,500		3,611	
Total finance receivables, net ⁽²⁾	\$ 8,497		\$ 8,813	

- (1) Encumbered finance receivables represent the book value of finance receivables that secure each of the indicated loans.
- (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, 2004 and 2003.

As of December 31, 2004 and 2003, debt secured by finance receivables was approximately 44 percent and 40 percent of total debt, respectively. The following represents our aggregate debt maturity schedule as of December 31, 2004 (\$ in millions):

	Bonds/ Bank Loans	Secured by Finance Receivables	Total Debt
2005	\$1,177	\$ 1,897	\$ 3,074 ⁽¹⁾
2006	36	915	951
2007	528	838	1,366
2008	385	656	1,041
2009	932	27	959
Thereafter	2,630	103	2,733
Total	\$5,688	\$ 4,436	\$10,124

- (1) Quarterly debt maturities (in millions) for 2005 are \$681, \$1,500, \$421 and \$472 for the first, second, third and fourth quarters, respectively.

The following table summarizes our secured and unsecured debt as of December 31, 2004 and 2003 (\$ in millions):

	December 31, 2004	December 31, 2003
Term Loan	\$ 300	\$ 300
Debt secured by finance receivables	4,436	4,425
Capital leases	58	29
Debt secured by other assets	235	99
Total Secured Debt	5,029	4,853
Senior Notes	2,936	2,137
Subordinated debt	19	19
Other Debt	2,140	4,157
Total Unsecured Debt	5,095	6,313
Total Debt	\$ 10,124	\$ 11,166

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 \$3.2 billion of cash and cash equivalents on hand at December 31, 2004, borrowing capacity under our 2003 Credit Facility of \$700 million (less \$15 million utilized for letters of credit) 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 to 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, 2004, 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, 2004, 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 percent and 3 percent 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 3.92 percent at December 31, 2004.

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, 2004, 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.

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 securitizations. In the United States, Canada, the U.K., and France, we are currently funding a significant portion of our customer financing activity through secured borrowing arrangements with GE and Merrill Lynch. In The Netherlands, Spain and Belgium, we utilize a consolidated joint venture relationship with De Lage Landen International BV ("DLL"), whereby the joint venture, funded by DLL's parent, became our primary equipment financing partner for new lease originations in those countries. We also have arrangements in 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 to the equipment to these financial institutions and generally have no continuing ownership rights in the equipment subsequent to its sale. Several of the more significant customer financing arrangements are discussed below. See Note 3 to the Consolidated Financial Statements for a more detailed discussion of our customer financing arrangements.

Secured Borrowing Arrangements: In October 2002, we finalized an eight-year Loan Agreement with General Electric Capital Corporation ("GECC"). The Loan Agreement provides for a series of monthly secured loans up to \$5 billion outstanding at any time (\$2.5 billion outstanding at December 31, 2004). The \$5 billion limit may be increased to \$8 billion subject to agreement between the parties. Additionally, the agreement contains mutually agreed renewal options for successive two-year periods. The Loan Agreement, as well as separate loan agreements with GE in the U.K. and Canada that have similar terms, incorporates the financial maintenance covenants contained in the 2003 Credit Facility and contains other affirmative and negative covenants.

Under the Loan Agreement, we expect GECC to fund a significant portion of new U.S. lease originations at over-collateralization rates, which vary over time, but are expected to approximate 10 percent at the inception of each funding. The secured loans are subject to interest rates calculated at each monthly loan occurrence at yield rates consistent with average rates for similar market based transactions. The funds received under this agreement are recorded as secured borrowings and the associated finance receivables are included in our Consolidated Balance Sheet. GECC's commitment to fund under this agreement is not subject to our credit ratings.

France Secured Borrowings: In July 2003, we securitized receivables of \$443 million, previously funded under a 364-day warehouse financing facility established in December 2002 with subsidiaries of Merrill Lynch, with a three-year public secured financing arrangement. In addition, we established a new warehouse financing facility to fund future lease originations in France. This facility can provide funding for new lease originations up to €350 million (U.S. \$477 million), outstanding at any time, and balances may be securitized through a similar public offering within two years.

The Netherlands Secured Borrowings: Beginning in the second half of 2002, we received a series of fundings through our consolidated joint venture with DLL from DLL's parent, De Lage Landen Ireland Company. The fundings are secured by our lease receivables in The Netherlands which were transferred to the DLL joint venture. In addition, the DLL joint venture also became our primary equipment financing provider in the Netherlands for all new lease originations. In the fourth quarter of 2003, the DLL joint venture expanded its operations to include Spain and Belgium.

Loan Covenants and Compliance: At December 31, 2004, 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, it would 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 percent of par. These notes, which are discussed further in Note 9 to the Consolidated Financial Statements, form a single series of debt. Interest on the Senior Notes accrues at the annual rate of 6.875 percent 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 percent. The weighted average effective interest rate associated with the Senior Notes reflects our recently 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 10 to the Consolidated Financial Statements.

Credit Ratings: Our credit ratings as of February 21, 2005 were as follows:

	Senior Unsecured Debt	Outlook	Comments
Moody's ⁽¹⁾ ⁽²⁾	Ba2	Stable	The Moody's rating was upgraded from B1 in August 2004.
S&P	B+	Stable	The S&P rating on Senior Secured Debt is BB-. The outlook was upgraded to stable in January 2005.
Fitch	BB	Positive	The Fitch rating was upgraded to a positive outlook in February 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 and the outlook is stable.

Both our ability to obtain financing and the related cost of borrowing are affected by our credit ratings, which are periodically reviewed by the major rating agencies. Our current credit ratings are below investment grade and we expect our access to the public debt markets to be limited to the non-investment grade segment until our ratings have been restored.

Contractual Cash Obligations and Other Commercial Commitments and Contingencies: At December 31, 2004, we had the following contractual cash obligations and other commercial commitments and contingencies (\$ in millions):

	Year 1	Years 2-3		Years 4-5		Thereafter
	2005	2006	2007	2008	2009	
Long-term debt, including capital lease obligations ¹	\$3,074	\$ 951	\$1,366	\$1,041	\$ 959	\$ 2,733
Minimum operating lease commitments ²	222	181	143	109	94	256
Liabilities to subsidiary trusts issuing preferred securities ³	—	88	—	—	—	629
Total contractual cash obligations ⁴	\$3,296	\$1,220	\$1,509	\$1,150	\$1,053	\$ 3,618

¹ Refer to Note 9 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 5 to our Consolidated Financial Statements for additional information related to minimum operating lease commitments.

³ Refer to Note 10 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 Certain long-term liabilities reflected on our balance sheet, such as unearned income, are not presented in this table because they do not require cash settlement in the future.

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 2004 cash fundings for these plans were \$409 million for pensions and \$104 million for other post-retirement plans. Our anticipated cash fundings for 2005 are \$114 million for pensions and \$128 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 contributions for pensions for 2005 include no expected

contributions to the domestic tax qualified plans because these plans have already exceeded the ERISA minimum funding requirements for the plans' 2004 plan year due to funding of approximately \$210 million in 2004. Our post-retirement 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.

Flextronics: In 2001, we outsourced certain manufacturing activities to Flextronics under a five-year agreement. During 2004, we purchased \$874 million of products from Flextronics. We anticipate that we will purchase approximately \$920 million of products from Flextronics during 2005 and expect this level to be commensurate with our sales in the future.

Fuji Xerox: We had product purchases from Fuji Xerox totaling \$1.1 billion, \$871 million, and \$727 million in 2004, 2003 and 2002, 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 \$1.2 billion of products from Fuji Xerox in 2005. Related party transactions with Fuji Xerox are disclosed in Note 6 to the Consolidated Financial Statements.

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.

EDS Contract: 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. On July 1, 2004, we extended the original ten-year contract through June 30, 2009. Although there are no minimum payments required under the contract, we anticipate making the following payments to EDS over the next five years (in millions): 2005—\$319; 2006—\$309; 2007—\$298; 2008—\$290; 2009—\$141 (for six months). Each framework has a process for estimating projected volumes. Pricing for the services (which are comprised of global mainframe system processing, application maintenance and enhancements, desktop services and help desk support, voice and data management) were established when the contract was signed in 1994 based on our actual costs in preceding years. Prices were renegotiated for the period from July 1, 2004 to July 1, 2009 and, in most cases, are subject to annual revision based upon inflation indices. 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.

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 5 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 3 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.

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. As permitted, certain of these derivative contracts have been designated for hedge accounting treatment under SFAS No. 133. However, certain of these instruments do not qualify for 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, purchased foreign currency options and interest rate collars to manage interest rate and foreign currency exposures. Our primary foreign currency market exposures include the Japanese yen, Euro, British pound sterling, Brazilian real and Canadian dollar. 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, 2004 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.

Assuming a 10 percent appreciation or depreciation in foreign currency exchange rates from the quoted foreign currency exchange rates at December 31, 2004, 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, 2004. A 10 percent appreciation or depreciation of the U.S. Dollar against all currencies from the quoted foreign currency exchange rates at December 31, 2004 would have a \$496 million impact on our Cumulative Translation Adjustment portion of equity. The amount permanently invested in foreign subsidiaries and affiliates, primarily Xerox Limited, Fuji Xerox and Xerox do Brasil, and translated into dollars using the year-end exchange rates, was \$5.0 billion at December 31, 2004, 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 2004, 2003 and 2002 approximated 5.8 percent, 6.0 percent, and 5.0 percent, 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 to secure financing loan arrangements and the interest rates on a significant portion of those loans are fixed. If we implement additional financing arrangements, the proportion of our financing assets which is match-funded against related secured debt may increase.

As of December 31, 2004, approximately \$3.2 billion of our debt bears interest at variable rates, including the effect of pay-variable interest rate swaps we are utilizing 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, 2004, a 10 percent change in market interest rates would change the fair values of such financial instruments by approximately \$378 million.

Forward-Looking Cautionary 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 2004 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,		
	2004	2003	2002
Revenues			
Sales	\$ 7,259	\$ 6,970	\$ 6,752
Service, outsourcing and rentals	7,529	7,734	8,097
Finance income	934	997	1,000
Total Revenues	15,722	15,701	15,849
Costs and Expenses			
Cost of sales	4,688	4,436	4,233
Cost of service, outsourcing and rentals	4,306	4,311	4,494
Equipment financing interest	345	362	401
Research and development expenses	760	868	917
Selling, administrative and general expenses	4,203	4,249	4,437
Restructuring and asset impairment charges	86	176	670
Gain on affiliate's sale of stock	—	(13)	—
Other expenses, net	369	876	593
Total Costs and Expenses	14,757	15,265	15,745
Income from Continuing Operations before Income Taxes, Equity Income and Cumulative Effect of Change in Accounting Principle			
	965	436	104
Income taxes	340	134	4
Equity in net income of unconsolidated affiliates	151	58	54
Income from Continuing Operations before Cumulative Effect of Change in Accounting Principle	776	360	154
Gain on sale of ContentGuard, net of income taxes of \$26	83	—	—
Income before Cumulative Effect of Change in Accounting Principle	859	360	154
Cumulative effect of change in accounting principle	—	—	(63)
Net Income	859	360	91
Less: Preferred stock dividends, net	(73)	(71)	(73)
Income available to common shareholders	\$ 786	\$ 289	\$ 18
Basic Earnings per Share			
Income from Continuing Operations before Cumulative Effect of Change in Accounting Principle	\$ 0.84	\$ 0.38	\$ 0.11
Net Earnings per Share	\$ 0.94	\$ 0.38	\$ 0.02
Diluted Earnings per Share			
Income from Continuing Operations before Cumulative Effect of Change in Accounting Principle	\$ 0.78	\$ 0.36	\$ 0.10
Net Earnings per Share	\$ 0.86	\$ 0.36	\$ 0.02

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

XEROX CORPORATION
CONSOLIDATED BALANCE SHEETS

(in millions)	December 31,	
	2004	2003
Assets		
Cash and cash equivalents	\$ 3,218	\$ 2,477
Accounts receivable, net	2,076	2,159
Billed portion of finance receivables, net	377	461
Finance receivables, net	2,932	2,981
Inventories	1,143	1,152
Other current assets	1,182	1,105
Total Current Assets	10,928	10,335
Finance receivables due after one year, net	5,188	5,371
Equipment on operating leases, net	398	364
Land, buildings and equipment, net	1,759	1,827
Investments in affiliates, at equity	845	644
Intangible assets, net	297	325
Goodwill	1,848	1,722
Deferred tax assets, long-term	1,521	1,526
Other long-term assets	2,100	2,477
Total Assets	\$24,884	\$24,591
Liabilities and Equity		
Short-term debt and current portion of long-term debt	\$ 3,074	\$ 4,236
Accounts payable	1,037	1,010
Accrued compensation and benefits costs	637	632
Unearned income	243	251
Other current liabilities	1,309	1,540
Total Current Liabilities	6,300	7,669
Long-term debt	7,050	6,930
Liabilities to subsidiary trusts issuing preferred securities	717	1,809
Pension and other benefit liabilities	1,189	1,058
Post-retirement medical benefits	1,180	1,168
Other long-term liabilities	1,315	1,278
Total Liabilities	17,751	19,912
Series B convertible preferred stock	—	499
Series C mandatory convertible preferred stock	889	889
Common stock, including additional paid-in capital	4,881	3,239
Retained earnings	2,101	1,315
Accumulated other comprehensive loss	(738)	(1,263)
Total Liabilities and Equity	\$24,884	\$24,591

Shares of common stock issued and outstanding were (in thousands) 955,997 and 793,884 at December 31, 2004 and 2003, respectively.

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

XEROX CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)	Year ended December 31,		
	2004	2003	2002
Cash Flows from Operating Activities			
Net income	\$ 859	\$ 360	\$ 91
Adjustments required to reconcile net income to cash flows from operating activities:			
Depreciation and amortization	686	748	1,035
Provisions for receivables and inventory	159	302	468
Deferred tax expense (benefit)	155	(70)	(178)
Net gains on sales of businesses, assets and affiliate's sale of stock	(61)	(1)	(1)
Undistributed equity in net income of unconsolidated affiliates	(89)	(37)	(23)
Loss (gain) on early extinguishment of debt	—	73	(1)
Gain on sale of ContentGuard	(83)	—	—
Impairment of goodwill	—	—	63
Restructuring and other charges	86	176	670
Cash payments for restructurings	(187)	(345)	(392)
Contributions to pension benefit plans	(409)	(672)	(138)
Early termination of derivative contracts	74	136	56
(Increase) decrease in inventories	(38)	62	16
Increase in on-lease equipment	(234)	(166)	(127)
Decrease in finance receivables	337	496	754
Decrease (increase) in accounts receivable and billed portion of finance receivables	224	164	(266)
Increase in accounts payable and accrued benefits	333	408	398
Net change in income tax assets and liabilities	(68)	(3)	(260)
Decrease in other current and long-term liabilities	(79)	(37)	(177)
Other, net	85	285	(8)
	1,750	1,879	1,980
Cash Flows from Investing Activities			
Cost of additions to land, buildings and equipment	(204)	(197)	(146)
Proceeds from sales of land, buildings and equipment	53	10	19
Cost of additions to internal use software	(48)	(53)	(50)
Proceeds from divestitures and investments, net	191	35	340
Acquisitions, net of cash acquired	(12)	—	—
Net change in escrow and other restricted investments	223	254	(63)
Other, net	—	—	(7)
	203	49	93
Cash Flows from Financing Activities			
Cash proceeds from new secured financings	2,061	2,450	3,055
Debt payments on secured financings	(1,906)	(2,181)	(1,662)
Net cash payments on debt	(1,422)	(4,044)	(4,619)
Proceeds from issuance of mandatorily redeemable preferred stock	—	889	—
Preferred stock dividends	(83)	(57)	(67)
Proceeds from issuances of common stock	73	477	4
Dividends to minority shareholders	(16)	(4)	(3)
	(1,293)	(2,470)	(3,292)
Effect of exchange rate changes on cash and cash equivalents	81	132	116
Increase (decrease) in cash and cash equivalents	741	(410)	(1,103)
Cash and cash equivalents at beginning of year	2,477	2,887	3,990
Cash and cash equivalents at end of year	\$ 3,218	\$ 2,477	\$ 2,887

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

XEROX CORPORATION
CONSOLIDATED STATEMENTS OF COMMON SHAREHOLDERS' EQUITY

(In millions, except share data)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss ⁽¹⁾	Total
Balance at December 31, 2001	722,314	\$ 724	\$ 1,898	\$ 1,008	\$ (1,833)	\$ 1,797
Net income				91		91
Translation adjustments ⁽²⁾					234	234
Minimum pension liability, net of tax					(279)	(279)
Unrealized gain on securities, net of tax					1	1
Unrealized gains on cash flow hedges, net of tax					6	6
Comprehensive income						\$ 53
Stock option and incentive plans, net	2,385	2	10			12
Convertible securities	7,118	7	48			55
Series B convertible preferred stock dividends (\$10.94 per share), net of tax				(73)		(73)
Equity for debt exchanges	6,412	6	45			51
Other	44	(1)		(1)		(2)
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 Capital Trust II (Note 10)	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

⁽¹⁾ As of December 31, 2004, Accumulated Other Comprehensive Loss is composed of cumulative translation adjustments of \$(524), unrealized gain on securities of \$1, minimum pension liabilities of \$(218) and cash flow hedging gains of \$3.

