

XEROX CORP
Form 10-Q/A
November 04, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A
(Amendment No. 1)

(Mark One)

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

For the quarterly period ended: September 30, 2003

OR

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

For the transition period from to

Commission File Number 1-4471

XEROX CORPORATION

(Exact Name of Registrant as specified in its charter)

New York
(State or other jurisdiction of incorporation or organization)

16-0468020
(IRS Employer Identification No.)

P.O. Box 1600

Stamford, Connecticut
(Address of principal executive offices)

06904-1600
(Zip Code)

(203) 968-3000

(Registrant's telephone number, including area code)

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

| <u>Class</u> | <u>Outstanding at September 30, 2003</u> |
|-----------------------------|--|
| Common Stock, \$1 par value | 791,857,130 shares |

The purpose of this Amendment No. 1 to Xerox Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003 is to correct typeset errors in the text of Management's Discussion and Analysis of Results of Operations and Financial Condition. The financial data remains unchanged.

Item 2

Xerox Corporation

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

Summary

| (in millions) | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|-----------------|----------------------|------------------|
| | September 30, | | September 30, | |
| | 2003 | 2002 | 2003 | 2002 |
| Equipment sales | \$ 948 | \$ 900 | \$ 2,869 | \$ 2,724 |
| Post sale and other revenue | 2,540 | 2,646 | 7,791 | 8,118 |
| Finance income | 244 | 247 | 749 | 761 |
| Total Revenues | \$ 3,732 | \$ 3,793 | \$ 11,409 | \$ 11,603 |
| <i>Reconciliation to Condensed Consolidated Statements of Income</i> | | | | |
| Sales | \$ 1,603 | \$ 1,593 | \$ 4,888 | \$ 4,838 |
| Less: Supplies, paper and other sales | (655) | (693) | (2,019) | (2,114) |
| Equipment sales | \$ 948 | \$ 900 | \$ 2,869 | \$ 2,724 |
| Service, outsourcing and rentals | \$ 1,885 | \$ 1,953 | \$ 5,772 | \$ 6,004 |
| Add: Supplies, paper and other sales | 655 | 693 | 2,019 | 2,114 |
| Post sale and other revenue | \$ 2,540 | \$ 2,646 | \$ 7,791 | \$ 8,118 |

Total third quarter 2003 revenues of \$3.7 billion declined 2 percent from \$3.8 billion in the 2002 third quarter including a 3-percentage point benefit from currency. Equipment sales grew 5 percent including a 3-percentage point benefit from currency. The remainder of the equipment sales growth was driven by the success of our office color multifunction and production color products, as well as growth in DMO. Post sale and other revenue declined 4 percent primarily due to declines in older technology light lens, DMO and the Small Office / Home Office (SOHO) business which we previously exited. These declines were partially offset by growth in our digital revenues and a 3-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. Finance income declined 1 percent, including a 4-percentage point benefit from currency. The decline in finance income continues to reflect reduced equipment sales from prior quarters.

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Total revenues of \$11.4 billion declined 2 percent from \$11.6 billion in the nine months ended September 30, 2002, including a 5-percentage point benefit from currency. Equipment sales increased 5 percent due to currency. Equipment sales have benefited from a significant improvement in DMO and the success of recent product launches. Post sale and other revenues declined 4 percent, including a 5-percentage point benefit from currency due primarily to declines in older technology light lens, DMO and SOHO.

| | Three Months | | Nine Months | |
|--|----------------|----------------|----------------|----------------|
| | Ended | | Ended | |
| | Sept. 30 | | Sept. 30 | |
| | 2003 | 2002 | 2003 | 2002 |
| (in millions, except per share data) | | | | |
| Net income | \$ 117 | \$ 99 | \$ 138 | \$ 72 |
| Preferred stock dividends | (25) | (63) | (46) | (63) |
| Income available to common shareholders | \$ 92 | \$ 36 | \$ 92 | \$ 9 |
| Diluted earnings per share | \$ 0.11 | \$ 0.04 | \$ 0.11 | \$ 0.01 |

The third quarter 2003 net income of \$117 million or \$0.11 per diluted share included an after-tax restructuring charge of \$7 million (\$11 million pre-tax). The third quarter 2002 net income of \$99 million or \$0.04 per diluted share, included after-tax restructuring charges of \$49 million (\$63 million pre-tax).

In the third quarter 2002, the Board of Directors declared dividends of \$67 million (\$63 million after tax) on the Company's Preferred Stock held by its Employee Stock Ownership Plan (ESOP). These dividends, which had been suspended in the second quarter 2001, represented the cumulative unpaid dividends that were in arrears, as well as the third quarter 2002 dividend. During the suspension of these dividends, in order to meet ESOP debt service requirements, we recorded additional ESOP-related compensation expense for each period that the dividends were not declared. The third quarter 2002 declaration of dividends resulted in the reversal of previously recorded compensation expense and accordingly increased net income in the third quarter 2002 by \$63 million. There was no corresponding earnings per share (EPS) improvement since the EPS calculation requires deduction of dividends declared from reported net income in arriving at income available to common shareholders.

