

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q/A
AMENDMENT NO. 1 TO FORM 10-Q

(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, 2001

OR

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

For the transition period from _____ to _____

Commission File Number 1-4471

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

New York 16-0468020

(State or other jurisdiction (IRS Employer Identification No.)
of incorporation or organization)

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

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

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports), and (2) has been subject to such
filing requirements for the past 90 days.

Yes No X

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class	Outstanding at October 31, 2001
Common Stock	719,988,021 shares

This document consists of 21 pages.

Forward-Looking Statements

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

The words "anticipate", "believe", "estimate", "expect", "intend", "will", and
similar expressions, as they relate to the Company or the Company's management,
are intended to identify forward-looking statements. Such statements reflect
the current views of the Registrant with respect to future events and are
subject to certain risks, uncertainties and assumptions. Should one or more of
these risks or uncertainties materialize, or should underlying assumptions
prove incorrect, actual results may vary materially from those described herein
as anticipated, believed, estimated or expected. The Registrant does not intend
to update these forward-looking statements.

In accordance with the provisions of the Litigation Reform Act we are making
investors aware that such "forward-looking" statements, because they relate to

future events, are by their very nature subject to many important factors which could cause actual results to differ materially from those contained in the "forward-looking" statements. Such factors include but are not limited to the following:

Competition - the Registrant operates in an environment of significant competition, driven by rapid technological advances and the demands of customers to become more efficient. There are a number of companies worldwide with significant financial resources which compete with the Registrant to provide document processing products and services in each of the markets served by the Registrant, some of whom operate on a global basis. The Registrant's success in its future performance is largely dependent upon its ability to compete successfully in its currently-served markets and to expand into additional market segments. If we are unable to compete successfully it could adversely affect our results of operations and financial condition.

Transition to Digital - presently black and white light-lens copiers represent approximately 25% of the Registrant's revenues. This segment of the market is mature with anticipated declining industry revenues as the market transitions to digital technology. Some of the Registrant's new digital products replace or compete with the Registrant's current light-lens equipment. Changes in the mix of products from light-lens to digital, and the pace of that change as well as competitive developments could cause actual results to vary from those expected.

Expansion of Color - color printing and copying represents an important and growing segment of the market. Printing from computers has both facilitated and increased the demand for color. A significant part of the Registrant's strategy and ultimate success in this changing market is its ability to develop and market machines that produce color prints and copies quickly and at reduced cost. The Registrant's continuing success in this strategy depends on its ability to make the investments and commit the necessary resources in this highly competitive market. If we are unable to develop and market alternative offerings in digital and color technologies, we may lose market share which could have a material adverse effect on our operating results.

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

Customer Financing Activities - On average, 75 - 80 percent of the Registrant's equipment sales are financed through the Registrant. To fund these arrangements, the Registrant must access the credit markets and the long-term viability and profitability of its customer financing activities is dependent on its ability to borrow and its cost of borrowing in these markets. This ability and cost, in turn, is dependent on the Registrant's credit ratings. Currently the Registrant's credit ratings effectively preclude its ready access to capital markets and the Registrant is currently funding its customer financing activity from available sources of liquidity including cash on hand. There is no assurance that the Registrant will be able to continue to fund its customer financing activity at present levels. The Registrant is actively seeking third parties to provide financing to its customers and recently announced a "framework agreement" for GE Capital's Vendor Financial Services to become the primary equipment financing for Xerox customers in the United States. This Agreement has not yet been completed and remains subject to the negotiation of definitive agreements and satisfaction of closing conditions, including completion of due diligence. We are in various stages of negotiations with third party vendors to offer financing to our customers in Canada and all of the major countries in Europe. There is no assurance if or when we will be able to successfully complete these negotiations. The Registrant's ability to continue to offer customer financing and be successful in the placement of its equipment with customers is largely dependent upon obtaining such third party financing. In addition, the Company does not expect to be able to access the capital markets in registered public offerings pending resolution of the review of the Company's accounting practices by the Securities and Exchange Commission referred to in Note 12 to the Consolidated Financial Statements. The Company cannot predict when the Securities and Exchange Commission will conclude either its investigation or its review or the outcome or impact of either.