⁽²⁾ Includes reclassification adjustments for foreign currency translation losses of \$59, that were realized in 2002 due to the sale of businesses. These amounts were included in accumulated other comprehensive loss in prior periods as unrealized losses. Refer to Note 18 for further discussion.

The accompanying notes are an integral part of the 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” or “our” refer to Xerox Corporation and its 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.

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 percent 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.

Certain reclassifications of prior year amounts have been made to conform to the current year presentation.

Income from Continuing Operations before Income Taxes, Equity Income and Cumulative Effect of Change in Accounting Principle: Throughout the Notes to the Consolidated Financial Statements, we refer to the effects of certain changes in estimates and other adjustments on Income from Continuing Operations before Income Taxes, Equity Income and Cumulative Effect of Change in Accounting Principle. For convenience and ease of reference, that caption in our Consolidated Statements of Income is hereafter referred to as “pre-tax income.”

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 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 of the more significant charges that require management estimates:

	Year ended December 31,		
	2004	2003	2002
Restructuring provisions and asset impairments	\$ 86	\$176	\$670
Amortization and impairment of goodwill and intangible assets	38	36	99
Provisions for receivables	86	224	353
Provisions for obsolete and excess inventory	73	78	115
Depreciation and obsolescence of equipment on operating leases	210	271	408
Depreciation of buildings and equipment	305	299	341
Amortization of capitalized software	134	143	249
Pension benefits—net periodic benefit cost	350	364	168
Other post-retirement benefits—net periodic benefit cost	111	108	120
Deferred tax asset valuation allowance provisions	12	(16)	15

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

Stock-Based Compensation: In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R, “Share-Based Payment” (“FAS 123R”), an amendment of FAS No. 123, “Accounting for Stock-Based Compensation.” FAS 123R eliminates the ability to account for share-based payments using Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” and instead requires companies to recognize compensation expense using a fair-value based method for costs related to share-based payments including stock options and employee stock purchase plans. The expense will be measured as the fair value of the award at its grant date based on the estimated number of awards that are expected to vest, and recorded over the applicable service period. In the absence of an observable market price for a share-based award, the fair value would be based upon a valuation methodology that takes into consideration various factors, including the exercise price of the award, the expected term of the award, the current price of the underlying shares, the expected volatility of the underlying share price, the expected dividends on the underlying shares and the risk-free interest rate. The requirements of FAS 123R are effective for our third quarter beginning July 1, 2005 and apply to all awards granted, modified or cancelled after that date.

The standard also provides for different transition methods for past award grants, including the restatement of prior period results. We have elected to apply the modified prospective transition method to all past awards outstanding and unvested as of the effective date of July 1, 2005 and will recognize the associated expense over the remaining vesting period based on the fair values previously determined and disclosed as part of our pro-forma disclosures. We will not restate the results of prior periods. Prior to the effective date of FAS 123R, we will continue to provide the pro-forma disclosures for past award grants as required under FAS 123 and as shown below.

In January 2005, we implemented changes in our stock-based compensation programs designed to help us continue to attract and retain the best employees, and to better align employee interests with those of our shareholders. In 2005, we began granting employees restricted stock awards with time and performance based

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

restrictions in lieu of stock options. The time-based restricted stock awards offer employees the opportunity to earn shares of our stock over time, rather than options that give employees the right to purchase stock at a set price. The performance-based restricted stock awards are a form of stock award in which the number of shares ultimately received depends on our performance against certain specified and predetermined financial performance targets.

The issuance of FAS 123R is expected to result in stock option-based compensation expense in 2005 of approximately \$28 (\$17 after-tax or \$0.02 per diluted share). The effect of the changes in our stock-based compensation program is not expected to be material in 2005.

Inventory: In November 2004, the FASB issued FAS 151, "Inventory Costs, an amendment of ARB 43, Chapter 4" ("FAS 151"). This statement amends previous guidance as it relates to inventory valuation to clarify that abnormal amounts of idle facility expense, freight, handling costs and spoilage should be recorded as current-period charges. The effective date of FAS 151 is January 1, 2006. Since the guidance in FAS 151 reflects our current practices, we do not expect there to be any impact on our results of operations, financial position or liquidity.

Goodwill and Other Intangible Assets: Effective January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets," whereby goodwill was no longer to be amortized, but instead is to be tested for impairment annually or more frequently if an event or circumstance indicates that an impairment loss may have been incurred. We estimate fair value by considering a number of factors including assessing operating results, business plans, economic projections, anticipated future cash flows and market data. In 2002, we recorded an impairment charge of \$63 as a cumulative effect of change in accounting principle in the accompanying Consolidated Statements of Income.

The following table presents the changes in the carrying amount of goodwill, by operating segment, for the three years ended December 31, 2004:

	<u>Production</u>	<u>Office</u>	<u>DMO</u>	<u>Other</u>	<u>Total</u>
Balance at January 1, 2002	\$ 605	\$710	\$ 70	\$121	\$1,506
Foreign currency translation adjustment	82	55	(3)	—	134
Impairment Charge	—	—	(63)	—	(63)
Divestitures and other	(4)	(5)	(4)	—	(13)
Balance at December 31, 2002	\$ 683	\$760	\$—	\$121	\$1,564
Foreign currency translation adjustment	88	67	—	3	158
Balance at December 31, 2003	771	827	—	124	1,722
Foreign currency translation adjustment	77	54	—	1	132
Other	—	—	—	(6)	(6)
Balance at December 31, 2004	\$ 848	\$881	\$—	\$119	\$1,848

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Intangible assets primarily relate to the Office operating segment. Intangible assets were comprised of the following as of December 31, 2004 and 2003:

	Weighted Average Amortization Period	As of December 31, 2004:			As of December 31, 2003:		
		Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Installed customer base	17 years	\$ 218	\$ 58	\$ 160	\$ 209	\$ 45	\$ 164
Distribution network	25 years	123	25	98	123	20	103
Existing technology	7 years	105	74	31	103	56	47
Licensed technology ⁽¹⁾	7 years	28	1	27	—	—	—
Trademarks	7 years	23	15	8	23	12	11
		<u>\$ 497</u>	<u>\$ 173</u>	<u>\$ 324</u>	<u>\$ 458</u>	<u>\$ 133</u>	<u>\$ 325</u>

⁽¹⁾ Licensed technology is included in Other long-term assets in the Consolidated Balance Sheet at December 31, 2004.

Amortization expense related to intangible assets was \$38, \$36, and \$36 for the years ended December 31, 2004, 2003 and 2002, respectively, and is expected to approximate \$41 annually through 2009. 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.

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

Equipment: Revenues from the sale of equipment, including those from sales-type leases, are recognized at the time of sale or at the inception of the lease, as appropriate. For equipment sales 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.

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 professional and value-added services are generally recognized as services are performed.

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

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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 consider the fixed payments for purposes of allocating to the relative fair value elements of the contract. We do not consider the contingent payments for purposes of allocating to the elements of the contract or recognizing revenue on the sale of the equipment, given the inherent uncertainties as to whether such amounts will ever be realized. Contingent payments 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 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 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 percent 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 percent 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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.

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.

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 borrowing 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, 2004 and 2003, such restricted cash amounts were as follows:

	December 31,	
	2004	2003
Escrow and cash collections related to secured borrowing arrangements	\$372	\$462
Escrow related to liability to trusts issuing preferred securities	—	79
Collateral related to risk management arrangements	61	74
Other restricted cash	97	114
Total	\$530	\$729

Of these amounts, \$370 and \$386 were included in Other current assets and \$160 and \$343 were included in Other long-term assets, as of December 31, 2004 and 2003, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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 \$183 and \$218, as of December 31, 2004 and 2003, respectively. Allowances for doubtful accounts on finance receivables were \$276 and \$315 at December 31, 2004 and 2003, 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 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 4 and 5 for further discussion.

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.

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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. 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.

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. In estimating this rate, we consider rates of return on high quality fixed-income investments over the period to expected payment of the pension and other post-retirement benefits.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Stock-Based Compensation: 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:

	2004	2003	2002
Net income—as reported ⁽¹⁾	\$ 859	\$ 360	\$ 91
Deduct: Stock-based employee compensation expense determined under fair value based method for awards, net of tax	(69)	(85)	(83)
Net income—pro forma	\$ 790	\$ 275	\$ 8
Basic EPS—as reported	\$0.94	\$0.38	\$ 0.02
Basic EPS—pro forma	0.86	0.27	(0.09)
Diluted EPS—as reported	\$0.86	\$0.36	\$ 0.02
Diluted EPS—pro forma	0.80	0.25	(0.09)

⁽¹⁾ Amounts include compensation expense for restricted stock grants of \$22 (\$13 after-tax), \$15 (\$9 after-tax) and \$17 (\$10 after-tax) in 2004, 2003, and 2002, respectively.

The pro forma periodic compensation expense amounts are not representative of future amounts since we will begin 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, 2003 and 2002 was \$8.38, \$5.39 and \$6.34, respectively. The fair values were estimated on the date of grant using the following weighted average assumptions:

	2004	2003	2002
Risk-free interest rate	3.2%	3.3%	4.8%
Expected life in years ⁽¹⁾	5.7	7.2	6.5
Expected price volatility	66.5%	66.2%	61.5%
Expected dividend yield	—	—	—

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

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 \$73, \$11 and \$77 in 2004, 2003 and 2002, 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 Production and Office segments are centered around strategic product groups which share common technology,

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

manufacturing and product platforms, as well as classes of customers. The accounting policies of all of our segments are the same as those described in the summary of significant accounting policies included in Note 1.

The Production segment includes black and white products which operate at speeds over 90 pages per minute and color products which operate at speeds over 40 pages per minute. 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 pages per minute and color devices up to 40 pages per minute. 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. 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 and other corporate costs.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Operating segment financial information for 2003 and 2002 has been restated to reflect changes in operating segment structure made during 2004. The changes made in 2004 relate to the reclassification of the operations of our Central and Eastern European entities to DMO to align our segment reporting with how we manage our business. Operating profit was reclassified for this change, as well as for certain other expense allocations. The adjustments (decreased) increased full year 2003 revenues as follows: Production—\$(40), Office—\$(61), DMO—\$147 and Other—\$(46). The full year 2003 segment profit was (decreased) increased as follows: Production—\$(21), Office—\$(11), DMO—\$21, and Other—\$11. The adjustments (decreased) increased full year 2002 revenues as follows: Production—\$(40), Office—\$(54), DMO—\$127, and Other—\$(33). The full year 2002 segment profit was (decreased) increased as follows: Production—\$(14), Office—\$(9), DMO—\$29, and Other—\$(6). Selected financial information for our operating segments for each of the three years ended December 31, 2004 was as follows:

	<u>Production</u>	<u>Office</u>	<u>DMO</u>	<u>Other</u>	<u>Total</u>
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⁾	\$ 115	\$ 163	\$ 12	\$ 418	\$ 708
Segment profit (loss) ⁽³⁾⁽⁴⁾	388	798	43	(29)	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⁾	\$ 121	\$ 181	\$ 34	\$ 548	\$ 884
Segment profit (loss) ⁽³⁾⁽⁴⁾	401	742	172	(327)	988
Equity in net income of unconsolidated affiliates	—	1	6	51	58
2002⁽¹⁾					
Information about profit or loss:					
Revenues	\$ 4,089	\$ 6,888	\$ 1,866	\$ 2,006	\$ 14,849
Finance income	393	599	19	(11)	1,000
Total segment revenues	\$ 4,482	\$ 7,487	\$ 1,885	\$ 1,995	\$ 15,849
Interest expense ⁽²⁾	\$ 157	\$ 223	\$ 17	\$ 499	\$ 896
Segment profit (loss) ⁽³⁾⁽⁴⁾	436	612	120	(335)	833
Equity in net income of unconsolidated affiliates	—	—	5	49	54

⁽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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

- (3) Other segment profit (loss) includes net corporate expenses of \$524, \$529 and \$362 for the years ended December 31, 2004, 2003 and 2002, respectively.
- (4) Depreciation and amortization expense is recorded in cost of sales, research and development 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.

The following is a reconciliation of segment profit to total company pre-tax income:

	Years ended December 31,		
	2004	2003	2002
Total segment profit	\$ 1,200	\$ 988	\$ 833
Unallocated items:			
Restructuring and asset impairment charges	(86)	(176)	(670)
2002 credit facility fee write-off ⁽¹⁾	—	(73)	—
Other unallocated expenses, net ⁽²⁾	2	(245)	(5)
Allocated item:			
Equity in net income of unconsolidated affiliates	(151)	(58)	(54)
Pre-tax income	\$ 965	\$ 436	\$ 104

- (1) The \$73 loss associated with extinguishment of debt on the 2002 Credit Facility, previously reflected in Other segment profit (loss), has been reclassified in the current year presentation.

- (2) 2003 unallocated expenses include a \$239 provision for litigation related to the court approved settlement of the Berger v. RIGP litigation discussed in Note 12.

Geographic area data was as follows:

	Revenues			Long-Lived Assets ⁽¹⁾		
	2004	2003	2002	2004	2003	2002
United States	\$ 8,346	\$ 8,547	\$ 9,096	\$ 1,427	\$ 1,477	\$ 1,524
Europe	5,281	4,863	4,425	585	616	718
Other Areas	2,095	2,291	2,328	434	460	379
Total	\$ 15,722	\$ 15,701	\$ 15,849	\$ 2,446	\$ 2,553	\$ 2,621

- (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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 3—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. The components of Finance receivables, net at December 31, 2004 and 2003 follow:

	2004	2003
Gross receivables	\$10,267	\$10,599
Unearned income	(1,619)	(1,651)
Unguaranteed residual values	125	180
Allowance for doubtful accounts	(276)	(315)
Finance receivables, net	8,497	8,813
Less: Billed portion of finance receivables, net	(377)	(461)
Current portion of finance receivables not billed, net	(2,932)	(2,981)
Amounts due after one year, net	\$ 5,188	\$ 5,371

Contractual maturities of our gross finance receivables subsequent to December 31, 2004 follow (including those already billed of \$377):

2005	2006	2007	2008	2009	Thereafter	Total
\$4,045	\$2,793	\$1,921	\$1,097	\$377	\$34	\$10,267

Customer Financing Arrangements

GE Secured Borrowings: In 2002, we completed an agreement (the “Loan Agreement”) under which GE Vendor Financial Services, a subsidiary of GE, became the primary equipment financing provider in the U.S., through monthly fundings of our new lease originations. In March 2003, this agreement was amended to allow for the inclusion of state and local governmental contracts in future fundings.

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 percent at the inception of each funding. The secured loans are subject to interest rates calculated at each monthly loan occurrence at yield rates consistent with average rates for similar market based transactions. Refer to Note 9 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 default would impair our ability to receive subsequent funding until the default was cured or waived but does not accelerate previous borrowings. However, in the event of a default, we could be replaced as the maintenance service provider for the associated equipment under lease.

During 2003, we entered into 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

with respect to funding conditions and covenants. The final funding date for all facilities is currently December 2010. The following is a summary of the facility amounts for the arrangements with GE in these countries.