Net income for the nine months ended September 30, 2003 was \$138 million or \$0.11 per diluted share compared with net income of \$72 million or \$0.01 per diluted share for the same period in the prior year. Net income for the nine months ended September 30, 2003 included a \$183 million (\$300 million pre-tax) charge related to the Berger v. Retirement Income Guarantee Plan Litigation, a \$45 million after-tax (\$73 million pre-tax) loss on the early extinguishment of debt related to the remaining unamortized fees associated with the terminated 2002 Credit Facility, after-tax restructuring charges of \$35 million (\$56 million pre-tax) and certain non-recurring income tax benefits of \$23 million. Net income for the nine months ended September 30, 2002 included a goodwill impairment of \$63 million associated with the adoption of SFAS No. 142, after-tax restructuring charges of \$191 million (\$262 million pre-tax), an after-tax charge of \$44 million (\$72 million pre-tax) for permanently impaired capitalized software, net after tax losses from currency exposures of \$53 million (\$69 million pre-tax).

Preferred stock dividends recorded in the third quarter 2003 consist of \$10 million related to our ESOP preferred stock and \$15 million related to the mandatory convertible preferred stock issued in June 2003. Preferred stock dividends recorded in the nine months ended September 30, 2003 consist of \$30 million related to our ESOP preferred stock and \$16 million related to the mandatory convertible preferred stock issued in June 2003. The prior year amount of \$63 million relates solely to dividends on our ESOP preferred stock.

Operations Review

Revenues for the three and nine months ended September 30, 2003 and 2002 were as follows:

| <u>(in millions)</u> | <u>Production</u> | <u>Office</u> | <u>DMO</u> | <u>Other</u> | <u>Total</u> |
|--|-------------------|-------------------|-------------------|-------------------|-------------------|
| Three months ended September 30, 2003 | | | | | |
| Equipment sales | \$ 251 | \$ 547 | \$ 108 | \$ 42 | \$ 948 |
| Post sale and other revenue | 716 | 1,142 | 293 | 389 | 2,540 |
| Finance income | 90 | 148 | 2 | 4 | 244 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total Revenue | \$ 1,057 | \$ 1,837 | \$ 403 | \$ 435 | \$ 3,732 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Memo - Color | | | | | \$ 771 |
| Three months ended September 30, 2002 | | | | | |
| Equipment sales | \$ 233 | \$ 557 | \$ 81 | \$ 29 | \$ 900 |
| Post sale and other revenue | 735 | 1,136 | 328 | 447 | 2,646 |
| Finance income | 97 | 151 | 3 | (4) | 247 |

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| | | | | | |
|---------------|----------|----------|--------|--------|----------|
| Total Revenue | \$ 1,065 | \$ 1,844 | \$ 412 | \$ 472 | \$ 3,793 |
| Memo - Color | | | | | \$ 670 |

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| (in millions) | Production | Office | DMO | Other | Total |
|---|-----------------|-----------------|-----------------|-----------------|------------------|
| Nine months ended September 30, 2003 | | | | | |
| Equipment sales | \$ 754 | \$ 1,698 | \$ 289 | \$ 128 | \$ 2,869 |
| Post sale and other revenue | 2,201 | 3,464 | 880 | 1,246 | 7,791 |
| Finance income | 283 | 447 | 7 | 12 | 749 |
| Total Revenue | \$ 3,238 | \$ 5,609 | \$ 1,182 | \$ 1,386 | \$ 11,409 |
| Memo - Color | | | | | \$ 2,297 |
| Nine months ended September 30, 2002 | | | | | |
| Equipment sales | \$ 723 | \$ 1,652 | \$ 222 | \$ 127 | \$ 2,724 |
| Post sale and other revenue | 2,236 | 3,440 | 1,089 | 1,353 | 8,118 |
| Finance income | 299 | 455 | 11 | (4) | 761 |
| Total Revenue | \$ 3,258 | \$ 5,547 | \$ 1,322 | \$ 1,476 | \$ 11,603 |
| Memo - Color | | | | | \$ 1,972 |

Equipment sales of \$948 million in the third quarter 2003 increased 5 percent from \$900 million in the third quarter 2002, reflecting significant improvement in sales within our developing markets operations segment, the success of numerous new products and a 3-percentage point benefit from currency. Color equipment sales continue to grow rapidly and now represent over 25 percent of total equipment sales.

Equipment sales of \$2.9 billion in the nine months ended September 30, 2003 increased 5 percent from the comparable period reflecting benefits from currency. Approximately 50 percent of equipment sales revenue in the third quarter of 2003 and in the nine month period ended September 30, 2003 was generated from products launched in the previous two years.

Production: 2003 third quarter equipment sales grew 8 percent from the third quarter 2002 as installation growth, improved mix and a 5-percentage point currency benefit more than offset price declines of approximately 5 percent. Very strong color equipment sales growth reflected the combination of modest installation increases and favorable mix due to an increased proportion of DocuColor 6060 and DocuColor iGen3 sales, which were only partially offset by price declines. Production monochrome equipment sales declined modestly reflecting lower revenue in production publishing as strong installation growth was more than offset by unfavorable mix. These declines were only partially offset by digital light-production growth driven by the Xerox 1010 and 2101, our new digital light-production copier/printers.

Production equipment sales for the nine months ended September 30, 2003 of \$754 million increased 4 percent from the comparable period as a 6-percentage point currency benefit and favorable mix more than offset price declines.