Manufacturing Outsourcing - In October 2001, the Registrant announced a manufacturing agreement with Flextronics, a \$12 billion global electronics manufacturing services company. The agreement includes a five-year supply contract for Flextronics to manufacture certain office equipment and components and the payment of approximately \$220 million to Registrant for inventory, property and equipment at a modest premium over book value, and the assumption of certain liabilities. The actual cash proceeds will vary, based upon the

actual net asset levels at the time of the closings. As a result of these actions, Registrant expects to incur restructuring charges in the fourth quarter of 2001. Approximately 50 percent of Registrant's manufacturing capacity has been sold to Flextronics. Registrant's ability to ensure continued product availability and achieve improved asset utilization, supply chain flexibilities and cost savings is dependent upon successfully completing the transition to Flextronics. The Registrant's future success in the market for office equipment will be significantly effected by the successful conclusion, implementation and operation of this manufacturing agreement.

Productivity - the Registrant's ability to sustain and improve its profit margins is largely dependent on its ability to maintain an efficient, cost-effective operation. Productivity improvements through process reengineering, design efficiency and supplier cost improvements, including manufacturing outsourcing discussed above, are required to offset labor cost inflation and potential materials cost changes and competitive price pressures. Registrant's productivity in the market for office equipment will be significantly effected by the successful conclusion, implementation and operation of the manufacturing agreement with Flextronics described above.

International Operations - Following the events of September 11, 2001, economic outlook in the United States and the other areas of the world has further weakened. The Registrant derives approximately half its revenue from operations outside of the United States. In addition, the Registrant manufactures or acquires many of its products and/or their components outside the United States. The Registrant's future revenue, cost and profit results could be affected by a number of factors, including global economic conditions, changes in foreign currency exchange rates, changes in economic conditions from country to country, changes in a country's political conditions, trade protection measures, licensing requirements and local tax issues. Our ability to enter into new foreign exchange contracts to manage foreign exchange risk is currently severely limited and, therefore, we anticipate increased volatility in our results of operations due to changes in foreign exchange rates.

New Products/Research and Development - the process of developing new high technology products and solutions is inherently complex and uncertain. It requires accurate anticipation of customers' changing needs and emerging technological trends. The Registrant must then make long-term investments and commit significant resources before knowing whether these investments will eventually result in products that achieve customer acceptance and generate the revenues required to provide anticipated returns from these investments.

Revenue - the Registrant's ability to attain a consistent trend of revenue over the intermediate to longer term is largely dependent upon stabilization and subsequent expansion of its equipment sales worldwide and usage growth (i.e., an increase in the number of images produced by customers). The ability to achieve equipment sales growth is subject to the successful implementation of our initiatives, including our vendor financing programs, to ensure the stability and increasing tenure of our direct sales force while continuing to expand indirect sales channels in the face of global competition and pricing pressures. The ability to grow usage may be adversely impacted by the movement towards distributed printing and electronic substitutes. Our inability to attain a consistent trend of revenue growth could materially affect the trend of our actual results.

Turnaround Program - In October 2000, the Registrant announced a turnaround program which includes a wide-ranging plan to generate cash, return to profitability and pay down debt. The success of the turnaround program is dependent upon successful and timely sales of assets, restructuring the cost base, placement of greater operational focus on the core business and the transfer of the financing of customer equipment purchases to third parties. Cost base restructuring is dependent upon effective and timely elimination of employees, closing and consolidation of facilities, outsourcing of certain manufacturing operations, reductions in operational expenses and the successful implementation of process and systems changes. See "Customer Financing Activities" and "Manufacturing Outsourcing" above for a description of two of the Turnaround initiatives.