	<u>Facility Amount</u>	<u>Maximum Facility Amount ⁽¹⁾</u>
U.S.	\$5 billion	\$8 billion
U.K.	£400 million (U.S. \$770)	£600 million (U.S. \$1.2 billion)
Canada	Cdn. \$850 million (U.S. \$706)	Cdn. \$2 billion (U.S. \$1.7 billion)

⁽¹⁾ Subject to mutual agreement by the parties

France Secured Borrowings: In July 2003, we securitized receivables of \$443, previously funded under a 364-day warehouse financing facility established in December 2002 with subsidiaries of Merrill Lynch, with a three-year public secured financing arrangement. In addition, we established a new warehouse financing facility to fund future lease originations in France. This facility can provide funding for new lease originations up to €350 million (U.S. \$477), outstanding at any time, and balances may be securitized through a similar public offering within two years.

The DLL Secured Borrowings: Beginning in the second half of 2002, we received a series of fundings through our consolidated joint venture with DLL from DLL's parent, De Lage Landen Ireland Company. The fundings are secured by our lease receivables in The Netherlands which were transferred to the DLL joint venture. In addition, the DLL joint venture also became our primary equipment financing provider in The Netherlands for all new lease originations and continues to receive funding for those lease originations from DLL's parent. In the fourth quarter of 2003, the DLL joint venture expanded its operations to include Spain and Belgium. Our DLL joint venture has been consolidated as we are deemed to be the primary beneficiary of the joint venture's financial results.

Germany Secured Borrowings: In May 2002, we entered into an agreement to transfer part of our financing operations in Germany to a GE entity in order to finance certain prospective leasing business. In conjunction with this transaction, we also received loans from GE secured by existing lease receivables that were transferred to this entity. At December 31, 2003, we consolidated this entity because we retained substantive rights related to the transferred finance receivables and were therefore deemed to be the primary beneficiary. During the first quarter 2004, the entity was deconsolidated because we were no longer deemed to be the primary beneficiary, as the transferred finance receivables had been reduced to a level whereby we no longer retained significant risks relative to the total assets of the entity. Further, we are not providing loss protection on the new leasing business entered into by the entity. The entity's total assets and debt at December 31, 2003 were \$114 and \$84, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The following table shows finance receivables and related secured debt as of December 31, 2004 and 2003:

	December 31, 2004		December 31, 2003	
	Finance Receivables, Net	Secured Debt	Finance Receivables, Net	Secured Debt
GE secured loans:				
United States	\$ 2,711	\$2,486	\$ 2,939	\$2,598
Canada	486	426	528	440
United Kingdom	771	685	719	570
Germany	—	—	114	84
Total GE encumbered finance receivables, net	3,968	3,597	4,300	3,692
Merrill Lynch Loan—France	368	287	138	92
Asset-backed notes—France	225	148	429	364
DLL—Netherlands, Spain, and Belgium ⁽¹⁾	436	404	335	277
Total encumbered finance receivables, net	4,997	\$4,436	5,202	\$4,425
Unencumbered finance receivables, net	3,500		3,611	
Total finance receivables, net ⁽²⁾	\$ 8,497		\$ 8,813	

⁽¹⁾ These represent the loans received by our consolidated joint venture with DLL. De Lage Landen Ireland Company is the lender of record.

⁽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 condensed consolidated balance sheets as of December 31, 2004 and 2003.

As of December 31, 2004, \$4,997 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, 2004 was \$4,436. 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 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 to 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 June 2004, we completed a transaction with GE for a three-year \$400 revolving credit facility secured by our U.S. accounts receivable. As of December 31, 2004, approximately \$200 was drawn, secured by \$354 of our accounts receivable. This arrangement is being accounted for as a secured borrowing in our Consolidated Balance Sheets.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 4—Inventories and Equipment on Operating Leases, Net

The components of inventories at December 31, 2004 and 2003 were as follows:

	<u>2004</u>	<u>2003</u>
Finished goods	\$ 900	\$ 911
Work in process	69	74
Raw materials	174	167
Total inventories	\$1,143	\$1,152

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 on operating leases from our inventories is presented in our Consolidated Statements of Cash Flows in the operating activities section as a non-cash adjustment. Equipment on operating leases and the related accumulated depreciation at December 31, 2004 and 2003 were as follows:

	<u>2004</u>	<u>2003</u>
Equipment on operating leases	\$ 1,649	\$ 1,795
Less: Accumulated depreciation	(1,251)	(1,431)
Equipment on operating leases, net	\$ 398	\$ 364

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 \$210, \$271 and \$408 for the years ended December 31, 2004, 2003 and 2002, 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:

<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Thereafter</u>
\$401	\$219	\$111	\$45	\$17

Total contingent rentals on operating leases, consisting principally of usage charges in excess of minimum contracted amounts, for the years ended December 31, 2004, 2003 and 2002 amounted to \$137, \$235 and \$187, respectively.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 5—Land, Buildings and Equipment, Net

The components of land, buildings and equipment, net at December 31, 2004 and 2003 were as follows:

	<u>Estimated Useful Lives (Years)</u>	<u>2004</u>	<u>2003</u>
Land		\$ 53	\$ 56
Buildings and building equipment	25 to 50	1,167	1,194
Leasehold improvements	Lease term	313	383
Plant machinery	5 to 12	1,667	1,588
Office furniture and equipment	3 to 15	1,072	1,081
Other	4 to 20	74	74
Construction in progress		96	114
Subtotal		<u>4,442</u>	<u>4,490</u>
Less: Accumulated depreciation		<u>(2,683)</u>	<u>(2,663)</u>
Land, buildings and equipment, net		<u>\$ 1,759</u>	<u>\$ 1,827</u>

Depreciation expense was \$305, \$299 and \$341 for the years ended December 31, 2004, 2003 and 2002, 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, 2004, 2003 and 2002 amounted to \$316, \$287, and \$299, respectively. Future minimum operating lease commitments that have remaining non-cancelable lease terms in excess of one year at December 31, 2004 follow:

<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>Thereafter</u>
\$222	\$181	\$143	\$109	\$94	\$256

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 \$17 at December 31, 2004.

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 recorded in selling, administrative and general expenses, were \$328, \$340, and \$385 for the years ended December 31, 2004, 2003 and 2002, 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, 2004, 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 6—Investments in Affiliates, at Equity

Investments in corporate joint ventures and other companies in which we generally have a 20 to 50 percent ownership interest at December 31, 2004 and 2003 were as follows:

	<u>2004</u>	<u>2003</u>
Fuji Xerox ⁽¹⁾	\$772	\$556
Investment in subsidiary trusts issuing preferred securities	39	69
Other investments	34	19
	<u> </u>	<u> </u>
Investments in affiliates, at equity	\$845	\$644
	<u> </u>	<u> </u>

⁽¹⁾ Fuji Xerox is headquartered in Tokyo and operates in Japan and other areas of the Pacific Rim, Australia and New Zealand. Our investment in Fuji Xerox of \$772 at December 31, 2004, differs from our implied 25 percent interest in the underlying net assets, or \$840, 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 percent of Xerox Limited from The Rank Group (plc). Such gains would only be realizable if Fuji Xerox sold a portion of the assets we previously sold to it or if we were to sell a portion of our ownership interest in Fuji Xerox.

Our equity in net income of our unconsolidated affiliates for the three years ended December 31, 2004 was as follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Fuji Xerox	\$134	\$41	\$37
Other investments	17	17	17
	<u> </u>	<u> </u>	<u> </u>
Total	\$151	\$58	\$54
	<u> </u>	<u> </u>	<u> </u>

Equity income for 2004 included \$38 related to our share of a pension settlement gain recorded by Fuji Xerox due to a non-recurring opportunity given to Japanese companies by the Japanese government in accordance with the Japan Welfare Pension Insurance Law. This law allowed Japanese companies to transfer a portion of their pension obligations to the Japanese government. Fuji Xerox completed this transfer and recognized a corresponding settlement gain in 2004.

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 percent ownership interest.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Condensed financial data of Fuji Xerox as of and for the three calendar years ended December 31, 2004 follow:

	2004	2003	2002
<i>Summary of Operations:</i>			
Revenues	\$ 9,461	\$ 8,430	\$ 7,539
Costs and expenses	8,606	8,011	7,181
Income before income taxes	855	419	358
Income taxes	331	194	134
Minorities' interests	18	34	36
Net income	\$ 506	\$ 191	\$ 188
<i>Balance Sheet Data:</i>			
Assets:			
Current assets	\$ 3,613	\$ 3,273	\$ 2,976
Long-term assets	4,606	4,766	3,862
Total assets	\$ 8,219	\$ 8,039	\$ 6,838
Liabilities and Shareholders' Equity:			
Current liabilities	\$ 2,757	\$ 2,594	\$ 2,152
Long-term debt	616	443	868
Other long-term liabilities	1,383	2,391	1,084
Minorities' interests in equity of subsidiaries	104	118	227
Shareholders' equity	3,359	2,493	2,507
Total liabilities and shareholders' equity	\$ 8,219	\$ 8,039	\$ 6,838

We have a technology agreement with Fuji Xerox whereby we receive royalty payments and rights to access their patent portfolio in exchange for access to our patent portfolio. In 2004, 2003 and 2002, we earned royalty revenues under this agreement of \$119, \$110 and \$99, respectively. Additionally, in 2004, 2003 and 2002, we received dividends of \$50, \$20 and \$29, respectively. 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, 2004 were as follows:

	2004	2003	2002
Sales	\$ 143	\$ 129	\$ 113
Purchases	\$ 1,135	\$ 871	\$ 727

In addition to the payments described above, in 2004, 2003 and 2002, we paid Fuji Xerox \$27, \$33 and \$20, respectively, and in 2004, 2003 and 2002 Fuji Xerox paid us \$9, \$9 and \$10, respectively, for unique research and development. As of December 31, 2004 and 2003, amounts due to Fuji Xerox were \$155 and \$111, respectively.

Note 7—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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

structure and improve productivity. Management continues to evaluate the 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 or redundant as a result of these programs. The restructuring and asset impairment charges in the Consolidated Statements of Income totaled \$86, \$176 and \$670 in 2004, 2003 and 2002, respectively. Detailed information related to restructuring program activity during the three years ended December 31, 2004 is outlined below.

<u>Restructuring Activity</u>	<u>Ongoing Programs</u>	<u>Legacy Programs ⁽¹⁾</u>	<u>TOTAL</u>
Ending Balance December 31, 2001	\$ —	\$ 282	\$ 282
Provision	357	291	648
Reversals of prior accruals	—	(33)	(33)
Charges against reserve and currency	(71)	(403)	(474)
Ending Balance December 31, 2002	\$ 286	\$ 137	\$ 423
Provision	193	11	204
Reversals of prior accruals	(16)	(13)	(29)
Charges against reserve and currency	(284)	(93)	(377)
Ending Balance December 31, 2003	\$ 179	\$ 42	\$ 221
Provision	\$ 103	\$ 2	\$ 105
Reversals of prior accruals	(11)	(9)	(20)
Charges against reserve and currency	(178)	(11)	(189)
Ending Balance December 31, 2004	\$ 93	\$ 24	\$ 117

⁽¹⁾ Legacy Programs, as explained further below, include the Turnaround, SOHO and 1998/2000 Programs.

Reconciliation to Statements of Income

	<u>For the year ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Restructuring provision	\$105	\$204	\$648
Restructuring reversal	(20)	(29)	(33)
Asset impairment charges	1	1	55 ⁽¹⁾
Restructuring and asset impairment charges	\$ 86	\$176	\$670

⁽¹⁾ Asset impairment charges consisted of \$45 and \$10 for the Ongoing and Legacy Programs, respectively.

Reconciliation to Statements of Cash Flows

	<u>For the year ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Charges to reserve	\$(189)	\$(377)	\$(474)
Pension curtailment, special termination benefits and settlements	8	33	59
Effects of foreign currency and other noncash	(6)	(1)	23
Cash payments for restructurings	\$(187)	\$(345)	\$(392)

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 continue to achieve the cost savings resulting from realized productivity improvements. These ongoing initiatives included downsizing our employee base and the outsourcing of certain internal functions. These initiatives are not individually significant and primarily include severance actions and impact all geographies and segments. We recorded an initial provision of \$402 associated with these ongoing programs in the fourth quarter 2002. The provision consisted of \$312 for severance and related costs, \$45 of net costs associated with lease terminations and future rental obligations and \$45 for asset impairments. The severance and related costs related to the elimination of approximately 4,700 positions worldwide. During 2003, we provided an additional \$177 for restructuring programs, net of reversals of \$16, related to changes in estimates for severance costs from previously recorded actions. The additional provision consisted of net charges of \$138 primarily related to the elimination of over 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 over 1,900 positions primarily in North America and Latin America, \$8 for pension settlements, \$8 for lease terminations and \$1 for asset impairments. The reserve balance for these Restructuring Programs at December 31, 2004 was \$93. The majority of this balance will be spent during 2005 and is summarized as follows:

	<u>Severance and Related Costs</u>	<u>Lease Cancellation and Other Costs</u>	<u>Total</u>
Initial Provision ⁽¹⁾	\$ 312	\$ 45	\$ 357
Charges against reserve	(71)	—	(71)
Balance at December 31, 2002	\$ 241	\$ 45	\$ 286
Provisions ⁽¹⁾	186	7	193
Reversals	(15)	(1)	(16)
Charges	(269)	(15)	(284)
Balance at December 31, 2003	\$ 143	\$ 36	\$ 179
Provisions ⁽¹⁾	95	8	103
Reversals	(11)	—	(11)
Charges	(157)	(21)	(178)
Balance at December 31, 2004	\$ 70	\$ 23	\$ 93

⁽¹⁾ These amounts exclude cumulative asset impairment charges of \$46 through December 31, 2004.

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, 2004:

Segment Reporting:

	<u>Cumulative amount incurred as of December 31, 2003</u>	<u>Net amount incurred for the year ended December 31, 2004</u>	<u>Cumulative amount incurred as of December 31, 2004</u>	<u>Total expected to be incurred *</u>
Production	\$ 228	\$ 27	\$ 255	\$ 255
Office	168	30	198	198
DMO	67	30	97	97
Other	116	6	122	126
Total Provisions	\$ 579	\$ 93	\$ 672	\$ 676

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

* The total amount of \$676 represents the cumulative amount incurred through December 31, 2004 plus \$4 for interest accretion on the liabilities.

Major Cost Reporting:

	Cumulative amount incurred as of December 31, 2003	Amount incurred for the year ended December 31, 2004	Cumulative amount incurred as of December 31, 2004	Total expected to be incurred *
Severance and related costs	\$ 483	\$ 84	\$ 567	\$ 568
Lease cancellation and other costs	51	8	59	62
Asset impairments	45	1	46	46
Total Provisions	\$ 579	\$ 93	\$ 672	\$ 676

Legacy Programs: The following is a summary of past restructuring programs undertaken by the Company:

- **Turnaround Program:** The Turnaround Program was initiated in October 2000 to reduce costs, improve operations, transition customer equipment financing to third parties and sell certain assets. This program included the outsourcing of certain Office operating segment manufacturing to Flextronics, as discussed in Note 18. Overall, approximately 11,200 positions were eliminated under this program.
- **SOHO Disengagement:** In 2001, we commenced a separate restructuring program associated with the disengagement from our worldwide small office/home office (“SOHO”) business. The program included provisions for the elimination of approximately 1,200 positions worldwide by the end of 2001, the closing of facilities and the write down of certain assets to net realizable value.
- **March 2000/April 1998 Programs:** These programs were likewise initiated to reduce overall costs and included reductions in workforce as well as the consolidation of facilities on a worldwide basis. Overall, approximately 14,200 positions were eliminated under these programs.