Office: 2003 third quarter equipment sales decreased 2 percent from the third quarter 2002, as price declines of approximately 10 percent and unfavorable mix offset strong installation growth and a 4-percentage point currency benefit. Equipment installation growth of approximately 20 percent reflects growth in both our monochrome and color products. Install growth in our monochrome multifunction/copier and color printing products was more than offset by lower price and mix. Increased installs include our CopyCentre, WorkCentre and WorkCentre Pro office products, which are intended to expand our market reach and include new entry-level configurations at more competitive prices. Growth in color multifunction primarily reflects the success of the DocuColor 3535 and WorkCentre Pro 32 and 40 multi-function color systems.

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Office equipment sales for the nine months ended September 30, 2003 of \$1.7 billion increased 3 percent from the comparable period as a 6-percentage point currency benefit and strong installation growth were only partially offset by price declines of approximately 10 percent and unfavorable mix.

DMO: Equipment sales in the third quarter 2003 grew 33 percent, or \$27 million, from the 2002 third quarter reflecting volume growth of over 60 percent, partially offset by price declines and unfavorable mix. DMO equipment revenue for the nine months ended September 30, 2003 increased 30 percent from the comparable period reflecting trends consistent with the third quarter 2003.

Post sale and other revenues of \$2.5 billion declined 4 percent from the third quarter 2002, including a 3-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 and the volume of prints and copies that our customers make on that equipment as well as associated services. Third quarter 2003 supplies, paper and other sales of \$655 million (included within post sale and other revenue) declined 5 percent from 2002 primarily due to declines in supplies from reduced usage in the lower installed base of equipment and our exit from the SOHO business in 2001. Service, outsourcing and rental revenue of \$1.9 billion declined 3 percent from the 2002 third quarter as declines in outsourcing, rental and other, were only partially offset by growth in service revenue attributable to currency. For the nine-months ended September 30, 2003, total post sale and other revenue declined \$327 million or 4 percent including a 4-percentage point benefit from currency. For the nine months ended September 30, 2003, supplies, paper and other sales of \$2.0 billion (included within post sale and other revenue) declined from the comparable period in 2002 primarily due to declines in supplies, partially offset by growth in paper. Supplies declines reflected a lower installed base of equipment and reduced sales in the SOHO business, which we exited in 2001. Service, outsourcing and rental revenue of \$5.8 billion declined 4 percent from the comparable period in 2002 as declines in rental, outsourcing and other were only partially offset by growth in service revenue due to favorable currency.

Production: 2003 third quarter post sale and other revenue of \$735 million declined 3 percent as favorable currency of 4 percent and improved mix, driven largely by an increased volume of color pages, was more than offset by the impact of monochrome page volume declines, primarily in older technology light lens products. Production post sale and other revenue for the nine months ended September 30, 2003 of \$2.2 billion decreased 2 percent from the comparable period as a 5-percentage point currency benefit and improved mix driven by an increased volume of color pages was more than offset by monochrome page volume declines, primarily in older technology light lens products.

Office: 2003 third quarter and nine month year-to-date post sale and other revenue grew 1 percent as strong digital page growth and favorable currency more than offset declines in older technology light lens products.

DMO: 2003 third quarter and nine month year-to-date post sale and other revenue declined 11 and 19 percent from the comparable periods, respectively, due largely to a lower equipment population at customer locations and page volume declines. These declines represent sequential improvements due to the stabilization of equipment populations in DMO, as evidenced by increasing equipment sales in recent quarters. We expect post sale declines will continue to moderate.

Other: Post sale and other revenue for the three and nine months ended September 30, 2003 declined 13 and 8 percent from the comparable periods, respectively, as declines in SOHO and XES more than offset the impact of favorable currency.

Segment Operating Profit

Production segment profit for the three and nine months ended September 30, 2003 of \$53 million and \$259 million decreased by \$42 million and \$8 million, respectively, from the comparable periods in 2002. 2003 segment operating margin for the three and nine months ended September 30, 2003 of 5.0 percent and 8.0 percent, respectively, declined by 3.9 percentage points and 0.2 percentage points, respectively, from the comparable periods in 2002. The declines in segment operating profit versus the comparable periods in 2002 reflect higher SAG expenses, partially offset by lower R&D spending.

Office segment profit for the three and nine months ended September 30, 2003 of \$181 million and \$496 million, respectively, increased by \$27 million and \$83 million, respectively, from the comparable periods in 2002. 2003 segment operating margins of 9.9 percent and 8.8 percent for the three and nine months ended September 30, 2003, respectively, improved by 1.5 percentage points and 1.4 percentage points from the comparable periods in 2002 reflecting improved gross margins driven primarily by improved manufacturing and service productivity as well as lower R&D and SAG expenses.

DMO segment profit for the three months ended September 30, 2003 of \$24 million decreased by \$4 million and the segment operating margin of 6.0 percent decreased by 0.8 percentage point from the comparable period in 2002. DMO segment profit for the nine months ended September 30, 2003 of \$101 million increased by \$57 million and the operating margin of 8.6 percent improved 5.3-percentage points from the comparable period in the prior year. The improvements reflect significantly lower SAG spending resulting from our cost saving initiatives, lower bad debts and gains on currency exposures compared to losses in 2002. These improvements were partially offset by lower gross profit as a result of declining post sale revenue.