Liquidity - the Registrant's liquidity is dependent on the timely implementation and execution of the various turnaround program initiatives as well as its ability to generate positive cash flow from operations, possible asset sales, and various financing strategies including securitizations and its ability to successfully refinance a portion of its \$7 billion Revolving Credit Agreement and extend its maturity beyond October, 2002. Should the Registrant not be able to successfully complete the turnaround program, generate cash and refinance and extend the maturity of the Revolving Credit Agreement on a timely or satisfactory basis, the Registrant will need to obtain additional sources of funds through other operating improvements, financing from third parties, asset sales, or a combination thereof. There can be no assurance that we can obtain these additional sources of funds. We have initiated discussions with the agent banks under our \$7 billion revolving credit agreement in order to

refinance a portion and extend its maturity beyond October, 2002. This agreement contains a consolidated tangible net worth ("CTNW") covenant and at September 30, 2001 we had a \$182 million cushion over the minimum amount required under the covenant. Operating losses, restructuring costs and adverse currency translation adjustments would erode the cushion. Failure to successfully refinance and extend the maturity of the agreement or a breach of the CTNW covenant could have a serious adverse impact on our liquidity.

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September 30, 2001

Explanation of amendment:

Amended filing to correct amounts reported in change in estimates table on page 7 for provisions for obsolete and excess inventory.

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For additional information about The Document Company Xerox, please visit our World-Wide Web site at www.xerox.com/investor. Any information on or linked from the website is not incorporated by reference into the form 10-Q.

Item 2 Xerox Corporation
Management's Discussion and Analysis of
Results of Operations and Financial Condition

Results of Operations

Summary

As discussed in Note 2 to the Consolidated Financial Statements, we have restated our 1999 and 1998 financial statements. This restatement has also impacted the quarterly and year to date financial information previously presented for the period ended September 30, 2000. All dollar and per share amounts and financial ratios have been revised, as appropriate, for the effects of the restatement.

Total third quarter 2001 revenues of \$3.9 billion declined 13 percent (12 percent pre-currency) from \$4.5 billion in the 2000 third quarter. This decline was driven by increased competitive pressure and continued weakness in the economy exacerbated by the events of September 11. While revenue in North America and Europe declined, both regions showed significant year-over-year profitability improvements led by North America. Developing Markets Operations third quarter 2001 revenues were 34 percent below the 2000 third quarter as we reconfigure our Latin American Operations to a new business approach prioritizing liquidity and profitable revenue rather than market share.

Total revenues in the first nine months of 2001 of \$12.2 billion declined 11 percent (10 percent pre-currency) from \$13.8 billion in the first nine months of 2000. Year to date pre-currency revenue declines of 2 percent in North America and 5 percent in Europe were the result of a weak economic environment and competition partly offset by stabilization of the U.S. direct sales force.

Including additional net after-tax restructuring provisions of \$37 million associated with the company's previously announced Turnaround Program and

disengagement from our worldwide small office / home office (SOHO) business and a \$1 million after tax gain on early retirement of debt, the third quarter 2001 net loss was \$211 million. Excluding these items, the third quarter 2001 after tax loss was \$175 million. In the 2001 third quarter, we incurred a \$37 million loss in our worldwide SOHO operations. The 2001 third quarter loss reflected the revenue decline, but our operating margin stabilized together with an improvement in the gross margin.

The 2001 year to date net loss was \$289 million compared to a net loss of \$237 million in the first nine months 2000. 2001 special items included the following after-tax charges - \$190 million associated with the Company's disengagement from the SOHO business, \$139 million related to the Company's previously announced Turnaround Program, and a \$2 million loss from the implementation of SFAS 133. Special items also included the following after-tax gains - \$300 million related to the March 2001 sale of half of our investment in Fuji Xerox Co., Ltd. (Fuji Xerox) to Fuji Photo Film Co. Ltd. (Fujifilm), and \$36 million associated with the early retirement of debt. 2000 special items include a \$423 million after tax restructuring provision and a \$16 million after tax in-process research and development charge associated with the January 1, 2000 acquisition of the Tektronix, Inc. Color Printing and Imaging Division (CPID).

Excluding all special items, the year to date 2001 net loss was \$294 million compared with net income of \$202 million in the first nine months of 2000.