Reversals of prior period charges were recorded for these programs during the three-year period ended December 31, 2004 primarily as a result of changes in estimates associated with employee severance and related costs.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 8—Supplementary Financial Information

The components of other current assets and other current liabilities at December 31, 2004 and 2003 were as follows:

	2004	2003
Other current assets		
Deferred taxes	\$ 289	\$ 402
Restricted cash	370	386
Prepaid expenses	142	35
Financial derivative instruments	125	24
Other	256	258
	<u> </u>	<u> </u>
Total	\$1,182	\$1,105
	<u> </u>	<u> </u>
Other current liabilities		
Income taxes payable	\$ 183	\$ 264
Other taxes payable	234	289
Interest payable	113	147
Restructuring reserves	93	180
Financial derivative instruments	46	51
Other	640	609
	<u> </u>	<u> </u>
Total	\$1,309	\$1,540
	<u> </u>	<u> </u>

The components of other long-term assets and other long-term liabilities at December 31, 2004 and 2003 were as follows:

	2004	2003
Other long-term assets		
Prepaid pension costs	\$ 891	\$ 774
Net investment in discontinued operations	440	449
Internal use software, net	255	307
Restricted cash	160	343
Investments in non-affiliated companies	—	104
Financial derivative instruments	19	89
Debt issuance costs, net	64	79
Other	271	332
	<u> </u>	<u> </u>
Total other long-term assets	\$2,100	\$2,477
	<u> </u>	<u> </u>
Other long-term liabilities		
Deferred and other tax liabilities	\$ 862	\$ 809
Minorities' interests in equity of subsidiaries	80	102
Financial derivative instruments	43	11
Other	330	356
	<u> </u>	<u> </u>
Total other long-term liabilities	\$1,315	\$1,278
	<u> </u>	<u> </u>

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”). In addition to our net investment, Income taxes payable also includes amounts for tax liabilities associated with our discontinued operations.

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, 2004 and 2003, the balance of the investments in the trust, consisting of U.S. government, government agency and high quality corporate bonds, was \$544 and \$531, respectively. Our remaining net investment in Ridge Re was \$82 and \$77 at December 31, 2004 and 2003, 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.

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 percent of TRG’s available cash flow as defined in the sale agreement. For the years ended December 31, 2004 and 2003, we received cash distributions of \$22 and \$23, 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 \$365 remaining balance of this instrument.

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 \$107, \$116, and \$215 for the years ended December 31, 2004, 2003 and 2002, respectively.

Note 9—Debt

Short-Term Debt: Short-term borrowings at December 31, 2004 and 2003 were as follows:

	2004	2003
Current maturities of long-term debt	\$3,038	\$4,194
Notes payable	36	42
Total	\$3,074	\$4,236

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: Long-term debt, including debt secured by finance receivables at December 31, 2004 and 2003 was as follows:

	<u>Weighted Average Interest Rates at December 31, 2004</u>	<u>2004</u>	<u>2003</u>
U.S. Operations			
Xerox Corporation			
Notes due 2004	— %	\$ —	\$ 194
Euro notes due 2004	—	—	377
Notes due 2006	7.25	15	15
Notes due 2007	7.38	25	25
Notes due 2008	1.31	27	27
Senior Notes due 2009	9.75	627	616
Euro Senior Notes due 2009	9.75	297	272
Senior Notes due 2010	7.13	704	701
Notes due 2011	7.01	50	50
Senior Notes due 2011	6.88	758	—
Senior Notes due 2013	7.63	550	548
Convertible Notes due 2014	9.00	19	19
Notes due 2016	7.20	252	254
2003 Credit Facility	3.92	300	300
Subtotal		\$ 3,624	\$ 3,398
Xerox Credit Corporation			
Yen notes due 2005	1.50	970	936
Yen notes due 2007	2.00	292	281
Notes due 2008	6.50	25	25
Notes due 2012	7.12	125	125
Notes due 2013	6.50	59	59
Notes due 2014	6.06	50	50
Notes due 2018	7.00	25	25
Subtotal		1,546	1,501
Other US Operations			
Borrowings secured by finance receivables ⁽¹⁾	4.81	2,486	2,598
Borrowings secured by other assets	4.18	257	70
Subtotal		\$ 2,743	\$ 2,668
Total U.S. operations		\$ 7,913	\$ 7,567
International Operations			
Xerox Capital (Europe) plc:			
Euros due 2004	—	\$ —	\$ 942
Japanese yen due 2005	1.30	97	93
U.S. dollars due 2004-2008	6.25	25	525
Subtotal		122	1,560
Other International Operations:			
Pound Sterling secured borrowings due 2008 ⁽¹⁾	6.95	685	570
Euro secured borrowings due 2005-2009 ⁽¹⁾	3.61	839	817
Canadian dollars secured borrowings due 2004-2007 ⁽¹⁾	5.78	426	440
Other debt due 2004-2010	4.93	103	170
Subtotal		2,053	1,997
Total international operations		2,175	3,557
Subtotal		10,088	11,124
Less current maturities		(3,038)	(4,194)
Total long-term debt		\$ 7,050	\$ 6,930

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

⁽¹⁾ Refer to Note 3 for further discussion of borrowings secured by finance receivables, net.

Consolidated Long-Term Debt Maturities: Scheduled payments due on long-term debt for the next five years and thereafter follow:

2005	2006	2007	2008	2009	Thereafter	Total
\$3,038	\$951	\$1,366	\$1,041	\$959	\$2,733	\$10,088

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, under which \$15 of letters of credit were outstanding at December 31, 2004. Xerox is the only borrower of the term loan. The revolving credit facility is available, without sub-limit, to Xerox and certain foreign subsidiaries of Xerox, including Xerox Canada Capital Limited, Xerox Capital (Europe) plc and other qualified foreign subsidiaries (excluding Xerox, the "Overseas Borrowers"). The 2003 Credit Facility matures on September 30, 2008. In conjunction with the 2003 Credit Facility, debt issuance costs of \$29 were deferred. As of December 31, 2004, 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.

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. Xerox is required to guarantee the obligations of the Overseas Borrowers. At December 31, 2004, 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 percent 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 percent and 3.00 percent 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, 2004 was 3.92 percent.

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, 2004, 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

2011 Senior Notes: In August 2004, we issued \$500 aggregate principal amount of Senior Notes due 2011, at par value, and received net proceeds of approximately \$492. In September 2004, we issued an additional \$250 aggregate principal amount Senior Notes due 2011, at 104.25 percent of par, resulting in net proceeds of approximately \$258. These notes form a single series of debt. Interest on the Senior Notes accrues at the annual rate of 6.875 percent and is payable semiannually 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 percent. In conjunction with the issuance of the Senior Notes, debt issuance costs of \$11 were deferred.

2010 and 2013 Senior Notes: In June 2003, we issued \$700 aggregate principal amount of Senior Notes due 2010 and \$550 aggregate principal amount of Senior Notes due 2013. Interest on the Senior Notes due 2010 and 2013 accrues at the rate of 7.125 percent and 7.625 percent, respectively, per annum and is payable semiannually on June 15 and December 15. In conjunction with the issuance of the 2010 and 2013 Senior Notes, debt issuance costs of \$32 were deferred.

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 1.0, and that the amount of the cash dividend does not exceed the then amount available under the restricted payments basket (as defined). The Senior Notes are guaranteed by our wholly-owned subsidiaries Intelligent Electronics, Inc. and Xerox International Joint Marketing, Inc.

Guarantees: At December 31, 2004, we have guaranteed \$206 of indebtedness of our foreign subsidiaries. This debt is included in our Consolidated Balance Sheet as of such date.

Interest: Interest paid by us on our short-term debt, long-term debt and liabilities to subsidiary trusts issuing preferred securities amounted to \$710, \$867 and \$903 for the years ended December 31, 2004, 2003 and 2002, respectively.

Interest expense and interest income consisted of:

	Year Ended December 31,		
	2004	2003	2002
Interest expense ⁽¹⁾	\$ 708	\$ 884	\$ 896
Interest income ⁽²⁾	(1,009)	(1,062)	(1,077)

⁽¹⁾ Includes Equipment financing interest of \$345, \$362 and \$401 for the years ended December 31, 2004, 2003 and 2002, respectively, as well as non-financing interest expense of \$363, \$522 and \$495 for the years ended December 31, 2004, 2003 and 2002, respectively, that is 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 a combination of actual interest expense incurred on financing debt, as well as an estimated cost of funds, applied against the estimated level of debt required to support our financed receivables. The estimate is based on an assumed ratio of debt as compared to our finance receivables. This ratio ranges from 80-90 percent of our average finance receivables. This methodology has been consistently applied for all periods presented.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

A summary of the Net cash payments on debt as shown on the Consolidated Statements of Cash Flows for the three years ended December 31, 2004 follows:

	2004	2003	2002
Cash (payments) proceeds on notes payable, net	\$ (6)	\$ 22	\$ (33)
Net cash proceeds from issuance of long-term debt ⁽¹⁾	974	1,580	1,053
Cash payments on long-term debt	(2,390)	(5,646)	(5,639)
	<u>\$ (1,422)</u>	<u>\$ (4,044)</u>	<u>\$ (4,619)</u>

⁽¹⁾ Includes payment of debt issuance costs.

Note 10—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 consolidated in our financial statements because we are not the primary beneficiary of the trusts. As of December 31, 2004 and 2003, the components of our liabilities to the trusts were as follows:

	2004	2003
Trust II	\$—	\$1,067
Trust I	629	665
Xerox Capital LLC	88	77
Total	<u>\$717</u>	<u>\$1,809</u>

Trust II: In 2001, Xerox Capital Trust II (“Trust II”) issued 20.7 million of 7.5 percent convertible trust preferred securities (the “Trust Preferred Securities”) to investors for \$1,035 and 0.6 million shares of common securities to us for \$32. With the proceeds from these securities, Trust II purchased \$1,067 of 7.5 percent convertible junior subordinated debentures due 2021 of one of our wholly-owned consolidated subsidiaries. The subsidiary purchased \$1,067 aggregate principal amount of 7.5 percent convertible junior subordinated debentures due 2021 of the Company. Trust II’s assets consisted principally of our subsidiary’s debentures and our subsidiary’s assets consisted principally of our debentures. On a consolidated basis, we received net proceeds of \$1,004. Fees of \$31 were capitalized as debt issuance costs and were amortized to interest expense over three years to the earliest put date. Interest expense was \$83 and \$89 in 2004 and 2003, respectively.

The Trust Preferred Securities accrued and paid cash distributions quarterly at a rate of 7.5 percent per year of the stated amount of fifty dollars per security. The Trust Preferred Securities were convertible at any time, at the option of the investors, into 5.4795 shares of our common stock per Trust Preferred Security (equivalent share price of \$9.125 per common share) (“the Conversion Ratio”). The Trust Preferred Securities were mandatorily redeemable upon the maturity of the debentures on November 27, 2021 at fifty dollars per Trust Preferred Security plus accrued and unpaid distributions.

In December 2004, Trust II redeemed 20.7 million of the issued and outstanding Trust Preferred Securities. In lieu of cash redemption, holders of substantially all of the securities converted \$1,035 aggregate principal amount of securities into 113,414,658 shares of Xerox common stock. As a result of the conversion and redemption, there is no remaining outstanding principal. The issuance of Xerox shares upon conversion had no impact on diluted earnings per share as they were previously included in the company’s diluted EPS calculation in accordance with the “if converted” accounting methodology.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Trust I: In 1997, Xerox Capital Trust I (“Trust I”) issued 650 thousand of 8.0 percent 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 percent 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 and \$52 in 2004 and 2003, respectively. In the first quarter of 2004, we entered into pay variable/receive fixed interest rate swaps with a notional amount of \$600 associated with the 2027 liability to Trust I. These swaps were designated and accounted for as fair value hedges and resulted in a fair value adjustment to reduce the Trust I liability by \$36 as of December 31, 2004. As of December 31, 2004, the interest rates on these swaps ranged from approximately 5.28% to 5.68% and are based on the 6 month LIBOR rate plus an applicable margin. 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 percent 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 U.S.) to investors and all of its common shares to us. The total proceeds of Cdn. \$63 (\$52 U.S.) were loaned to us. The deferred preferred shares are mandatorily redeemable on February 28, 2006 for Cdn. \$90 (equivalent to \$75 U.S. at December 31, 2004). Our liability to the subsidiary trust of \$88 includes the current amount of the deferred preferred shares of \$69.

Note 11—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, certain of these instruments do not qualify for 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, purchased foreign currency options and interest rate collars to manage interest rate and foreign currency exposures. Our primary foreign currency market exposures include the Japanese yen, Euro, British pound sterling, Brazilian real and Canadian dollar. 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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, 2004 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, 2004 and 2003, we had outstanding single currency interest rate swap agreements with aggregate notional amounts of \$2.8 billion and \$2.5 billion, respectively. The net (liability) asset fair values at December 31, 2004 and 2003 were \$(37) and \$46, respectively.

Fair Value Hedges: As of December 31, 2004 and 2003, pay variable/receive fixed interest rate swaps with notional amounts of \$2.4 billion and \$1.7 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 2004 or 2003. The following is a summary of our fair value hedges at December 31, 2004:

Debt Instrument	Year first Designated	Notional Amount	Weighted-average Interest Rate paid	Interest Rate received	Basis	Maturity
Senior Notes due 2010	2003	\$ 700	6.04%	7.13%	Libor	2010
Senior Notes due 2013	2003/2004	550	6.01%	7.63%	Libor	2013
Notes due 2016	2004	250	5.44%	7.20%	Libor	2016
Senior Notes due 2011	2004	250	5.41%	6.88%	Libor	2011
Liability to Capital Trust I	2004	600	5.52%	8.00%	Libor	2027
Total		\$2,350				

Cash Flow Hedges: During 2004, pay fixed/receive variable interest rate swaps with notional amounts of £200 million (\$385) 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 2004.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Derivatives Marked-to-Market Results: While the remainder of our portfolio of interest rate derivative instruments is intended to economically hedge interest rate risks to the extent possible, differences between the contract terms of these derivatives and the underlying related debt reduce our ability to obtain hedge accounting in accordance with SFAS No. 133. This results in mark-to-market valuation of these derivatives directly through earnings, which accordingly leads to increased earnings volatility. During 2004 and 2003, we recorded net gains of \$4 and net losses of \$13, respectively, from the mark-to-market valuation of interest rate derivatives for which we did not apply hedge accounting.

Terminated Swaps: 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 fair value of \$55 had previously been designated as fair value hedges against the Senior Notes due 2009. Accordingly, the corresponding \$55 fair value adjustment to the Senior Notes will be amortized to interest expense over the remaining term of the notes and amounted to \$9 during 2004. During 2003, we terminated interest rate swaps with a notional value of \$2.0 billion and a net fair asset value of \$136. The remaining derivatives terminated in 2004 as well as those terminated in 2003 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: In cases where we issue foreign currency denominated debt, we may enter into cross-currency interest rate swap agreements whereby we swap the proceeds and related interest payments with a counterparty. In return, we receive and effectively denominate the debt in local functional currencies. In addition, we may also 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.

We also utilize forward exchange contracts and purchased option contracts to hedge against the potentially adverse impacts of foreign currency fluctuations on foreign currency denominated assets and liabilities. Generally, 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.

We also utilize currency derivatives to hedge anticipated transactions, primarily forecasted purchases of foreign-sourced inventory. These contracts generally mature in six months or less. Although these contracts are intended to economically hedge foreign currency risks to the extent possible, differences between the contract terms of our derivatives and the underlying forecasted exposures reduce our ability to obtain hedge accounting in accordance with SFAS No. 133. Accordingly, the changes in value for these derivatives are recorded directly through earnings.

During 2004, 2003, and 2002, we recorded aggregate exchange losses of \$73, \$11 and \$77, respectively. Net currency losses primarily result from the spot/forward premiums on foreign exchange forward contracts, the re-measurement of unhedged foreign currency-denominated assets and liabilities and the mark-to-market impact of economic hedges of anticipated transactions for which we do not qualify for cash flow hedge accounting treatment.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

At December 31, 2004, we had outstanding forward exchange and purchased option contracts with gross notional values of \$5,040. The following is a summary of the primary hedging positions and corresponding fair values held as of December 31, 2004:

<u>Currency Hedged (Buy/Sell)</u>	<u>Gross Notional Value</u>	<u>Fair Value Asset (Liability)</u>
Euro/Pound Sterling	\$1,817	\$ 41
Yen/US Dollar	895	38
Pound Sterling/Euro	441	(5)
US Dollar/Euro	371	(29)
Canadian Dollar/Euro	230	(2)
US Dollar/Pound Sterling	203	—
Yen/Euro	190	(1)
Kronor/Pound Sterling	173	3
Swiss Franc/Pound Sterling	131	1
Euro/Canadian Dollar	108	1
Canadian Dollar/US Dollar	100	5
All Other	381	(3)
Total	\$5,040	\$ 49

At December 31, 2004 and 2003, we had outstanding cross-currency interest rate swap agreements with aggregate notional amounts of \$597 and \$696, respectively. The net asset fair values at December 31, 2004 and 2003 were \$44 and \$4, respectively. Of the outstanding agreements at December 31, 2004, the Japanese yen was the largest single currency hedged and accounted for over 98 percent of our agreements.