Key Ratios and Expenses

As previously discussed, the third quarter 2002 declaration of preferred dividends resulted in the reversal of previously recorded compensation expense. The total 2002 pre-tax ESOP adjustment of \$67 million was therefore allocated to the applicable income statement line items as discussed below.

| | Three months ended | | Nine months ended | |
|----------------------------------|--------------------|-------------|-------------------|-------------|
| | September 30, | | September 30, | |
| | 2003 | 2002 | 2003 | 2002 |
| | % | % | % | % |
| Gross Margin | | | | |
| Sales | 34.5 | 36.1 | 36.2 | 36.8 |
| Service, outsourcing and rentals | 43.8 | 45.0 | 43.8 | 43.5 |
| Finance income | 63.5 | 56.7 | 63.4 | 60.6 |
| Total | 41.1 | 42.0 | 41.8 | 41.9 |

Third quarter 2003 total **gross margin** of 41.1 percent decreased 0.9 percentage points from the third quarter 2002. The absence of the \$28 million ESOP adjustment represents 0.7 percentage points of the decline. In addition, beginning with the third quarter 2003, we completed the R&D phase of the DocuColor iGen3 development. Accordingly, ongoing engineering costs associated with its commercial production are included in cost of sales and represent 0.4 percentage points of the decline. In the third quarter 2003, improved manufacturing and service productivity essentially offset lower prices and approximately \$20 million of higher pension and other employee benefit expenses. The third quarter 2003 sales margin decline of 1.6 percentage points from the third quarter 2002 included approximately 1 percentage point due to DocuColor iGen3 ongoing engineering costs and approximately 0.4 points due to the 2002 ESOP adjustment, partially offset by an adjustment of deferred inventory profit of .8 points. Service, outsourcing and rentals margin declined 1.2 percentage points from the third quarter 2002 with approximately 1 percentage point of the decline due to the 2002 ESOP adjustment. Third quarter 2003 finance income gross margin of 63.5 percent is consistent with previous 2003 quarters and represents an improvement of 6.8 percentage points year-over-year, in line with declining interest costs specific to equipment financing. Total gross margin of 41.8 percent for the nine months ended September 30, 2003 was essentially unchanged year-over-year.

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Research and development (R&D) expense for the three months ended September 30, 2003 of \$207 million, or 5.5 percent of third quarter 2003 revenue, was \$22 million less than the third quarter 2002, primarily related to the commercial launch of the DocuColor iGen3. This reduction more than offset higher pension and other employee benefit expenses and the absence of the third quarter 2002 \$11 million ESOP adjustment. R&D expense of \$668 million for the nine months ended September 30, 2003 declined \$31 million, or 4 percent,

compared to the comparable period as reduced DocuColor iGen3 spending more than offset increased pension and other employee benefit expenses. We continue to invest in technological development, particularly in color, and believe that 2003 R&D spending is at an adequate level to remain technologically competitive. Xerox R&D remains strategically coordinated with that of Fuji Xerox.

Selling, administrative and general (SAG) expenses of \$1.0 billion in the 2003 third quarter increased by \$5 million from the 2002 third quarter. The increase reflects the absence of the third quarter 2002 \$28 million ESOP adjustment, an increase in pension and other employee benefit expenses of approximately \$20 million and an adverse currency impact of \$38 million, as offset by the benefits from increased productivity and lower bad debt expenses. Third quarter 2003 bad debt expense of \$53 million decreased by \$34 million due to improved receivables aging and historical write-off trends. SAG expense of \$3.1 billion for the nine months ended September 30, 2003 decreased \$165 million or 5 percent compared to the comparable period reflecting the benefit from previous restructuring actions, lower bad debt expense of \$75 million and the absence of a capitalized software write-off and Winter Olympics advertising, partially offset by a \$72 million increase in pension and other employee benefit expenses.

For the three and nine months ended September 30 2003, we recorded **restructuring and asset impairment charges** totaling \$11 million and \$56 million, respectively, primarily consisting of new severance actions and pension settlements related to previous employee restructuring actions. The remaining restructuring reserve balance at September 30, 2003 for all programs was \$144 million. We expect additional provisions will be required in the fourth quarter 2003, as additional plans are finalized and committed to. The fourth quarter provision, which may approach \$100 million cannot be determined until the plans are finalized.

Worldwide **employment** of 62,800 declined by 1,100 from the 2003 second quarter and by 5,000 since December 31, 2002, as a result of reductions attributable to our restructuring programs and other attrition.

In the nine months ended September 30, 2003, we recorded a \$300 million **provision for litigation** relating to the Berger v. Retirement Income Guarantee Plan (RIGP) litigation. This case is discussed in more detail in Note 10 to the condensed consolidated financial statements.

For the nine months ended September 30, 2003, we recorded cumulative **gains on affiliate s sale of stock** of \$13 million in accordance with SEC Staff Accounting Bulletin No. 51, Accounting for sales of stock of a subsidiary, reflecting our proportionate share of the increase in equity of ScanSoft Inc., an equity investment. The gain in the third quarter of \$12 million 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. Subsequent to the acquisition, we account for this investment using the cost method.