Our loss per share was \$0.29 in the 2001 third quarter. Excluding the \$0.05 restructuring provision, the third quarter 2001 loss per share was \$0.24 compared with \$0.30 loss per share in the 2000 third quarter.

Including the \$0.27 SOHO disengagement charge, \$0.20 restructuring provision, \$0.43 gain on the sale of Fuji Xerox, and \$0.05 gain from the early retirement of debt, the year to date 2001 loss per share was \$0.43. The year to date 2000 loss per share was \$0.39 including charges of \$0.66 for restructuring and acquired CPID in-process R&D. Excluding all special items, the 2001 year to date loss per share was \$0.44 compared with \$0.27 earnings per share in the first nine months of 2000.

In the ordinary course of business, management makes many estimates in the accounting for items that affect our reported results of operations and financial position. The following table summarizes the more significant of these estimates, and the changes therein, and their impacts on pre-tax income (loss):

	Three months ended September 30,		Nine months ended September 30,	
	2001	2000	2001	2000
Impact on pre-tax income (loss):				
Provisions for doubtful accounts	\$(186)	\$(172)	\$(401)	\$(417)
Provisions for obsolete and excess inventory	(46)	(36)	(177)	(109)
Revenue allocations	(21)	18	(37)	50
Finance discount rates	(8)	-	(25)	22

The significant preceding items are analyzed as appropriate in succeeding sections of this Management's Discussion and Analysis of Operations and Financial Condition and/or the accompanying Notes to Consolidated Financial Statements.

Pre-Currency Growth

To understand the trends in the business, we believe that it is helpful to adjust revenue and expense growth (except for ratios) to exclude the impact of changes in the translation of European and Canadian currencies into U.S. dollars. We refer to this adjusted growth as "pre-currency growth." Latin American currencies are shown at actual exchange rates for both pre-currency and post-currency reporting, since these countries generally have volatile currency and inflationary environments.

A substantial portion of our consolidated revenues is derived from operations outside of the United States where the U.S. dollar is not the functional currency. When compared with the average of the major European and Canadian currencies on a revenue-weighted basis, the U.S. dollar was approximately 2 percent stronger in the 2001 third quarter than in the 2000 third quarter. As a result, currency translation had an unfavorable impact of approximately one percentage point on revenue growth.

Segment Analysis

Revenues and year-over-year revenue growth rates by segment are as follows (Dollars are in billions):

	2000 Full Year Revenues	Pre-Currency Revenue Growth									
		2000					2001				
		Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Revenues	Growth
Total Revenues	\$18.7	8%	-(2)%	(9)%	(1)%	(5)%	(12)%	(12)%	(12)%	\$3.9	(13)%
Production	6.3	1	(2)	(8)	(12)	(6)	(2)	(8)	(7)	1.4	(8)
Office	7.1	4	5	4	(3)	2	3	(5)	(4)	1.6	(5)
SOHO	0.6	35	(3)	(2)	1	6	(24)	(30)	(22)	0.1	(23)
DMO	2.5	36	4	(3)	(21)	-	(21)	(31)	(33)	0.4	(34)
Other	2.2	7	(9)	(1)	(4)	(2)	(16)	(17)	(26)	0.4	(27)
Memo: Color	2.9	64	60	74	54	62	17	1	(4)	0.7	(6)

YTD 2001

	Revenues	Revenue Growth	
		Pre Currency	Post Currency
Total Revenues	\$12.2	(10)%	(11)%
Production	4.3	(6)	(8)
Office	5.0	(2)	(4)
SOHO	0.3	(25)	(26)
DMO	1.3	(29)	(30)
Other	1.3	(20)	(22)
Memo: Color	2.1	4	2

2000 pre-currency revenue growth includes the beneficial impact of the January 1, 2000 acquisition of the Tektronix, Inc. Color Printing and Imaging Division.