Cash Flow Hedges: As of December 31, 2004, cross currency swaps with a notional amount of \$589 were used to hedge the currency exposure for interest payments and principal on half of our Japanese yen denominated debt of \$1.3 billion. 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 and 2003, 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 2004 or 2003 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 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. During 2003, an \$8 after-tax increase in the fair value of cash flow hedges was recorded in AOCL while an after-tax amount of \$(6) 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, 2003.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Fair Value of Financial Instruments: The estimated fair values of our financial instruments at December 31, 2004 and 2003 follow:

	2004		2003	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 3,218	\$3,218	\$ 2,477	\$2,477
Accounts receivable, net	2,076	2,076	2,159	2,159
Short-term debt	3,074	3,093	4,236	4,281
Long-term debt	7,050	7,442	6,930	7,177
Liabilities to trusts issuing preferred securities	717	738	1,809	2,407

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 12—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:

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Change in Benefit Obligation				
Benefit obligation, January 1	\$ 8,971	\$7,931	\$1,579	\$1,563
Service cost	222	197	22	26
Interest cost	660	934	89	91
Plan participants' contributions	14	15	18	9
Plan amendments	232	1	—	(30)
Actuarial loss	272	312	70	18
Currency exchange rate changes	356	486	6	12
Divestitures	—	(45)	—	—
Curtailments	(2)	1	—	—
Special termination benefits	2	—	—	—
Benefits paid/settlements	(699)	(861)	(122)	(110)
Benefit obligation, December 31	\$10,028	\$8,971	\$1,662	\$1,579

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Change in Plan Assets				
Fair value of plan assets, January 1	\$ 7,301	\$ 5,963	\$ —	\$ —
Actual return on plan assets	772	1,150	—	—
Employer contribution	409	672	104	101
Plan participants' contributions	14	15	18	9
Currency exchange rate changes	311	401	—	—
Divestitures	2	(39)	—	—
Benefits paid/settlements	(699)	(861)	(122)	(110)
Fair value of plan assets, December 31	\$ 8,110	\$ 7,301	\$ —	\$ —
Funded status (including under-funded and non-funded plans)	(1,918)	(1,670)	(1,662)	(1,579)
Unamortized transition assets	(1)	(2)	—	—
Unrecognized prior service cost	(23)	(24)	(112)	(136)
Unrecognized net actuarial loss	1,993	1,870	494	447
Net amount recognized	\$ 51	\$ 174	\$ (1,280)	\$ (1,268)
Amounts recognized in the Consolidated Balance Sheets consist of:				
Prepaid benefit cost	\$ 897	\$ 756	\$ —	\$ —
Accrued benefit liability	(1,092)	(850)	(1,280)	(1,268)
Intangible asset	4	6	—	—
Minimum pension liability included in AOCL	242	262	—	—
Net amount recognized	\$ 51	\$ 174	\$ (1,280)	\$ (1,268)

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Change in minimum liability included in AOCL	\$ (20)	\$ (200)		

Information for benefit plans that are under-funded or non-funded on a Projected Benefit Obligation basis is presented below:

	Pension Benefits		Other Benefits	
	2004	2003	2004	2003
Aggregate projected benefit obligation	\$9,959	\$8,853	\$1,662	\$1,579
Aggregate fair value of plan assets	\$8,019	\$7,164	\$ —	\$ —

The accumulated benefit obligation for all defined benefit pension plans was \$8,966 and \$8,036 at December 31, 2004 and 2003, respectively.

Information for pension plans with an accumulated benefit obligation in excess of plan assets is presented below:

	2004	2003
Aggregate projected benefit obligation	\$6,464	\$5,882
Aggregate accumulated benefit obligation	\$5,727	\$5,207
Aggregate fair value of plan assets	\$4,668	\$4,367

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		
	2004	2003	2002	2004	2003	2002
Components of Net Periodic Benefit Cost						
Defined benefit plans						
Service cost	\$ 222	\$ 197	\$ 180	\$ 22	\$ 26	\$ 26
Interest cost ⁽¹⁾	660	934	(210)	89	91	96
Expected return on plan assets ⁽²⁾	(678)	(940)	134	—	—	—
Recognized net actuarial loss	104	53	7	24	13	3
Amortization of prior service cost	(1)	—	3	(24)	(18)	(5)
Recognized net transition asset	(1)	—	(1)	—	—	—
Recognized curtailment/settlement loss (gain)	44	120	55	—	(4)	—
Net periodic benefit cost	350	364	168	111	108	120
Special termination benefits	2	—	27	—	—	2
Defined contribution plans	69	62	10	—	—	—
Total	\$ 421	\$ 426	\$ 205	\$ 111	\$ 108	\$ 122

⁽¹⁾ Interest cost includes interest expense on non-TRA obligations of \$331, \$289, and \$238 and interest (income) expense directly allocated to TRA participant accounts of \$329, \$645, and \$(448) for the years ended December 31, 2004, 2003 and 2002, respectively.

⁽²⁾ Expected return on plan assets includes expected investment income on non-TRA assets of \$349, \$295, and \$314 and actual investment income (losses) on TRA assets of \$329, \$645, and \$(448) for the years ended December 31, 2004, 2003 and 2002, respectively.

Settlement/curtailment losses and special termination benefits were incurred as a result of our restructuring programs in all periods presented. Refer to Note 7 for that portion included in restructuring charges for each of the three years ended December 31, 2004.

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 2004 and 2003 measurement dates, the global pension plan assets were \$8.1 billion and \$7.3 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:

Asset Category	Asset Value		Percentage of Total Assets	
	2004	2003	2004	2003
Equity securities ⁽¹⁾	\$4,753	\$4,222	58%	58%
Debt securities ⁽¹⁾	2,592	1,900	32%	26%
Real estate	464	366	6%	5%
Other	301	813	4%	11%
Total	\$8,110	\$7,301	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 2004 were 59 percent invested in equities, 34 percent invested in fixed income, 6 percent invested in real estate and 1 percent invested in Other. For 2003 the target asset allocations were 60 percent invested in equities, 28 percent invested in fixed income, 4 percent invested in real estate and 8 percent invested in Other. The pension assets outside of the U.S. as of the 2004 and 2003 measurement dates were \$4.1 billion and \$3.4 billion, respectively.

The target asset allocations for the U.S. pension plan include 64 percent invested in equities, 30 percent in fixed income, 5 percent in real estate and 1 percent 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 percent.

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.

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

Contributions: We expect to contribute \$114 to our worldwide pension plans and \$128 to our other post retirement benefit plans in 2005. The 2005 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 2005 fiscal year. However, once the January 1, 2005 actuarial valuations and projected results as of the end of the 2005 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.

Estimated Future Benefit Payments: The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	<u>Pension Benefits</u>	<u>Other Benefits</u>
2005	\$ 672	\$ 128
2006	444	122
2007	489	124
2008	496	125
2009	571	127
Years 2010-2014	3,653	633

Assumptions

	<u>Pension Benefits</u>			<u>Other Benefits</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Weighted-average assumptions used to determine benefit obligations at the plan measurement dates						
Discount rate	5.6%	5.8%	6.2%	5.8%	6.0%	6.5%
Rate of compensation increase	4.0	3.9	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>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31								
Discount rate	5.6%	5.8%	6.2%	6.8%	5.8%	6.0%	6.5%	7.2%
Expected return on plan assets	8.0	8.1	8.3	8.8	⁽¹⁾	⁽¹⁾	⁽¹⁾	⁽¹⁾
Rate of compensation increase	4.0	3.9	3.9	3.8	⁽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.

Assumed health care cost trend rates at December 31

	<u>2004</u>	<u>2003</u>
Health care cost trend rate assumed for next year	11.9%	11.4%
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	2008

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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:

	<u>One- percentage- point increase</u>	<u>One- percentage- point decrease</u>
Effect on total service and interest cost components	\$ 4	\$ (3)
Effect on post-retirement benefit obligation	\$ 60	\$ (52)

Medicare Prescription Drug, Improvement and Modernization Act of 2003: In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (“Act”) was signed into law. The Act will provide prescription drug coverage to retirees beginning in 2006 and will provide subsidies to sponsors of post-retirement medical plans that provide actuarially equivalent prescription drug coverage. We currently provide post-retirement benefits to a group of retirees under two plans whereby retirees have little or no cost sharing for the prescription benefits. For these retirees, the prescription drug benefit provided by us would be considered to be actuarially equivalent to the benefit provided under the Act. We have reduced our Accumulated Projected Benefit Obligation (APBO) by \$64 for the subsidy related to benefits attributed to past service under these plans. This reduction will be reflected through the reduction of the amortization of actuarial losses over an effective amortization period of 12 years, which reflects the average remaining service period of the employees in the plan. We also provide postretirement benefits to another group of retirees. We have not treated the employer paid drug coverage under this plan as actuarially equivalent to the benefits provided under the Act. This assessment was made prior to the recent issuance of final regulations regarding the Act. When we have completed our final review of these regulations, we may determine that the benefits under this plan are actuarially equivalent for a period of time.

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 2004 actuarial valuation. 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. The dividends were payable in cash or additional Convertible Preferred shares, or in a combination thereof.

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 the three years ended December 31, 2004 follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Dividends declared on Convertible Preferred Stock	\$ 15	\$ 41	\$ 78
Cash contribution to the ESOP	—	14	31
Compensation expense	—	8	10

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

Note 13—Income and Other Taxes

Income (loss) before income taxes for the three years ended December 31, 2004 follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Domestic income (loss)	\$426	\$(299)	\$ 15
Foreign income	539	735	89
Income before income taxes	\$965	\$ 436	\$104

Provisions (benefits) for income taxes for the three years ended December 31, 2004 follow:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Federal income taxes			
Current	\$ 26	\$ 77	\$ 39
Deferred	114	(132)	(35)
Foreign income taxes			
Current	178	144	145
Deferred	21	72	(141)
State income taxes			
Current	(19)	(17)	(2)
Deferred	20	(10)	(2)
	<u>\$340</u>	<u>\$ 134</u>	<u>\$ 4</u>

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, 2004 follows:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
U.S. federal statutory income tax rate	35.0%	35.0%	35.0%
Nondeductible expenses	3.4	5.0	17.6
Effect of tax law changes	(1.5)	1.0	(15.3)
Change in valuation allowance for deferred tax assets	1.3	(3.8)	14.0
State taxes, net of federal benefit	1.3	(2.7)	(2.3)
Audit and other tax return adjustments	0.7	7.6	(53.7)
Tax-exempt income	(0.7)	(1.0)	(9.3)
Dividends on Series B convertible preferred stock	(0.6)	(3.1)	(22.7)
Other foreign, including earnings taxed at different rates	(2.4)	(7.0)	43.8
Other	(1.3)	(0.3)	(3.3)
Effective income tax rate	35.2%	30.7%	3.8%

The 2004 consolidated effective income tax rate of 35.2 percent was comparable to the U.S. federal statutory income tax rate. The effective income tax rate reflects the impact of nondeductible expenses and unrecognized tax benefits primarily related to recurring losses in certain jurisdictions where we continue to maintain deferred tax asset valuation allowances. This tax expense was partially offset by tax benefits from other foreign adjustments, including earnings taxed at different rates, tax law changes and other items that are individually insignificant.

The difference between the 2003 consolidated effective income tax rate of 30.7 percent and the U.S. federal statutory income tax rate relates primarily to tax benefits arising from the reversal of valuation allowances on

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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 dividends on Series B Convertible Preferred Stock and state tax benefits. Such benefits were partially offset by tax expense for audit and other tax return adjustments, as well as recurring losses in certain jurisdictions where we continue to maintain deferred tax asset valuation allowances.

The difference between the 2002 consolidated effective income tax rate of 3.8 percent and the U.S. federal statutory income tax rate relates primarily to the recognition of tax benefits from the favorable resolution of a foreign tax audit, tax law changes as well as the retroactive declaration of Series B Convertible Preferred Stock dividends. Such benefits were offset, in part, by tax expense recorded for the ongoing examination in India, the sale of our interest in Katun Corporation as well as recurring losses in certain jurisdictions where we are not providing tax benefits and continue to maintain deferred tax asset valuation allowances.

On a consolidated basis, we paid a total of \$253, \$207, and \$442 in income taxes to federal, foreign and state jurisdictions in 2004, 2003 and 2002, respectively.

Total income tax expense (benefit) for the three years ended December 31, 2004 was allocated as follows:

	2004	2003	2002
Income taxes on income	\$340	\$134	\$ 4
Common shareholders' equity ⁽¹⁾	(20)	123	(173)
Total	\$320	\$257	\$(169)

⁽¹⁾ For tax effects of items in accumulated other comprehensive loss and tax benefits related to stock option and incentive plans.

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, 2004 was approximately \$6 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. However, as discussed below, upon completion of our evaluation of the American Jobs Creation Act of 2004 ("the Act"), we will reassess these plans. It is not practicable to estimate the amount of additional tax that might be payable on the foreign earnings. As a result of the March 31, 2001 disposition of one-half of our ownership interest in Fuji Xerox, the investment no longer qualified 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.

The United States Congress passed the Act, which the President signed into law on October 22, 2004. The Act allows a temporary incentive of an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. We are in the process of evaluating whether we will repatriate foreign earnings under the Act and we are awaiting the issuance of further regulatory guidance with respect to certain provisions prior to making a definitive decision. Based on our preliminary analysis, we believe there will not be a material benefit from this temporary incentive and accordingly, we do not expect to repatriate foreign earnings as a result of the provision. The Act also provides a deduction for income from qualified domestic production activities, which will be phased in from 2005 through 2010. Based on guidance received from the U.S. government with respect to this provision of the Act, we do not anticipate recognizing a significant tax benefit from this provision for the next several years due to U.S. taxable income limitations. However, we will continue to evaluate this provision as new guidance is issued.

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The tax effects of temporary differences that give rise to significant portions of the deferred taxes at December 31, 2004 and 2003 were as follows:

	<u>2004</u>	<u>2003</u>
Tax effect of future tax deductions		
Research and development	\$ 1,281	\$ 1,238
Post-retirement medical benefits	499	491
Depreciation	247	311
Net operating losses	450	442
Other operating reserves	333	262
Tax credit carryforwards	289	237
Deferred compensation	198	182
Allowance for doubtful accounts	149	151
Restructuring reserves	43	69
Other	40	340
	<u>3,529</u>	<u>3,723</u>
Valuation allowance	(567)	(577)
Total deferred tax assets	<u>\$ 2,962</u>	<u>\$ 3,146</u>
Tax effect of future taxable income		
Unearned income and installment sales	\$(1,293)	\$(1,250)
Other	(79)	(112)
	<u>(1,372)</u>	<u>(1,362)</u>
Total deferred taxes, net	<u>\$ 1,590</u>	<u>\$ 1,784</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, 2004 and 2003 amounted to \$289 and \$402, 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, 2003 was \$524. The net change in the total valuation allowance for the years ended December 31, 2004 and 2003 was a decrease of \$10 and an increase of \$53, 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, 2004, we had tax credit carryforwards of \$289 available to offset future income taxes, of which \$183 is available to carryforward indefinitely while the remaining \$106 will begin to expire, if not utilized, in 2005. We also had net operating loss carryforwards for income tax purposes of \$252 that will expire in 2005 through 2024, if not utilized, and \$2.4 billion available to offset future taxable income indefinitely.

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From 1995 through 1998, we incurred capital losses from the disposition of our insurance group operations. Such losses were disallowed under the tax law existing at the time of the respective dispositions. As a result of IRS regulations issued in 2002, some portion of the losses could be claimed subject to certain limitations. We have filed amended tax returns for 1995 through 1998 reporting \$1.2 billion of additional capital losses. As of December 31, 2004 we have \$474 of capital gains available to be offset by these capital losses and could realize a potential tax and related interest benefit of approximately \$195. We could also realize additional income tax and related interest benefits of \$55 associated with the further utilization of these capital losses against a prior business sale. The additional losses claimed and related tax benefits are subject to formal review by the U.S. government, which is currently in process. We will not recognize any tax benefit of these losses until this review has reached a stage that we can estimate the probability of a favorable outcome. All remaining capital loss carryforwards from this matter expired December 31, 2003. The aggregate potential tax benefit of approximately \$250 will not result in a significant cash refund, but will increase tax credit carryforwards and reduce taxes otherwise potentially due.