Other expenses, net for the three and nine months ended September 30, 2003 and 2002 were as follows:

| | Three months | | Nine months | |
|--------------------------------|----------------------|-------------|----------------------|-------------|
| | ended | | ended | |
| | September 30, | | September 30, | |
| | 2003 | 2002 | 2003 | 2002 |
| (in millions) | | | | |
| Non-financing interest expense | \$ 105 | \$ 92 | \$ 327 | \$ 250 |
| Currency losses (gains), net | 12 | 12 | (8) | 69 |

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| | | | | |
|---|-----------------|-----------------|-----------------|-----------------|
| Amortization of intangible assets | 9 | 9 | 27 | 28 |
| Loss (gain) on sales of businesses and assets | 4 | (14) | 15 | (21) |
| Interest income | (17) | (21) | (39) | (64) |
| Loss on early extinguishment of debt | | | 73 | |
| Legal and regulatory matters | 6 | 20 | 3 | 30 |
| All other, net | 14 | 5 | 22 | 25 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total | \$ 133 | \$ 103 | \$ 420 | \$ 317 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

Third quarter 2003 non-financing interest expense was \$13 million higher than the 2002 third quarter, reflecting the increase of \$14 million resulting from the adoption of SFAS No. 150 (refer to Note 2 to the condensed consolidated financial statements herein). Year-over-year interest expense reductions of \$32 million due to lower average debt balances and lower variable interest rates were offset by unrealized mark-to-market losses of \$10 million on interest rate swaps compared to gains of \$21 million on those swaps in the third quarter 2002. Year-to-date 2003 non-financing interest expense of \$327 million was \$77 million higher than the comparable period in 2002 resulting from the higher variable interest rate associated with the 2002 Credit Facility prior to its repayment in June 2003, the related amortization of debt issuance costs and the \$14 million increase associated with the adoption of SFAS 150 which more than offset the impact of lower average debt balances.

Currency gains for the nine months ended September 30, 2003 of \$8 million were due largely to the strengthening of local currencies in developing markets where exposures have been hedged with purchased options, partially offset by the cost of hedging our foreign currency exposures. These gains compare to currency losses of \$69 million for the nine months ended September 30, 2002. Currency losses of \$40 million arose due to then unhedged exposures in developing markets and \$17 million reflect the mark-to-market accounting of contracts hedging anticipated transactions, while the remainder relate to costs associated with hedging our foreign currency exposure. We could experience volatility in future periods equivalent to the reversal of current year gains. We continue to monitor our exposures and update our hedge positions on an ongoing basis.

The third quarter 2003 loss on sales of businesses and assets related to the disposal of fixed assets. The 2002 third quarter gain primarily related to the sale of our 22 percent investment in Katun Corporation, a supplier of after-market copier/printer parts and supplies. The loss on sales of businesses and assets for the nine months ended September 30, 2003 relates to the disposal of fixed assets and the sale of XES subsidiaries in France and Germany, partially offset by a gain on the sale of our investment in Xerox South Africa. The gain for the nine months ended September 30, 2002 related to the \$19 million gain on the sale of Prudential Insurance Company common stock associated with the company's demutualization and the sale of our investment in Katun Corporation, partially offset by a loss related to the sale of our Italian leasing subsidiary.

Lower average interest rates for the three and nine months ended September 30, 2003 resulted in a reduction in interest income as compared to the comparable periods in 2002.

The loss on early extinguishment of debt realized during the nine months ended September 30, 2003 reflects the write-off of the remaining unamortized fees associated with the 2002 Credit Facility, which was repaid in June 2003 upon completion of the 2003 Credit Facility.

All other, net for the three and nine months ended September 30, 2003 includes professional fees of \$7 million and \$9 million, respectively, related to our European vendor financing initiatives.

The following table summarizes our consolidated **income taxes** and the related effective tax rate for the three and nine months ended September 30, 2003 and 2002 (\$ in millions):

| Three Months | | Nine Months | |
|---------------|------|---------------|------|
| Ended | | Ended | |
| September 30, | | September 30, | |
| 2003 | 2002 | 2003 | 2002 |
| | | | |

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| | | | | |
|--------------------|--------|--------|--------|--------|
| Pre-tax income | \$ 166 | \$ 176 | \$ 202 | \$ 276 |
| Income taxes | 47 | 77 | 47 | 118 |
| Effective tax rate | 28.3% | 43.8% | 23.3% | 42.8% |

The difference between the 2003 third quarter effective tax rate and the U.S. statutory tax rate primarily related to \$10 million of favorable audit settlements in the U.S. and Europe realized in the third quarter of 2003. The difference between the year-to-date effective tax rate and the U.S. statutory tax rate primarily related to favorable audit settlements realized in the current quarter as well as \$13 million of net tax benefits arising in foreign jurisdictions that we realized in the first quarter of 2003.

The difference between the 2002 third quarter and year-to-date effective tax rates and the U.S. statutory tax rate primarily related to additional tax expense recorded for the sale of our interest in Katun Corporation, the examination in India, as well as losses in certain jurisdictions where we are not providing tax benefits. Such expense is offset, in part, by certain benefits arising from tax law changes and the retroactive declaration of ESOP dividends.

Our effective tax rate will change based on discrete events (such as restructuring initiatives and 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 2003 annual effective tax rate will approximate 35 percent.

Equity in net income of unconsolidated affiliates primarily consists of our 25 percent share of Fuji Xerox income. Refer to Note 12 to the condensed consolidated financial statements for summarized income statement data for Fuji Xerox.

Minorities interests in earnings of subsidiaries was \$15 million and \$17 million in the third quarters of 2003 and 2002, respectively. The 2003 amount consists primarily of the \$13 million of distributions, net of tax, on our Capital Trust II company-obligated mandatorily redeemable preferred securities. The 2002 amount includes these distributions as well as \$9 million (net of tax) associated with the securities that were reclassified upon adoption of SFAS 150. In addition, 2002 included an offsetting adjustment of \$8 million associated with losses, which were allocable to our minority partners in certain DMO affiliates.