Production revenues include DocuTech, Production Printing, color products for the production and graphic arts markets and light-lens copiers over 90 pages per minute sold predominantly through direct sales channels in North America and Europe. Third quarter 2001 revenues declined 8 percent (7 percent pre-currency). Third quarter 2001 pre-currency revenues declined 3 percent in North America and 7 percent in Europe from the 2000 third quarter. Monochrome production revenue declines reflect the downturn in the economy, competitive product introductions and continued movement to distributed printing and electronic substitutes. In addition, revenue was adversely impacted by reduced DocuTech sales to Fuji Xerox and unfavorable product mix reflecting installations of the recently introduced DocuTech 75 and DocuPrint 75. Post equipment install revenues continue to be adversely affected by reduced equipment placements in earlier quarters and lower print volumes. Production color revenues declined as the weaker economic environment impacted sales of color equipment and competitive product introductions continued. Revenues from the successful DocuColor 2000 series, which began shipments in June 2000, continued to grow reflecting increased equipment sales and recurring revenues. Reduced DocuColor 30/40 and mid-range installs combined with more aggressive pricing resulted in revenue declines. Production revenues represented 35 percent of third quarter 2001 revenues compared with 33 percent in the 2000 third quarter. Third quarter 2001 gross margin for the production segment improved from the 2000 third quarter as significant improvement in document outsourcing margins and improved service productivity were only partially offset by unfavorable mix.

Production revenues declined 8 percent (6 percent pre-currency) in the first nine months of 2001 from the first nine months of 2000 due to a weaker economic environment and continued movement to distributed printing and electronic substitutes. Good growth in production color revenues are not yet sufficient to offset monochrome declines.

Office revenues include our family of Document Centre digital multi-function products; light-lens copiers under 90 pages per minute; and our color laser, solid ink and monochrome laser desktop printers, digital copiers and facsimile products sold through direct and indirect sales channels in North America and Europe. Third quarter 2001 revenues declined 5 percent (4 percent pre-currency) from the third quarter 2000. Black and white revenues declined as equipment sales were impacted by the weaker economy, continued competitive pressures and light lens declines and our decision in Europe to reduce our participation in very aggressively priced competitive customer bids and tenders as we reorient our focus from market share to profitable revenue. Shipments of the Document Centre 490, the fastest in its class at 90 pages-per-minute began in North America in September. European launch is scheduled for the first quarter 2002. Strong office color revenue growth was driven by continued growth in the Document Centre ColorSeries 50 partially offset by office color printer equipment sales declines. The Document Centre ColorSeries 50 is the industry's first color-enabled digital multi-function product. Office revenues represented 41 percent of third quarter 2001 revenues compared with 38 percent in the 2000

third quarter. Third quarter 2001 gross margin for the office segment improved significantly from the 2000 third quarter primarily as a result of our reduced participation in very aggressively priced competitive bids and tenders, improving Document Centre margins facilitated by strong Document Centre 480 placements and initial Document Centre 490 placements, improved manufacturing and service productivity, favorable currency and significantly improved document outsourcing margins.

Office revenues declined 4 percent (2 percent pre-currency) in the first nine months of 2001 from the first nine months of 2000 as strong office color revenue growth was insufficient to offset black and white declines.

Small Office/Home Office (SOHO) revenues include inkjet printers and personal copiers sold through indirect channels in North America and Europe. On June 14, 2001 we announced our disengagement from the SOHO business. Third quarter and year to date 2001 SOHO revenues declined 23 percent (22 percent pre-currency) and 26 percent (25 percent pre-currency), respectively, from the 2000 periods and gross margin declined as we exit this business and reduce equipment inventory in a very difficult market environment. SOHO revenues represented 3 percent of third quarter and year to date revenues in both 2001 and 2000.

Developing Markets Operations (DMO) includes operations in Latin America, Russia, India, the Middle East and Africa. Third quarter 2001 revenue declined significantly in Brazil from the 2000 third quarter reflecting reduced equipment placements and the transition of its business model to maximize liquidity and profitable revenue rather than market share, compounded by an average 29 percent devaluation in the Brazilian Real. During the third quarter and first nine months of 2000 revenues in Brazil included structured transactions, as discussed below, of \$30 million and \$111 million, respectively; there were no similar arrangements in the 2001 third quarter and first nine months.