Note 14—Contingencies

Guarantees, Indemnifications and Warranty Liabilities:

As of December 31, 2004, we have accrued our estimate of liability incurred under our indemnification arrangements and guarantees, if any. The following is a description of arrangements in which we are a guarantor.

Indemnifications provided as part of contracts and agreements: We are a party to a variety of agreements pursuant to which we may be obligated to indemnify the other party with respect to certain matters. These obligations arise in the context of 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. In addition, we have provided guarantees on behalf of our subsidiaries with respect to real estate leases. In certain instances, these lease guarantees may remain in effect subsequent to the sale of the subsidiary. Furthermore, in certain contracts we have agreed 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 their own willful misconduct or gross negligence. Also, in certain sales contracts, we have guaranteed our performance to our customers and indirectly the performance of third parties with whom we have subcontracted for their services.

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. For the indemnification agreements discussed above, it is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of our obligations and the unique facts and circumstances involved in each agreement. Historically, payments we have made under these agreements did not have a material effect on our business, financial condition or results of operations.

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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 carriers for certain payments made by us. The litigation matters and regulatory actions described below involve certain of our current and former directors and officers, all of whom are covered by the aforementioned indemnity and if applicable, current and prior period insurance policies. 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.

The Securities and Exchange Commission (“SEC”) announced on June 5, 2003 that it had reached a settlement with several individuals who are former officers of Xerox Corporation regarding the same accounting and disclosure matters which were involved in its investigation of Xerox Corporation. These individuals neither admitted nor denied wrongdoing and agreed to pay fines, disgorgement and interest. These individuals are responsible for paying their own fines. However, because all of the individuals who settled were officers of Xerox Corporation, we were required under our by-laws to reimburse the individuals for the disgorgement, interest and legal fees of \$19. This amount was accrued in 2002.

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. The following table summarizes product warranty activity for the three years ended December 31, 2004:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Balance as of January 1	\$ 19	\$ 25	\$ 46
Provisions and adjustments	45	47	51
Payments	(41)	(53)	(72)
Balance as of December 31	<u>\$ 23</u>	<u>\$ 19</u>	<u>\$ 25</u>

Tax Related Contingencies: At December 31, 2004, our Brazilian operations had received assessments levied against it for indirect and other taxes which, inclusive of interest, were approximately \$559. The change since the December 31, 2003 disclosed amount of \$449 is primarily due to indexation and interest, additional assessments and currency. The assessments principally relate to the internal transfer of inventory. We are disputing these assessments and intend to vigorously defend our position. Based on the opinion of legal counsel, we do not believe that the ultimate resolution of these assessments will materially impact our results of operations, financial position or cash flows. In connection with these proceedings, we may be required to make cash deposits and other security of up to half of the total amount in dispute. Generally, any such amounts would be refundable to the extent the matter is resolved in our favor.

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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 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.

In 2002, we reached a settlement with the SEC, in which we neither admitted nor denied wrongdoing, with respect to previously disclosed allegations relating to matters that had been under investigation since 2000. As a result, the SEC filed a complaint, which we simultaneously settled by consenting to the entry of an Order enjoining us from future violations of Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a) and 13(b) of the 1934 Act and Rules 10b-5, 12b-20, 13a-1, 13a-13 and 13b2-1 thereunder, requiring payment of a civil penalty of \$10, and imposing other ancillary relief. We continue to be subject to the provisions of the Order relating to future violations of law.

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

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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. That motion has not yet been fully briefed or argued before the court. On or about November 8, 2004, the International Brotherhood of Electrical Workers Welfare Fund of Local Union No. 164 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. 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.

Christine Abarca, et al. v. City of Pomona, et al. (Pomona Water Cases): In 1999, a series of complaints was filed against the Company in the Superior Court of the State of California for the County of Los Angeles on behalf of individual plaintiffs, claiming damages as a result of our alleged disposal and/or release of hazardous substances into the soil and groundwater. Plaintiffs alleged that hazardous substances from the Company's operations entered the municipal drinking water supplied by the City of Pomona and the Southern California Water Company, and as a result they were exposed to the substances by inhalation, ingestion and dermal contact. Plaintiffs' claims against the Company included personal injury, wrongful death, property damage, negligence, trespass, nuisance, and violation of the California Unfair Trade Practices Act. In November 2004, the parties entered into a confidential settlement agreement, the terms of which were not material to the Company.

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 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. That motion has been fully briefed, but has not been argued before the court. The court has not issued a ruling. 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.

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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 Carlson action. That motion has been fully briefed, but has not been argued before the court. The court has not issued a ruling. 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

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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. 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 \$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. Following the withdrawal, plaintiffs will apply to the district court for the entry of a new, appealable judgment. Assuming such judgment is entered, plaintiffs will have the right to file a new notice of appeal. 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: A dispute between MPI Technologies, Inc. (“MPI”) and the Company and Xerox Canada Ltd. (“XCL”) is being arbitrated in Ontario, Canada. The dispute arose under a license agreement (“Agreement”) made as of March 15, 1994 between MPI and XCL. Subsequently, the Company became MPI’s primary interface for the Agreement and the activities thereunder. MPI has alleged damages of \$93 for royalties owed under the Agreement, \$35 for breach of fiduciary duty or breach of confidence, \$35 in punitive damages and has claimed \$4 in damages, disgorgement of profits and injunctive relief with respect to a claim of copyright infringement. The Company and XCL have asserted a counterclaim against MPI for overpayment of royalties and breach of contract. In November 2004, MPI’s motion to amend its claim to add its parent, MPI Tech S.A., as a claimant was granted and the motion of the Company and XCL to dismiss MPI’s copyright claim was denied. The hearing of the arbitration commenced on January 18, 2005 and is expected to last approximately three months. The Company and XCL deny any wrongdoing, deny that any damages are owed and are vigorously defending the action. It is not possible at this stage of the arbitration to estimate the amount of loss or the range of possible loss that might result from an adverse ruling or a settlement of this matter.

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

Accuscan, Inc. v. Xerox Corporation: On April 11, 1996, an action was commenced by Accuscan, Inc. (“Accuscan”), in the United States District Court for the Southern District of New York, against the Company seeking unspecified damages for infringement of a patent of Accuscan which expired in 1993. The suit, as amended, was directed to facsimile and certain other products containing scanning functions and sought damages for sales between 1990 and 1993. On April 1, 1998, a verdict was entered in favor of Accuscan for \$40. However, on September 14, 1998, the court granted our motion for a new trial on damages. The trial ended on October 25, 1999 with a verdict of \$10. We appealed to the Court of Appeals for the Federal Circuit (“CAFC”) which found the patent was not infringed, thereby terminating the lawsuit subject to an appeal which was filed by Accuscan to the U.S. Supreme Court. The decision of the U.S. Supreme Court was to remand the case back to the CAFC to consider its previous decision based on the U.S. Supreme Court’s May 28, 2002 ruling in the Festo case. On September 17, 2003, the CAFC reconsidered the case and again held that the patent was not infringed. On December 15, 2003, Accuscan filed a petition to the U.S. Supreme Court to appeal the CAFC’s September 17, 2003 decision. This petition was denied on February 23, 2004. The period during which Accuscan could obtain reconsideration of the Supreme Court’s denial of the petition for writ of certiorari has expired. Xerox and Accuscan have filed a joint motion with the District Court to have a judgment (consistent with the mandate issued by the CAFC) entered for Xerox. The parties are awaiting action on the motion by the District Court.

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 seeking to limit coverage based on particular provisions in the policy. Plaintiff filed notices of appeal on January 10, 2005 and February 11, 2005. The Company and the individual defendants intend to seek dismissal of the remaining claims. 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.

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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). We deny any wrongdoing and are vigorously defending this action. 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, with document production continuing through the first half of 2005. 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. 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:

In re Xerox Derivative Actions: A consolidated putative shareholder derivative action is pending in the Supreme Court of the State of New York, County of New York 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. The plaintiffs purportedly brought this action in the name of and for the benefit of the Company, which is named as a nominal defendant, and its public shareholders. The second consolidated amended complaint alleged 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 alleged 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 second amended complaint also asserted claims of negligence, negligent misrepresentation, breach of contract and breach of fiduciary duty against KPMG. Additionally, plaintiffs claimed 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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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. On December 16, 2002, the Company and the individual defendants answered the complaint. The plaintiffs filed a third consolidated and amended derivative action complaint on July 23, 2003 adding factual allegations relating to subsequent acts and transactions, namely indemnification of six former officers for disgorgements imposed pursuant to their respective settlements with the SEC and related legal fees, and adding a demand for injunctive relief with respect to that indemnification. On September 12, 2003, Xerox and the individuals filed an answer to the third consolidated and amended derivative action complaint. Discovery in this case has been stayed, to the extent it is duplicative of discovery in *Carlson*, as discussed herein, pending determination of the motion to dismiss in *Carlson*. The individual defendants deny any wrongdoing and are vigorously defending the action.

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 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

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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. Xerox plans to appeal the grant of summary judgment of invalidity in due course.

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.

U.S. Attorney's Office Investigation: We previously reported that the U.S. attorney's office in Bridgeport, Connecticut was conducting an investigation into matters relating to Xerox, namely accounting and disclosure issues during the period 1998 to 2000, particularly relating to the Company's operations in Latin America. The accounting matters upon which the U.S. Attorney's office appeared to be focusing were the ones that were investigated by the SEC and addressed in the Company's restatements. The Company cooperated with the investigation and provided documents as requested. On October 15, 2004 the U.S. Attorney's office informed the Company that it has completed its investigation and declined to bring charges against the Company or any individuals in connection with the investigation.

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. The Indian Ministry of Company Affairs has provided our Indian subsidiary with a portion of the investigator's report which addresses the previously disclosed misappropriation of funds and improper payments and has requested comments, which the Indian subsidiary intends to provide in due course. The report includes allegations that Xerox Modicorp Ltd.'s senior officials and the Company were aware of such activities. The report also asserts the need for further investigation into potential criminal acts related to the improper activities addressed by the report. The matter is now pending in the Indian Ministry of Company Affairs. The Company has reported these developments and furnished a copy of the portion of the report received by Xerox Modicorp Ltd. to the U.S. Department of Justice and the SEC. In October 2004, we increased our ownership interest in our Indian subsidiary to 86 percent, further increasing our controlling interest over this subsidiary.

Note 15—Preferred Stock

As of December 31, 2004, we have 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 June 2003, we issued 9.2 million shares of 6.25 percent 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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

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 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 16—Common Stock

We have 1.75 billion authorized shares of common stock, \$1 par value. At December 31, 2004, 131 million shares were reserved for issuance under our incentive compensation plans. In addition, at December 31, 2004, 90 million common shares were reserved for the conversion of the Series C Mandatory Convertible Preferred Stock, 48 million common shares were reserved for debt to equity exchanges, and 2 million common shares were reserved for the conversion of convertible debt.

Stock Option and Long-term Incentive Plans: We have a long-term incentive plan whereby eligible employees may be granted non-qualified stock options, shares of common stock (restricted or unrestricted) and stock appreciation rights (“SARs”). Stock options and stock awards are settled with newly issued shares of our common stock, while SARs are settled with cash.

We granted 2.5 million, 1.6 million and 1.6 million shares of restricted stock to key employees for the years ended December 31, 2004, 2003 and 2002, respectively. No monetary consideration is paid by employees who receive restricted shares. Compensation expense for restricted grants is based upon the grant date market price and is recorded over the vesting period, which is generally three years. Compensation expense recorded for restricted grants was \$22, \$15 and \$17 in 2004, 2003 and 2002, respectively.

Stock options generally vest over a period of three years and expire between eight and ten years from the date of grant. The exercise price of the options is equal to the market value of our common stock on the effective date of grant.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

At December 31, 2004 and 2003, 33.9 million and 21.4 million shares, respectively, were available for grant of options or awards. 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, 2004 (stock options in thousands):

	2004		2003		2002	
	Stock Options	Average Option Price	Stock Options	Average Option Price	Stock Options	Average Option Price
Employee Stock Options						
Outstanding at January 1	97,839	\$ 21	76,849	\$ 26	68,829	\$ 29
Granted	11,216	14	31,106	10	14,286	10
Cancelled	(8,071)	32	(6,840)	21	(5,668)	34
Exercised	(9,151)	7	(3,276)	6	(598)	5
Outstanding at December 31	91,833	21	97,839	21	76,849	26
Exercisable at end of year	65,199		58,652		45,250	

Options outstanding and exercisable at December 31, 2004 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 Exercise Price
Range of Exercise Prices					
\$4.75 to \$6.98	8,058	5.97	\$ 4.86	7,348	\$ 4.82
7.13 to 10.69	34,920	7.34	9.09	21,342	9.30
10.70 to 15.27	11,507	6.97	13.66	396	13.06
16.91 to 22.88	12,545	5.00	21.77	11,310	21.77
25.38 to 36.70	7,830	2.93	31.58	7,830	31.58
41.72 to 60.95	16,973	2.72	52.60	16,973	52.60
	91,833	5.62	\$ 20.98	65,199	\$ 24.93

Note 17—Earnings Per Share

Basic earnings per share is computed by dividing income available to common shareholders (the numerator) by the weighted-average number of common shares outstanding (the denominator) for the period. Diluted earnings per share assumes that any dilutive convertible preferred shares, convertible subordinated debentures, and convertible securities outstanding were converted, with related preferred stock dividend requirements and outstanding common shares adjusted accordingly. It also assumes that outstanding common shares were increased by shares issuable upon exercise of those stock options for which market price exceeds the exercise price, less shares which could have been purchased by us with the related proceeds. In periods of losses, diluted loss per share is computed on the same basis as basic loss per share as the inclusion of any other potential shares outstanding would be anti-dilutive.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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

The detail of the computation of basic and diluted EPS follows (shares in thousands):

	2004	2003	2002
Basic Earnings per common share:			
Income from continuing operations before cumulative effect of change in accounting principle	\$ 776	\$ 360	\$ 154
Accrued dividends on:			
Series C Mandatory Convertible Preferred Stock	(57)	(30)	—
Series B Convertible Preferred Stock, net	(16)	(41)	(73)
Adjusted income from continuing operations before cumulative effect of change in accounting principle	703	289	81
Gain on sale of ContentGuard, net	83	—	—
Cumulative effect of change in accounting principle	—	—	(63)
Adjusted net income available to common shareholders	\$ 786	\$ 289	\$ 18
Weighted average common shares outstanding	834,321	769,032	731,280
Basic earnings per share:			
Income from continuing operations before cumulative effect of change in accounting principle	\$ 0.84	\$ 0.38	\$ 0.11
Gain on sale of ContentGuard, net	0.10	—	—
Cumulative effect of change in accounting principle	—	—	(0.09)
Basic earnings per share	\$ 0.94	\$ 0.38	\$ 0.02
Diluted Earnings per common share:			
Income from continuing operations before cumulative effect of change in accounting principle	\$ 776	\$ 360	\$ 154
ESOP expense adjustment, net	(6)	(35)	(73)
Accrued dividends on Series C Mandatory Convertible Preferred Stock	—	(30)	—
Interest on Convertible Securities, net of tax	51	—	—
Adjusted income from continuing operations before cumulative effect of change in accounting principle	821	295	81
Gain on sale of ContentGuard, net	83	—	—
Cumulative effect of change in accounting principle	—	—	(63)
Adjusted net income available to common shareholders	\$ 904	\$ 295	\$ 18
Weighted Average Common Shares Outstanding	834,321	769,032	731,280
Common shares issuable with respect to:			
Stock options	14,198	8,273	5,401
Series B Convertible Preferred Stock	17,359	51,082	70,463
Convertible Securities	106,272	—	—
Series C Mandatory Convertible Preferred Stock	74,797	—	—
Adjusted Weighted Average Shares Outstanding	1,046,947	828,387	807,144
Diluted earnings per share:			
Income from continuing operations before cumulative effect of change in accounting principle	\$ 0.78	\$ 0.36	\$ 0.10
Gain on sale of ContentGuard, net of income taxes	0.08	—	—
Cumulative effect of change in accounting principle	—	—	(0.08)
Diluted earnings per share	\$ 0.86	\$ 0.36	\$ 0.02

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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The 2004, 2003 and 2002 computation of diluted earnings per share did not include the effects of 38 million, 63 million and 64 million stock options, respectively, because their respective exercise prices were greater than the corresponding market value per share of our common stock.