Capital Resources and Liquidity

Cash Flow Analysis

The following summarizes our cash flows for the nine months ended September 30, 2003 and 2002 as reported in our Condensed Consolidated Statement of Cash Flows in the accompanying Condensed Consolidated Financial Statements:

| <u>(in millions)</u> | <u>2003</u> | <u>2002</u> |
|--|-------------------|-------------------|
| Operating cash flows | \$ 908 | \$ 1,381 |
| Investing cash (usage) flows | (65) | 82 |
| Financing cash usage | (1,496) | (3,236) |
| Effect of exchange rate changes on cash | 36 | 64 |
| | <u> </u> | <u> </u> |
| Decrease in cash and cash equivalents | (617) | (1,709) |
| Cash and cash equivalents at beginning of period | 2,887 | 3,990 |
| | <u> </u> | <u> </u> |
| Cash and cash equivalents at end of period | <u>\$ 2,270</u> | <u>\$ 2,281</u> |

Cash flows from operating activities for the nine months ended September 30, 2003 were \$908 million and reflect pre-tax income of \$202 million adjusted for the following non-cash items: depreciation and amortization of \$566 million, the provision for litigation of \$300 million, provisions for receivables and inventory of \$253 million and the loss on early extinguishment of debt of \$73 million. In addition, reductions in finance and accounts receivable of \$545 million and \$174 million, respectively, contributed positively to our cash flow. These cash flows were

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partially offset by \$656 million of pension contributions (including \$450 million in the U.S. and \$132 million in the U.K.), \$142 million of tax payments, \$299 million of restructuring related cash payments and \$107 million of on-lease equipment investment. The \$473 million decline in operating cash flow for the nine months ended September 30, 2003 as compared to the comparable period in 2002 primarily reflects increased pension contributions of \$527 million and an increase in inventories of \$129 million related to our new products and \$111 million lower net finance receivables collections. These increased uses of cash were partially offset by lower cash taxes paid of \$246 million, primarily due to the absence of the 2002 tax payment related to our 2001 sale of half our interest in Fuji Xerox and improved accounts receivable collections of \$185 million.

Cash flows from investing activities for the nine months ended September 30, 2003 and 2002 primarily consisted of capital and internal use software spending, changes in restricted cash balances related principally to our secured financing activity and proceeds from divestitures. The 2003 period includes proceeds from the sale of our investment in Xerox South Africa, certain small Latin American affiliates as well as XES France and XES Germany, while the 2002 period includes proceeds from the sale of our interest in Katun, our Italian leasing business, certain manufacturing locations to Flextronics and our investment in Prudential common stock.

Cash flows from financing activities for the nine months ended September 30, 2003 included net proceeds from secured borrowing activity with GE and other vendor financing partners of \$32 million, net proceeds from the June 2003 convertible preferred stock offering of \$889 million, net proceeds from the June 2003 common stock offering of \$451 million and other net cash outflows related to debt of \$2,850 million, which are detailed below:

| | <u>\$ In Millions</u> |
|--|-----------------------------|
| Payments | |
| 2002 Credit Facility | \$ (3,490) |
| Convertible Subordinated Debentures | (560) |
| All Other | (379) |
| | <u> </u> |
| | \$ (4,429) |
| | <u> </u> |
| Borrowings, net of issuance costs | |
| 2010/2013 Senior Notes | \$ 1,218 |
| 2003 Credit Facility | 271 |
| All Other | 90 |
| | <u> </u> |
| | \$ 1,579 |
| | <u> </u> |
| Net Cash Outflow | \$ (2,850) |

Financing activities for the comparable 2002 period consisted primarily of \$3.5 billion of repayments under the 2002 Credit Facility and other scheduled payments of maturing debt of \$1,259 million, partially offset by proceeds from our 9.75 percent Senior Notes offering of \$746 million and net proceeds from secured borrowing activity with GE and other vendor financing partners of \$775 million.

During the nine months ended September 30, 2003, we originated loans, secured by finance receivables, generating cash proceeds of \$1,609 million. These loans, net of cash collections of \$1,577 million, maintained the proportion of total finance receivables which are secured at 54 percent. As of September 30, 2003, debt secured by finance receivables represents approximately 35 percent of total debt. The following table compares finance receivables to financing-related debt as of September 30, 2003:

| (in millions) | Finance | |
|--|-------------|---------------------|
| | Receivables | Debt ⁽²⁾ |
| Finance Receivables Encumbered by Loans ⁽¹⁾ : | | |
| GE Loans U.S. and Canada | \$ 3,207 | \$ 2,845 |
| Merrill Lynch Loan France | 507 | 446 |
| GE Loans Germany | 112 | 112 |
| Subtotal SPEs | 3,826 | 3,403 |
| GE Loans UK | 666 | 541 |
| Other Europe | 143 | 138 |
| Total Finance Receivable Securitizations | \$ 4,635 | \$ 4,082 |
| Unencumbered Finance Receivables | 3,951 | |
| Total Finance Receivables ⁽³⁾ | \$ 8,586 | |

(1) Encumbered Finance receivables represent the net book value of finance receivables that secure each of the indicated loans.

(2) Represents the debt secured by finance receivables, including transactions utilizing special purpose/variable interest entities.

(3) 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 September 30, 2003.