Revenue declined throughout the other Latin American countries due to weaker economies and our decision to focus on liquidity and profitable revenue rather than market share. DMO revenues represented 11 percent of third quarter 2001 revenues compared with 14 percent in the 2000 third quarter. DMO incurred a substantial pre-tax loss in the third quarter 2001. Gross margin declined in DMO as a result of lower equipment and service margins, currency devaluation not offset by price increases, weak mix and the absence of any structured transactions in Brazil.

DMO revenues decreased 30 percent (29 percent pre-currency) in the first nine months of 2001 from the first nine months of 2000 reflecting reduced equipment placements, an increased competitive environment, the lack of structured transactions in 2001, and lower prices as we focused on reducing inventory, compounded by a 21 percent devaluation in the Real.

Since 1985 the company, primarily in North America, has sold pools of equipment subject to operating leases to third party finance companies (the counter-party) and recorded these transactions as sales at the time the equipment is accepted by the counter-party. The various programs provided us with additional funding sources and/or enhanced credit positions. The counter-party accepts the risks of ownership of the equipment. Remanufacturing and remarketing of off-lease equipment belonging to the counter-party is performed by the company on a nondiscriminatory basis for a fee. North American transactions are structured to provide cash proceeds up front from the counter-party versus collection over time from the underlying customer lessees. There were \$22 million of sales of equipment subject to operating leases in North America in the third quarter and first nine months of 2000, none in the first nine months of 2001. The reduction of operating lease revenues as a result of prior year sales of equipment on operating leases was \$9 million and \$15 million in the third quarter of 2001 and 2000, respectively, and \$30 million and \$52 million in the first nine months of 2001 and 2000, respectively.

Beginning in 1999 several Latin American affiliates entered into certain structured transactions involving contractual arrangements which transferred the risks of ownership of equipment subject to operating leases to third party financial companies who are obligated to pay the Company a fixed amount each month. The Company accounts for these transactions similar to its sales-type leases. The counter-party assumes the risks associated with the payments from the underlying customer lessees thus mitigating risk and variability from the cash flow stream. The following shows the effects of such sales of equipment under structured finance arrangements offset by the associated reductions of operating lease revenues from current and prior year transactions:

	Three months		Nine months	
	Ended September 30,		Ended September 30,	
	2001	2000	2001	2000
Sales of equipment	\$ -	\$ 30	\$ -	\$ 111
Reduced Operating Lease Revenue	(27)	(34)	(89)	(92)

 Net revenue impact \$ (27) \$ (4) \$ (89) \$ 19

Over time the number and value of the contracts will vary depending on the number of operating leases entered into in any given period, the willingness of third party financing institutions to accept the risks of ownership, and our consideration as to the desirability of entering into such arrangements. At this time, the Company does not expect to enter into any structured transactions for the remainder of 2001.

Key Ratios and Expenses

The trend in key ratios was as follows:

	2000					2001			
	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	YTD
Gross Margin	39.1%*	40.4%	35.0%	35.1%	37.4%*	33.6%	35.8%**	36.1%**	35.2%**
SAG % Revenue	28.0	28.8	31.7	32.2	30.2	27.4	30.6	31.1	29.6

*Includes inventory charges associated with the 2000 restructuring. If excluded the gross margin would have been 41.1 percent and 37.9 percent, respectively.

**Includes inventory charges associated with the SOHO disengagement. If excluded the gross margin would have been 36.4 percent for second quarter, 36.2 percent for the third quarter and 35.4 percent for the first nine months of 2001.

The third quarter 2001 gross margin improved by 1.2 percentage points from the 2000 third quarter as improved manufacturing and service productivity and favorable currency were only partially offset by unfavorable mix. Weak performance in DMO reduced the gross margin by 0.7 percentage points. Excluding SOHO operations, the 2001 third quarter gross margin was 37.7 percent.