In addition, in 2003 and 2002 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	2002
Series C Mandatory Convertible Preferred Stock	43,656	—
Liability to subsidiary trust issuing preferred securities—Trust II	113,426	113,426
Convertible subordinated debentures	1,992	9,121
Total	159,074	122,547

All such securities were dilutive or converted to common stock in 2004.

Note 18—Divestitures and Other Sales

During the three years ended December 31, 2004, the following significant transactions occurred:

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 expenses, net in the accompanying consolidated statements of income.

ContentGuard: In March 2004, we sold all but 2 percent of our 75 percent 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.

Xerox Engineering Systems: In the second quarter 2003, we sold our XES subsidiaries in France and Germany for a nominal amount and recognized a loss of \$12.

Nigeria: In December 2002, we sold our remaining investment in Nigeria for a nominal amount and recognized a loss of \$35, primarily representing cumulative translation adjustment losses which were previously unrealized.

Licensing Agreement: In September 2002, we signed a license agreement with a third party, related to a nonexclusive license for the use of certain of our existing patents. In October 2002, we received proceeds of \$50 and granted the license. We have no continuing obligation or other commitments to the third party and recorded the income associated with this transaction as revenue in Service, outsourcing and rentals in the accompanying Consolidated Statement of Income.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

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Katun Corporation: In July 2002, we sold our 22 percent investment in Katun Corporation, a supplier of aftermarket copier/printer parts and supplies, for net proceeds of \$67. This sale resulted in a pre-tax gain of \$12, which is included in Other expenses, net, in the accompanying Consolidated Statements of Income. After-tax, the sale was essentially break-even, as the taxable basis of Katun was lower than our carrying value on the sale date resulting in a high rate of income tax.

Italy Leasing Business: In April 2002, we sold our leasing business in Italy to a company now owned by GE for \$200 in cash plus the assumption of \$20 of debt. This sale is part of an agreement under which GE, as successor, provides ongoing, exclusive equipment financing to our customers in Italy. The total pre-tax loss on this transaction, which is included in Other expenses, net, in the accompanying Consolidated Statements of Income, was \$27 primarily related to recognition of cumulative translation adjustment losses and final sale contingency settlements.

Prudential Insurance Company Common Stock: In the first quarter of 2002, we sold common stock of Prudential Insurance Company, associated with that company's demutualization. In connection with this sale, we recognized a pre-tax gain of \$19 that is included in Other Expenses, net, in the accompanying Consolidated Statements of Income.

Flextronics Manufacturing Outsourcings: In the fourth quarter of 2001, we entered into purchase and supply agreements with Flextronics, a global electronics manufacturing services company. Under the agreements, Flextronics purchased related inventory, property and equipment. Pursuant to the purchase agreement, we sold our operations in Toronto, Canada; Aguascalientes, Mexico, Penang, Malaysia, Venray, The Netherlands and Resende, Brazil to Flextronics in a series of transactions, which were completed in 2002. In total, approximately 4,100 Xerox employees in certain of these operations transferred to Flextronics. Total proceeds from the sales in 2002 and 2001 were \$167, plus the assumption of certain liabilities.

Under the supply agreement, Flextronics manufactures and supplies equipment and components, including electronic components, for the Office segment of our business. This represents approximately 50 percent of our overall worldwide manufacturing operations. The initial term of the Flextronics supply agreement is through December 2006 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. We also must purchase certain electronic components from Flextronics, so long as Flextronics meets certain pricing requirements. 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. Our remaining manufacturing operations are primarily located in Rochester, NY for our high end production products and consumables and Wilsonville, OR for consumable supplies and components for the Office segment products.

Note 19—Financial Statements of Subsidiary Guarantors

The Senior Notes due 2009, 2010, 2011 and 2013 are jointly and severally guaranteed by Intelligent Electronics, Inc. and Xerox International Joint Marketing, Inc. (the "Guarantor Subsidiaries"), each of which is wholly-owned by Xerox Corporation (the "Parent Company"). The following supplemental financial information sets forth, on a condensed consolidating basis, the balance sheets, statements of income and statements of cash flows for the Parent Company, the Guarantor Subsidiaries, the non-guarantor subsidiaries and total consolidated Xerox Corporation and subsidiaries as of December 31, 2004 and December 31, 2003 and for the years ended December 31, 2004, 2003, and 2002.

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

Condensed Consolidating Statements of Income for the Year Ended December 31, 2004

	Parent Company	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Total Company
Revenues					
Sales	\$ 3,469	\$ —	\$ 4,081	\$ (291)	\$ 7,259
Service, outsourcing and rentals	4,050	—	3,696	(217)	7,529
Finance income	314	—	713	(93)	934
Intercompany revenues	713	—	365	(1,078)	—
Total Revenues	8,546	—	8,855	(1,679)	15,722
Costs and Expenses					
Cost of sales	2,399	—	2,715	(426)	4,688
Cost of service, outsourcing and rentals	2,248	—	2,075	(17)	4,306
Equipment financing interest	106	—	332	(93)	345
Intercompany cost of sales	619	—	297	(916)	—
Research and development expenses	669	—	127	(36)	760
Selling, administrative and general expenses	2,321	—	2,088	(206)	4,203
Restructuring and asset impairment charges	51	—	35	—	86
Other (income) expenses, net	(35)	(19)	424	(1)	369
Total Costs and Expenses	8,378	(19)	8,093	(1,695)	14,757
Income from Continuing Operations before Income Taxes and					
Equity Income	168	19	762	16	965
Income taxes	100	7	229	4	340
Equity in net income of unconsolidated affiliates	15	—	131	5	151
Equity in net income of consolidated affiliates	693	(33)	—	(660)	—
Income (Loss) from Continuing Operations	776	(21)	664	(643)	776
Gain on sale of ContentGuard, net of income taxes of \$26	83	—	—	—	83
Net Income (Loss)	\$ 859	\$ (21)	\$ 664	\$ (643)	\$ 859

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 Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Total Company
Assets					
Cash and cash equivalents	\$ 2,446	\$ —	\$ 772	\$ —	\$ 3,218
Accounts receivable, net	358	—	1,718	—	2,076
Billed portion of finance receivables, net	206	—	171	—	377
Finance receivables, net	581	—	2,351	—	2,932
Inventories	669	—	514	(40)	1,143
Other current assets	457	—	672	53	1,182
Total Current Assets	4,717	—	6,198	13	10,928
Finance receivables due after one year, net	1,099	—	4,089	—	5,188
Equipment on operating leases, net	229	—	169	—	398
Land, buildings and equipment, net	979	—	780	—	1,759
Investments in affiliates, at equity	61	—	801	(17)	845
Investments in and advances to consolidated subsidiaries	9,050	(136)	(165)	(8,749)	—
Intangible assets, net	289	—	8	—	297
Goodwill	490	290	1,060	8	1,848
Other long-term assets	1,106	—	2,515	—	3,621
Total Assets	\$18,020	\$ 154	\$ 15,455	\$ (8,745)	\$24,884
Liabilities and Equity					
Short-term debt and current portion of long-term debt	\$ 5	\$ —	\$ 3,069	\$ —	\$ 3,074
Accounts payable	476	—	522	39	1,037
Other current liabilities	1,428	7	760	(6)	2,189
Total Current Liabilities	1,909	7	4,351	33	6,300
Long-term debt	3,632	—	3,418	—	7,050
Intercompany payables, net	1,891	(239)	(1,630)	(22)	—
Liabilities to subsidiary trusts issuing preferred securities	717	—	—	—	717
Other long-term liabilities	2,738	—	961	(15)	3,684
Total Liabilities	10,887	(232)	7,100	(4)	17,751
Series C mandatory convertible preferred stock	889	—	—	—	889
Common shareholders' equity	6,244	386	8,355	(8,741)	6,244
Total Liabilities and Equity	\$18,020	\$ 154	\$ 15,455	\$ (8,745)	\$24,884

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

	<u>Parent Company</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Total Company</u>
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
	<u>1,345</u>	<u>—</u>	<u>(604)</u>	<u>741</u>
Increase (decrease) in cash and cash equivalents	1,345	—	(604)	741
Cash and cash equivalents at beginning of period	1,101	—	1,376	2,477
	<u>1,101</u>	<u>—</u>	<u>1,376</u>	<u>2,477</u>
Cash and cash equivalents at end of period	\$ 2,446	\$ —	\$ 772	\$ 3,218
	<u>\$ 2,446</u>	<u>\$ —</u>	<u>\$ 772</u>	<u>\$ 3,218</u>

Condensed Consolidating Statements of Income for the Year Ended December 31, 2003

	<u>Parent Company</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Total Company</u>
Revenues					
Sales	\$ 3,326	\$ —	\$ 3,704	\$ (60)	\$ 6,970
Service, outsourcing and rentals	4,257	—	3,680	(203)	7,734
Finance income	337	—	750	(90)	997
Intercompany revenues	535	—	427	(962)	—
	<u>8,455</u>	<u>—</u>	<u>8,561</u>	<u>(1,315)</u>	<u>15,701</u>
Total Revenues	8,455	—	8,561	(1,315)	15,701
Cost and Expenses					
Cost of sales	2,155	—	2,487	(206)	4,436
Cost of service, outsourcing and rentals	2,314	—	2,019	(22)	4,311
Equipment financing interest	88	—	364	(90)	362
Intercompany cost of sales	473	—	342	(815)	—
Research and development expenses	765	—	116	(13)	868
Selling, administrative and general expenses	2,485	—	1,955	(191)	4,249
Restructuring and asset impairment charges	105	—	71	—	176
Gain on affiliate's sale of stock	(13)	—	—	—	(13)
Other expenses (income), net	517	(18)	371	6	876
	<u>8,889</u>	<u>(18)</u>	<u>7,725</u>	<u>(1,331)</u>	<u>15,265</u>
Total Costs and Expenses	8,889	(18)	7,725	(1,331)	15,265
(Loss) Income before Income Taxes (Benefits) and Equity Income	(434)	18	836	16	436
Income taxes (benefits)	(108)	7	224	11	134
Equity in net income of unconsolidated affiliates	—	—	61	(3)	58
Equity in net income of consolidated affiliates	686	(28)	—	(658)	—
	<u>686</u>	<u>(28)</u>	<u>—</u>	<u>(658)</u>	<u>—</u>
Net Income (Loss)	\$ 360	\$ (17)	\$ 673	\$ (656)	\$ 360
	<u>\$ 360</u>	<u>\$ (17)</u>	<u>\$ 673</u>	<u>\$ (656)</u>	<u>\$ 360</u>

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, 2003

	Parent Company	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminations	Total Company
Assets					
Cash and cash equivalents	\$ 1,101	\$ —	\$ 1,376	\$ —	\$ 2,477
Accounts receivable, net	717	—	1,442	—	2,159
Billed portion of finance receivables, net	270	—	191	—	461
Finance receivables, net	454	—	2,527	—	2,981
Inventories	669	—	520	(37)	1,152
Other current assets	466	—	639	—	1,105
Total Current Assets	3,677	—	6,695	(37)	10,335
Finance receivables due after one year, net	834	—	4,537	—	5,371
Equipment on operating leases, net	212	—	176	(24)	364
Land, buildings and equipment, net	1,024	—	803	—	1,827
Investments in affiliates, at equity	73	—	571	—	644
Investments in and advances to consolidated subsidiaries	7,849	(64)	192	(7,977)	—
Intangible assets, net	325	—	—	—	325
Goodwill	491	296	935	—	1,722
Other long-term assets	1,611	—	2,392	—	4,003
Total Assets	\$16,096	\$ 232	\$ 16,301	\$ (8,038)	\$24,591
Liabilities and Equity					
Short-term debt and current portion of long-term debt	\$ 588	\$ —	\$ 3,648	\$ —	\$ 4,236
Accounts payable	517	—	493	—	1,010
Other current liabilities	968	13	1,431	11	2,423
Total Current Liabilities	2,073	13	5,572	11	7,669
Long-term debt	2,840	—	4,090	—	6,930
Intercompany payables, net	3,042	(188)	(2,869)	15	—
Liabilities to subsidiary trusts issuing preferred securities	743	—	1,066	—	1,809
Other long-term liabilities	2,719	—	684	101	3,504
Total Liabilities	11,417	(175)	8,543	127	19,912
Series B convertible preferred stock	499	—	—	—	499
Series C mandatory convertible preferred stock	889	—	—	—	889
Common shareholders' equity	3,291	407	7,758	(8,165)	3,291
Total Liabilities and Equity	\$16,096	\$ 232	\$ 16,301	\$ (8,038)	\$24,591

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 Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Total Company</u>
Net cash provided by (used in) operating activities	\$ 2,673	\$ —	\$ (794)	\$ 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
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
(Decrease) increase in cash and cash equivalents	(571)	—	161	(410)
Cash and cash equivalents at beginning of period	1,672	—	1,215	2,887
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Cash and cash equivalents at end of period	\$ 1,101	\$ —	\$ 1,376	\$ 2,477

Condensed Consolidating Statements of Income for the Year Ended December 31, 2002

	<u>Parent Company</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Total Company</u>
Revenues					
Sales	\$ 3,396	\$ —	\$ 3,427	\$ (71)	\$ 6,752
Service, outsourcing and rentals	4,589	—	3,657	(149)	8,097
Finance income	294	—	806	(100)	1,000
Intercompany revenues	327	—	513	(840)	—
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total Revenues	8,606	—	8,403	(1,160)	15,849
Cost and Expenses					
Cost of sales	2,055	—	2,403	(225)	4,233
Cost of service, outsourcing and rentals	2,471	—	2,046	(23)	4,494
Equipment financing interest	119	—	382	(100)	401
Intercompany cost of sales	294	—	382	(676)	—
Research and development expenses	804	—	125	(12)	917
Selling, administrative and general expenses	2,607	—	1,970	(140)	4,437
Restructuring and asset impairment charges	95	—	575	—	670
Other expenses (income), net	255	(25)	360	3	593
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total Cost and Expenses	8,700	(25)	8,243	(1,173)	15,745
(Loss) Income before Income Taxes (Benefits), Equity Income and Cumulative Effect of Change in Accounting Principle					
	(94)	25	160	13	104
Income taxes (benefits)	(17)	10	5	6	4
Equity in net income of unconsolidated affiliates	(6)	—	65	(5)	54
Equity in net income of consolidated affiliates	237	(18)	—	(219)	—
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Income (Loss) before Cumulative Effect of Change in Accounting Principle	154	(3)	220	(217)	154
Cumulative effect of change in accounting principle	(63)	—	(62)	62	(63)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net Income (Loss)	\$ 91	\$ (3)	\$ 158	\$ (155)	\$ 91

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, 2002

	<u>Parent Company</u>	<u>Guarantors Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Total Company</u>
Net cash provided by (used in) operating activities	\$ 2,812	\$ 4	\$ (836)	\$ 1,980
Net cash (used in) provided by investing activities	(1,718)	(1)	1,812	93
Net cash used in financing activities	(1,836)	(3)	(1,453)	(3,292)
Effect of exchange rate changes on cash and cash equivalents	—	—	116	116
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Decrease in cash and cash equivalents	(742)	—	(361)	(1,103)
Cash and cash equivalents at beginning of period	2,414	—	1,576	3,990
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Cash and cash equivalents at end of period	\$ 1,672	—	\$ 1,215	\$ 2,887

Note 20—Subsequent Event

In February 2005, we entered into an agreement to sell our entire ownership interest in Integic Corporation (“Integic”) for which we will receive an estimated \$96 in cash at closing. The sale, which we expect to close in the first half of 2005, is expected to result in a pre-tax gain of approximately \$92 (\$57 after-tax). These amounts, however, are subject to change based on final closing adjustments, which are not expected to be material. Our investment in Integic is currently accounted for on the equity method and is included in Investments in affiliates, at equity in our consolidated balance sheets. Integic is an information technology provider specializing in enterprise health and business process management solutions.

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, our management has concluded that, as of December 31, 2004, we did not have any material weaknesses in our internal control over financial reporting and our internal control over financial reporting was effective. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm (independent auditors), 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 an integrated audit of Xerox Corporation's 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 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, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 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.

As discussed in Note 1, the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" on January 1, 2002.