Our debt maturities for the remainder of 2003 and 2004 by quarter, and 2005, 2006, 2007 by year and thereafter are as follows:

| (in millions) | 2003 | 2004 | 2005 | 2006 | 2007 | Thereafter |
|----------------|----------|----------|----------|--------|--------|------------|
| First Quarter | | \$ 884 | | | | |
| Second Quarter | | 974 | | | | |
| Third Quarter | | 661 | | | | |
| Fourth Quarter | \$ 1,631 | 1,286 | | | | |
| Full Year | \$ 1,631 | \$ 3,805 | \$ 2,099 | \$ 337 | \$ 492 | \$ 3,450 |

Of the debt maturities shown in the table above, the amount that relates to debt secured by finance receivables for the years 2003, 2004, 2005, 2006, 2007 and thereafter are as follows: \$450 million, \$1,722 million, \$1,069 million, \$300 million, \$180 million, and \$361 million respectively.

Liquidity, Financial Flexibility and Funding Plans:

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References to Xerox Corporation below refer to the standalone parent company and do not include subsidiaries. References to we, our or us refer to Xerox Corporation and its consolidated subsidiaries.

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 parties and (3) the policies and cooperation of the financial institutions we utilize to maintain and provide cash management services. As described in our 2002 consolidated

financial statements, prior years' operating and liquidity issues led to a series of credit rating downgrades, eventually to below investment grade. As a result, our access to capital and derivative markets was restricted.

Our current credit ratings are as follows:

| | Senior Unsecured Debt | Outlook |
|----------------------|--------------------------------------|----------------|
| Moody's | B1 | Negative |
| S&P ⁽¹⁾ | B+ | Negative |
| Fitch ⁽²⁾ | BB | Stable |

⁽¹⁾ S&P rating on Senior Secured Debt is BB-.

⁽²⁾ The Fitch rating was upgraded from BB- (with a negative outlook) on June 23, 2003.

2003 Credit Facility and 2010/2013 Senior Notes

On June 25, 2003, we completed a \$3.6 billion recapitalization that included the offering and sale of 9.2 million shares of 6.25% Series C Mandatory Convertible Preferred Stock, 46 million shares of Common Stock, \$700 million of 7 1/8% Senior Notes due 2010 and \$550 million of 7 5/8% Senior Notes due 2013 and the closing of our new \$1.0 billion credit agreement which matures on September 30, 2008 (the "2003 Credit Facility"). The 2003 Credit Facility (which was filed as an exhibit to our Current Report on Form 8-K dated June 25, 2003) 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). Terms of the 2003 Credit Facility and the 2010 and 2013 Senior Notes are included in Note 9 to the condensed consolidated financial statements.

At September 30, 2003, we were in full compliance with the covenants and other provisions of the 2003 Credit Facility and the Senior Notes and expect to remain in full compliance for at least the next twelve months. 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.

Payment of Convertible Debt due 2018

In April 2003, \$560 million of convertible debt due 2018 was put back to us in accordance with the terms of the debt and was paid in cash.

Vendor Financing

Our financing business, including our vendor financing outsourcing and securitization activities, is described in detail in our 2002 consolidated financial statements. During the nine months ended September 30, 2003, we completed the following significant vendor financing initiatives:

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During the nine months ended September 30, 2003, we received \$1.1 billion secured by our finance receivables in connection with our U.S. Vendor Financing Agreement with GECC and affiliates (GE). The agreement with GE was amended in March 2003 to allow for the inclusion of state and local governmental contracts in future securitizations. Total amounts outstanding under this Loan Agreement were \$2.4 billion at September 30, 2003.

In July 2003 we replaced the 364-day warehouse financing facility in France, received from Merrill Lynch in December 2002, with a long-term public secured financing and established a new warehouse financing facility. This facility can provide funding of up to 350 million (U.S. \$407 million), outstanding at anytime, for new lease originations and may be securitized through a similar public offering within two years. Total amounts outstanding under this agreement and the original financing facility were \$47 million and \$399 million, respectively, at September 30, 2003.

In August 2003, we announced a seven-year agreement in Canada, under which GE Vendor Financial Services Canada became our primary equipment-financing provider in Canada through monthly fundings of new lease originations. The new agreement calls for GE to initially provide funding on new lease originations, of up to Cdn \$850 million (U.S. \$629 million), with the ability to increase the funding to Cdn \$2 billion (U.S. \$1.5 billion) outstanding at any time, subject to agreement between the parties. Under this agreement, we expect GE to fund approximately 80 percent of new lease originations at over-collateralization rates which vary over time but are expected to approximate 13 percent of the net receivables balance. The monthly interest rates will be consistent with rates for similar market based transactions. Consistent with the loans already received from GE both in the U.S. and Canada, the funding received under this new agreement will be recorded as secured borrowings and the associated receivables will be included in our Consolidated Balance Sheet. During the third quarter, we received \$104 million in conjunction with this program. Total amounts outstanding under this agreement (including balances previously funded) were \$432 million at September 30, 2003.

In September 2003, GE European Equipment Finance (EEF) and Xerox completed a four-year agreement for EEF to finance Xerox business in the United Kingdom through a £400 million (U.S. \$665 million) revolving loan. This replaces the existing short-term facility which was scheduled to expire in June 2004. The agreement is renewable for an additional three years and the facility size may also be increased to £600 million (U.S. \$998 million), subject to agreement between the parties. Total amounts outstanding under this agreement were \$541 million at September 30, 2003.