Including inventory charges associated with the SOHO disengagement, the gross margin was 35.2 percent for the first nine months of 2001, a decline of 3.0 percentage points from the first nine months of 2000 gross margin which includes inventory charges associated with the 2000 restructuring program. Excluding the 2001 SOHO inventory charges and the 2000 restructuring inventory charges, the gross margin for the first nine months of 2001 was 35.4 percent compared to 38.9 percent in the first nine months of 2000. Approximately two percentage points of the decline was due to weak activity in Developing Markets, primarily in Brazil, as well as lower lease residual values being recognized in 2001 versus the prior year, and the absence of the previously described structured transactions. In addition, improved asset management practices, lower activity levels and unfavorable mix adversely impacted gross margin.

Selling, administrative and general expenses (SAG) declined 15 percent (14 percent pre-currency) in the 2001 third quarter from the third quarter 2000. SAG declined 11 percent (10 percent pre-currency) in the first nine months of 2001 from the first nine months of 2000. SAG declines in both the third quarter and first nine months reflect continued benefits from our Turnaround Program including significantly lower labor costs and advertising and marketing communications spending. These reductions were partially offset by increased professional costs related to our regulatory filings and related matters and higher costs incurred by Developing Markets Operations in the renegotiation of customer contracts associated with implementation of their new business approach. Third quarter 2001 bad debt provisions of \$186 million were \$14 million higher than the 2000 third quarter despite an improvement in Mexico. Increased provisions in North America primarily associated with higher risk smaller customers in this weakened economic environment more than offset the significant 2000 third quarter provisions in Mexico. Bad debt provisions were \$401 million and \$417 million for the first nine months of 2001 and 2000, respectively. In the 2001 third quarter, SAG represented 31.1 percent of revenue compared with 31.7 percent of revenue in the 2000 third quarter. SAG represented 29.6 percent of revenue in the first nine months of 2001 compared with 29.5 percent of revenue in the first nine months of 2000.

Research and development (R&D) expense was \$15 million and \$5 million higher in the 2001 third quarter and first nine months, respectively, compared to the 2000 third quarter and first nine months due to increased iGen3 expenses. R&D spending was 7 percent and 6 percent of revenue in the 2001 third quarter and first nine months, respectively, as we continue to invest in technological development, particularly color, to maintain our position in the rapidly changing document processing market. Xerox R&D remains technologically competitive and is strategically coordinated with Fuji Xerox.

Worldwide employment declined by 2,300 and 8,900 in the 2001 third quarter and first nine months, respectively, to 83,300 primarily as a result of employees leaving the company under our restructuring programs. Excluding divestitures,

worldwide employment has declined by 10,900 since implementation of our Turnaround Program in October 2000.

Other, net was \$119 million in the 2001 third quarter compared to \$115 million in the third quarter 2000. In the third quarter 2001 we incurred \$54 million of net currency losses resulting from the remeasurement of unhedged foreign currency-denominated assets and liabilities. These currency exposures are unhedged in 2001 largely due to our restricted access to the derivatives markets. Also included in Other, net in the 2001 third quarter is \$10 million of property losses related to the September 11 incident. In addition, the 2000 third quarter included approximately \$30 million of non-recurring interest income related to an income tax refund receivable. Lower third quarter 2001 net non-financing interest expense of \$94 million primarily reflects lower interest rates and lower debt levels as compared to the prior year, including net gains of \$46 million from the mark-to-market of our remaining interest rate swaps required to be recorded as a result of applying SFAS 133 accounting rules. This was primarily driven by sharply lower variable rates in the quarter. Differences between the contract terms of our interest rate swaps and the underlying related debt preclude hedge accounting treatment in accordance with SFAS 133 which requires us to record the mark-to-market valuation of these derivatives directly through earnings. Due to the inherent volatility in the interest and foreign currency markets, the company is unable to predict the amount of the above-noted remeasurement and mark-to-market gains or losses in future periods.