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, 2004 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, 2004, 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 21, 2005

QUARTERLY RESULTS OF OPERATIONS (Unaudited) In millions, except per-share data

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
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 and Equity Income	202	272	163	328	965
Income taxes	67	91	62	120	340
Equity in net income of unconsolidated affiliates ⁽²⁾	30	27	62	32	151
Gain on sale of ContentGuard, net	83	—	—	—	83
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
2003					
Revenues	\$3,757	\$3,920	\$3,732	\$4,292	\$15,701
Costs and Expenses ⁽¹⁾	3,903	3,810	3,590	3,962	15,265
(Loss) Income before Income Taxes (Benefits) and Equity Income	(146)	110	142	330	436
Income taxes (benefits)	(67)	40	38	123	134
Equity in net income of unconsolidated affiliates	14	16	13	15	58
Net (Loss) Income	\$ (65)	\$ 86	\$ 117	\$ 222	\$ 360
Basic (Loss) Earnings per Share ⁽³⁾	\$ (0.10)	\$ 0.10	\$ 0.12	\$ 0.25	\$ 0.38
Diluted (Loss) Earnings per Share ⁽³⁾	\$ (0.10)	\$ 0.09	\$ 0.11	\$ 0.22	\$ 0.36

⁽¹⁾ Costs and expenses include restructuring and asset impairment charges of \$6, \$33, \$23 and \$24 for the first, second, third and fourth quarters of 2004, respectively, and \$8, \$37, \$11 and \$120 for the first, second, third and fourth quarters of 2003, respectively. Costs and expenses include a gain of \$38 from the sale of our investment in ScanSoft in the second quarter of 2004. Cost and expenses include a provision relating to the Berger v. Retirement Income Guarantee Plan (RIGP) litigation of \$300 and \$(61) in the first quarter and fourth quarter of 2003, respectively. Cost and expenses include a \$73 loss on early extinguishment of debt in the second quarter 2003.

⁽²⁾ Equity in net income of unconsolidated affiliates for the third quarter 2004 includes an after-tax \$38 pension settlement benefit from Fuji Xerox.

⁽³⁾ The sum of quarterly (loss) 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.

FIVE YEARS IN REVIEW

	2004	2003	2002	2001	2000
(Dollars in millions, except per-share data)					
Per-Share Data ⁽¹⁾					
Income (Loss) from continuing operations before cumulative effect of change in accounting principle					
Basic	\$ 0.84	\$ 0.38	\$ 0.11	\$ (0.15)	\$ (0.48)
Diluted	0.78	0.36	0.10	(0.15)	(0.48)
Earnings (Loss)					
Basic	\$ 0.94	\$ 0.38	\$ 0.02	\$ (0.15)	\$ (0.48)
Diluted	0.86	0.36	0.02	(0.15)	(0.48)
Common stock dividends	—	—	—	0.05	0.65
Operations					
Revenues	\$15,722	\$15,701	\$15,849	\$17,008	\$18,751
Sales	7,259	6,970	6,752	7,443	8,839
Service, outsourcing and rentals	7,529	7,734	8,097	8,436	8,750
Finance income	934	997	1,000	1,129	1,162
Research and development expenses	760	868	917	997	1,064
Selling, administrative and general expenses	4,203	4,249	4,437	4,728	5,518
Income (loss) from continuing operations before cumulative effect of change in accounting principle	776	360	154	(92)	(273)
Net income (loss) ⁽¹⁾	859	360	91	(94)	(273)
Financial Position					
Cash and cash equivalents	\$ 3,218	\$ 2,477	\$ 2,887	\$ 3,990	\$ 1,750
Accounts and finance receivables, net	10,573	10,972	11,077	11,574	13,067
Inventories	1,143	1,152	1,231	1,364	1,983
Equipment on operating leases, net	398	364	450	804	1,266
Land, buildings and equipment, net	1,759	1,827	1,757	1,999	2,527
Investment in discontinued operations	440	449	728	749	534
Total assets	24,884	24,591	25,550	27,746	28,291
Consolidated capitalization					
Short-term debt and current portion of long-term debt	3,074	4,236	4,377	6,637	3,080
Long-term debt	7,050	6,930	9,794	10,107	15,557
Total debt	10,124	11,166	14,171	16,744	18,637
Minorities' interests in equity of subsidiaries	80	102	73	73	87
Obligation for equity put options	—	—	—	—	32
Liabilities to subsidiary trusts issuing preferred securities	717	1,809	1,793	1,787	721
Series B convertible preferred stock	—	499	508	470	426
Series C mandatory convertible preferred stock	889	889	—	—	—
Common shareholders' equity	6,244	3,291	1,893	1,797	1,801
Total capitalization	\$18,054	\$17,756	\$18,438	\$20,871	\$21,704
Selected Data and Ratios					
Common shareholders of record at year-end	55,152	56,326	57,300	59,830	59,879
Book value per common share	\$ 6.53	\$ 4.15	\$ 2.56	\$ 2.49	\$ 2.68
Year-end common stock market price	\$ 17.01	\$ 13.80	\$ 8.05	\$ 10.42	\$ 4.63
Employees at year-end	58,100	61,100	67,800	78,900	91,500
Gross margin	40.6%	42.0%	42.4%	38.2%	37.4%
Sales gross margin	35.4%	36.4%	37.3%	30.5%	31.2%
Service, outsourcing and rentals gross margin	42.8%	44.3%	44.5%	42.2%	41.1%
Finance gross margin	63.1%	63.7%	59.9%	59.5%	57.1%
Working capital	\$ 4,628	\$ 2,666	\$ 3,242	\$ 2,340	\$ 4,928
Current ratio	1.7	1.4	1.4	1.2	1.8
Cost of additions to land, buildings and equipment	\$ 204	\$ 197	\$ 146	\$ 219	\$ 452
Depreciation on buildings and equipment	\$ 305	\$ 299	\$ 341	\$ 402	\$ 417

⁽¹⁾ Net income (loss), as well as Basic and Diluted Earnings per Share for the years ended December 31, 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 and \$58, in 2001 and 2000, respectively.

⁽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 percent to 25 percent.

Subsidiaries of Xerox Corporation

The following companies are subsidiaries of Xerox Corporation as of December 31, 2004. 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:

Name of Subsidiary	Incorporated In
AMTX, Inc.	Delaware
Carmel Valley, Inc.	Delaware
ContentGuard Holdings, Inc.	Delaware ⁽¹⁴⁾
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
InConcert, Inc.	Delaware
Infotonics Technology Center Inc.	New York ⁽¹⁶⁾
Institute for Research on Learning	Delaware
Intelligent Electronics, Inc.	Pennsylvania
Xerox Global Services, Inc.	Pennsylvania
Jeremiad Co.	Delaware
Leeroit S.A.	Ecuador
Low-Complexity Manufacturing Group, Inc.	Delaware
New PARC LLC	Delaware
Pacific Services and Development Corporation	Delaware
PageCam, Inc.	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
Synergix Image Solutions Suzhou Co. Ltd.	China ⁽²²⁾
The Xerox Foundation	Delaware
XDI, Inc.	Delaware
Xerox Argentina, I.C.S.A.	Argentina
Xerox Canada Capital Ltd.	Canada
Xerox Canada Inc.	Ontario
832667 Ontario Inc.	Ontario
1192990 Ontario Inc.	Ontario
1324029 Ontario Inc.	Ontario
1343175 Ontario Inc.	Ontario
Xerox (Barbados) SRL	Barbados ⁽¹³⁾
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

<u>Name of Subsidiary</u>	<u>Incorporated In</u>
Xerox Toner (Ireland) Limited	Ireland
Xerox Canada Facilities Management Ltd.	Ontario
Xerox Canada Finance Inc.	Ontario
Xerox Canada Leasing Partnership	Ontario ⁽¹⁷⁾
Xerox Canada Ltd.	Canada ⁽⁴⁾
Ionographic Operations Partnership	Massachusetts ⁽¹⁹⁾
XESystems Canada Inc.	Ontario
Xerox Canada Leasing Company	Nova Scotia
Xerox Canada Realty Inc.	Ontario ⁽³⁾
Xerox Capital, LLC	Turks & Caicos Islands ⁽⁸⁾
Xerox Capital Services LLC	Delaware ⁽¹⁸⁾
Xerox Capital Trust I	Delaware ⁽¹⁰⁾
Xerox Capital Trust II	Delaware ⁽¹⁰⁾
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
Talegen Properties, Inc.	Delaware
Xerox Credit Corporation	Delaware
Xerox Foreign Sales Corporation	Barbados
Xerox Funding LLC II	Delaware
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 ⁽⁹⁾
Xerox Investments Europe B.V.	Netherlands
Xerox Holdings (Ireland) Limited	Ireland
Xerox (Europe) Limited	Ireland
Bipolar Limited	Ireland
Xerox Channels Limited	Ireland
Xerox Ink Jet (Ireland) Limited	Ireland
Xerox Ink Tanks (Ireland) Limited	Ireland
Xerox XF Holdings (Ireland) Limited	Ireland
Xerox Finance (Cyprus) Limited	Cyprus
Xerox Finance (Ireland) Limited	United Kingdom
Xerox Leasing Ireland Limited	Jersey
Xerox—THE DOCUMENT COMPANY S.A.S.	France ⁽²³⁾
Xerobail SAS	France
Xerox Financial Services SAS	France

<u>Name of Subsidiary</u>	<u>Incorporated In</u>
Xerox Document Services SNC	France
Set Electronique SA	France
Set Belgium (EPC)	Belgium
Set Engineering SA	France
Set Italia	Italy
Set R&D Belgium (EES)	Belgium
Set UK Limited	United Kingdom
Xerox Business Services SNC	France
Xerox Document Supplies SNC	France
Xerox Israel Ltd.	Israel
Xerox UK Holdings Limited	United Kingdom
Triton Business Finance Limited	United Kingdom
Xerox Engineering Systems Europe 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⁾
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
NV Xerox Management Services S.A.	Belgium
N.V. Xerox S.A.	Belgium
The Xerox (UK) Trust	United Kingdom
Xerox AB	Sweden
Xerox AG	Switzerland
Xerox Office Supplies AG	Switzerland
Xerox A/S	Denmark
Xerox Finans	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
Xerox (C.I.S.) LLC	Russia
Xerox Credit AB	Sweden
XEROX CZECH Republic s r.o.	Czech Republic
Xerox Direct Rhein-Main GmbH	Germany
Xerox Engineering Systems SpA	Italy

<u>Name of Subsidiary</u>	<u>Incorporated In</u>
Xerox Espana-The Document Company, S.A.U.	Spain
Xerox Renting S.A.U.	Spain
Xerox de Financiacion S.A.U., E.F.C.	Spain
Xerox Office Supplies S.A.U.	Spain
Xerox Exports Limited	United Kingdom
Xerox Fabricacion S.A.U.	Spain
Xerox Finance AG	Switzerland
Xerox Finance (Nederland) BV	Netherlands
Xerox Financial Services B.V.	Netherlands ⁽²⁴⁾
Xerox Financial Services Espana Sa	Spain
Xerox Financial Services Belux NV	Belgium
Xerox GmbH	Germany
Xerox Dienstleistungsgesellschaft GmbH	Germany
Xerox Leasing Deutschland GmbH	Germany
Xerox Office Printing GmbH	Germany
Xerox Capital Services Verwaltungs GmbH	Germany
Xerox Capital Services GmbH & Co. KG	Germany ⁽²⁰⁾
Xerox Reprographische Services GmbH	Germany
Xerox Service GmbH	Germany
Xerox Hellas AEE	Greece
Xerox Hungary Trading Limited	Hungary
Xerox (Ireland) Limited	Ireland
Xerox Modicorp Ltd	India ⁽⁷⁾
Xerox (Nederland) BV	Netherlands
“Veco” Beheer Onroerend Goed BV	Netherlands
Xerox Document Supplies BV	Netherlands
Xerox Rentalease BV	Netherlands
Xerox Services BV	Netherlands
Xerox Office Printing S.A.S	France
Xerox Oy	Finland
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 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
Xexco Trading Limited	United Kingdom
Xerox XHB Limited	Bermuda ⁽⁶⁾

<u>Name of Subsidiary</u>	<u>Incorporated In</u>
Xerox XIB Limited	Bermuda ⁽⁶⁾
XRO Limited	United Kingdom
Nemo (AKS) Limited	United Kingdom
XRI Limited	United Kingdom
RRXH Limited	United Kingdom ⁽¹¹⁾
RRXO Limited	United Kingdom
RRXIL Limited	United Kingdom ⁽⁶⁾
Xerox West Africa Limited	United Kingdom
Xerox Latinamerican Holdings, Inc.	Delaware
Xerox Lease Funding LLC	Delaware
Xerox Lease Equipment LLC	Delaware
Xerox Mexicana, S.A. de C.V.	Mexico
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 de Panama, S.A.	Panama
Xerox Participacoes Ltda.	Brazil
Xerox Comercio e Industria Ltda	Brazil
Xerox Desenvolvimento de Sistemas e de Tecnologia 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
Xerox XBS Warehouse Funding LLC	Delaware
Xerox XBS Warehouse Funding II LLC	Delaware
XES Merger Corp.	Delaware
XESystems Foreign Sales Corporation	Barbados
XESystems UK Limited	United Kingdom
Xerox Engineering Systems Limited	United Kingdom
XGUA Servicios, Ltda.	Guatemala

(1) [Reserved]

(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 21.32% by Kapwell, Ltd., 65.43% by Xerox Corporation, and 13.25% by Pacific Services and Development Corporation.

(6) Includes indirect holdings.

- (7) Xerox Corporation has an indirect economic interest in 18.199% of XM through EMCO Fininvest Limited, which is a controlled subsidiary of Spiccorp Ltd (formerly Modicorp Ltd) the joint venture partner. Xerox Corporation also owns an additional 4.421% through its wholly-owned subsidiary Xerox Developing Markets Limited. The total ownership by Xerox Corporation is 68.199%.
- (8) Owned 99.9% by Xerox Corporation and .1% by Pacific Services and Development Corporation, a wholly-owned subsidiary of Xerox Corporation.
- (9) Xerox International Partners is a California general partnership between FX Global, Inc. (49%) and Xerox International Joint Marketing, Inc. (51%).
- (10) Each of Xerox Capital Trust I and Xerox Capital Trust II is a Delaware statutory business trust which is 100% beneficially owned by Xerox Corporation. Each Trust is a special purpose financing vehicle.
- (11) 50% owned by XRI Limited.
- (12) Owned 99% by Xerox Overseas Holdings Limited and 1% by Xerox Property Services Limited as nominee for Xerox Overseas Holdings Limited.
- (13) Owned 88.27% by Xerox Canada Inc. and 11.73% by Xerox Corporation.
- (14) Owned 75% by Xerox Corporation and 25% by Microsoft Corporation. Although Xerox Corporation has 75% of the physical vote, there is a valid shareholders' voting agreement between Xerox Corporation and Microsoft that effectively reduces Xerox Corporation's voting control to 50/50.
- (15) Owned 50% by Xerox Corporation and 50% by e-PaperSign, LLC.
- (16) 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.
- (17) Xerox Canada Leasing Partnership is an Ontario general partnership between Xerox Canada Inc. (99%) and Xerox Canada Finance Inc. (1%).
- (18) Owned 19% by Xerox Corporation and 81% by GE Capital Information Technology Solutions, Inc. [Included in Xerox Corporation's consolidated financial statements.]
- (19) Owned 66.995% by Xerox Canada Ltd. and 33.005% by Xerox Canada Inc.
- (20) Owned by Xerox GmbH and Xerox Capital Services Verwaltungs GmbH.
- (21) Owned 76% by Xerox Limited and 24% by Xerox Property Services Limited.
- (22) Owned 85% by Xerox Corporation and 15% by Jiansu Wuzhong Economic and Technological Development Corporation.
- (23) Owned 89.77% by Xerox XF Holdings (Ireland) Limited and 10.23% by Xerox Limited.
- (24) Xerox Financial Services B.V. is a joint venture between De Lage Landen International B.V. (51%) and Xerox Limited (49%), established in 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.]

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 and 333-111623) and Form S-8 (Nos. 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 21, 2005 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 21, 2005 relating to the financial statement schedule, which appears in this Form 10-K.

/s/ PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP
Stamford, CT
February 22, 2005

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 22, 2005

/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 22, 2005

/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, 2004, 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 22, 2005

/s/ LAWRENCE A. ZIMMERMAN

Lawrence A. Zimmerman
Chief Financial Officer
February 22, 2005

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.