Summary Financial Flexibility and Liquidity:

With \$2.3 billion of cash and cash equivalents on hand at September 30, 2003 and borrowing capacity under our 2003 Credit Facility of \$700 million, less \$78 million utilized for letters of credit, 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; however, our ability to maintain positive liquidity going forward depends on our ability to generate cash from operations and access the financial markets, both of which are subject to general economic, financial, competitive, legislative, regulatory and other market factors that are beyond our control.

Special Purpose/Variable Interest Entities

From time to time, we have generated liquidity by selling or securitizing portions of our finance and accounts receivable portfolios. We have typically utilized special purpose/variable interest entities (SPEs/VIEs) in order to implement these transactions in a manner that isolates, for the benefit of the securitization investors, the securitized receivables from our other assets which would otherwise be available to our creditors. These transactions are typically credit-enhanced through over-collateralization. Such use of SPEs/VIEs is standard industry practice, is typically required by securitization investors and makes the securitizations easier to market. All our SPE/VIE transactions are accounted for as secured borrowings, with the debt and related assets remaining on our balance sheets. A detailed discussion of the terms of these transactions, including descriptions of our retained interests, is included in Note 5 to our 2002 consolidated financial statements.

Financial Risk Management

As a multinational company, we are exposed to market risk from changes in foreign currency exchange rates and interest rates that could affect our results of operations and financial condition. As a result of our improved liquidity and financial position, our ability to utilize derivative contracts as part of our risk management strategy, described below, has substantially improved. Only certain of these hedging arrangements qualify for hedge accounting treatment under SFAS 133. Accordingly, our results of operations are exposed to volatility. The level of volatility will vary with the level of derivative hedges outstanding, as well as the currency and interest rate market movements in the period.

We enter into limited types of derivative contracts, including interest rate swap agreements, foreign currency swap agreements, cross currency interest rate swap agreements, forward exchange contracts, purchased foreign currency options and purchased interest rate collars, to manage interest rate and foreign currency exposures. 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 change in their values is offset by changes in the values of the underlying exposures. Our derivative instruments are held solely to hedge economic exposures; we do not enter into derivative instrument transactions for trading or other speculative purposes and we employ long-standing policies prescribing that derivative instruments are only to be used to achieve a very limited set of objectives.

Our primary foreign currency market exposures include the Japanese yen, Euro, Brazilian real, British pound sterling and Canadian dollar. For each of our legal entities, we generally hedge foreign currency denominated assets and liabilities, primarily through the use of derivative contracts. We typically enter into simple unleveraged derivative transactions. Our policy is to use only counterparties with an investment-grade or better rating and to monitor market risk and exposure for each counterparty. We also utilize arrangements with each counterparty that allow us to net gains and losses on separate contracts. This further mitigates the credit risk associated with our financial instruments. Based upon our ongoing evaluation of the replacement cost of our derivative transactions and counterparty credit worthiness, we consider the risk of a material default by a counterparty to be remote.

Some of our derivative contracts and several other material contracts at September 30, 2003 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.

PART II OTHER INFORMATION

Item 6 Exhibits and Reports on Form 8-K

(a) Exhibit 3(a)(1) Restated Certificate of Incorporation of Registrant filed with the Department of State of the State of New York on October 29, 1996, as amended by Certificate of Amendment of the Certificate of Incorporation of Registrant filed with the Department of State of New York on May 21, 1999.

Incorporated by reference to Exhibit 3(a) to Amendment No. 5 to Registrant's Form 8-A Registration Statement dated February 8, 2000.

Exhibit 3(a)(2) Certificate of Amendment of Certificate of Incorporation of Registrant filed with the Department of State of New York on September 9, 2002.

Incorporated by reference to Exhibit 3(a) to Registrant's Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2002.

Exhibit 3(a)(3) Certificate of Amendment of Certificate of Incorporation of Registrant filed with the Department of State of New York on June 2, 2003.

Incorporated by reference to Exhibit 4(a)(1)(iii) to Registrant's Registration Statement No. 333-101164.

Exhibit 3(a)(4) Certificate of Amendment of Certificate of Incorporation of Registrant filed with the Department of State of New York on June 24, 2003.

Incorporated by reference to Exhibit 3 to Registrant's Current Report on Form 8-K dated June 25, 2003 (filed June 27, 2003).

Exhibit 3 (b) By-Laws of Registrant, as amended through September 1, 2002.

Incorporated by reference to Exhibit 3(b) to Registrant's Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2002.

Exhibit 12 Computation of Ratio of Earnings to Fixed Charges and Computation of Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends. (previously filed)

Exhibit 31 (a) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 31 (b) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Current Reports on Form 8-K dated July 23, 2003 (two filings) and September 15, 2003, reporting Item 5 Other Events ; a Current Report on Form 8-K dated June 25, 2003 (filed July 3, 2003) reporting Item 7 Financial Statements, Pro Forma Financial Information and Exhibits ; and a Current Report on Form 8-K dated July 28, 2003 reporting Item 12 Results of Operations and Financial Condition ; were filed during the quarter for which this Quarterly Report on Form 10-Q is filed.

SIGNATURES

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

XEROX CORPORATION
(Registrant)

By:

/s/ GARY R. KABURECK

Date: November 4, 2003

Gary R. Kabureck

Vice President and

Chief Accounting Officer

(Principal Accounting Officer)

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