The year to date 2001 increase in Other, net of \$96 million was primarily due to a \$48 million increase in Brazilian indirect taxes, approximately \$30 million of non-recurring interest income in 2000 related to an income tax refund receivable and gains in 2000 of \$75 million associated with the sale of the North American commodity paper business and sales of other assets. These unfavorable items were offset by a decrease of \$64 million in net non financing interest expense reflecting our lower net debt levels and lower interest rates.

During the fourth quarter of 2000 we announced a Turnaround Program in which we outlined a wide-ranging plan to sell assets, cut costs and strengthen our strategic core. We announced plans that were designed to reduce costs by at least \$1.0 billion annually, the majority of which will affect 2001. As part of the cost cutting program, we continue to take additional charges for finalized initiatives under the Turnaround Program. As a result of these actions, in the third quarter of 2001 we provided an incremental \$56 million to complete our open initiatives under the Turnaround plan. For the first nine months of 2001, we have provided a total of \$220 million under this plan. We expect additional provisions will be required in 2001 as additional plans are finalized. The restructuring reserve balance at September 30, 2001 for both the Turnaround Program and the March 2000 program amounted to \$142 million.

In connection with the disengagement from our SOHO business, we recorded a second-quarter pretax charge of \$274 million (\$196 million after taxes). The charge includes provisions for the elimination of approximately 1,200 jobs worldwide by the end of 2001, the closing of facilities and the write-down of certain assets to net realizable value. In the 2001 third quarter, changes in estimates for employee termination and decommitment costs reduced the original reserve by approximately \$12 million. The year to date \$262 million pretax charge for the SOHO disengagement consists of approximately \$30 million in employee termination costs, \$144 million of asset impairments, \$29 million in inventory charges, \$24 million in purchase commitments, \$16 million in decommitment costs, and \$19 million in other miscellaneous charges. The SOHO disengagement reserve balance at September 30, 2001 was \$49 million.

Over the remainder of the fourth quarter we will discontinue our line of personal inkjet and xerographic printers, copiers, facsimile machines and multi-function devices which are sold primarily through retail channels to small offices, home offices and personal users (consumers). We intend to sell the remaining inventory through current channels. We will continue to provide service, support and supplies, including the manufacturing of such supplies, for customers who currently own SOHO products during a phase-down period to meet customer commitments.

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

Our pre-tax loss was \$(248) million in the 2001 third quarter including the restructuring provisions. Excluding these items, the pre-tax loss was \$(204) million in the 2001 third quarter compared to a loss of \$(235) million in the 2000 third quarter.

Including the effect of special items, pre-tax loss was \$(137) million in the first nine months of 2001 compared to a \$(348) million loss for the first nine months of 2000. Excluding special items, the pre-tax loss was \$(455) million for the first nine months 2001 compared to pre-tax income of \$273 million for

the first nine months 2000. 2001 special items included a net charge of \$262 million related to the SOHO disengagement, a \$190 million net charge in connection with our existing restructuring programs and a gain of \$769 million related to the sale of half our ownership in Fuji Xerox. In the first nine months of 2000, special items included a \$594 million charge related to the 2000 restructuring program and a \$27 million charge for acquired in-process research and development associated with the CPID acquisition.

The effective tax rate, including the net tax benefit related to additional restructuring provisions and an adjustment to the underlying tax rate on the 2001 first half loss was 22.6 percent in the 2001 third quarter. Excluding these items, the 2001 third quarter and year to date tax rates were 33.7 percent compared to 34.9 percent in the 2000 third quarter. This reduction in the tax rate is due primarily to continued losses in low-tax rate jurisdictions where losses could not be tax effected, offset by a favorable tax audit.

The third quarter change in the tax rate from 42.0 percent to 33.7 percent required a catch up adjustment to the previously recorded first half tax benefits. This catch-up adjustment reduced the tax benefit and increased the third quarter 2001 net loss by \$21 million. A similar 2000 third quarter adjustment reduced that tax benefit and increased the 2000 net loss by \$41 million.

Equity in net income of unconsolidated affiliates is principally our 25 percent share of Fuji Xerox income. Total equity in net income declined by \$11 million and \$29 million in the 2001 third quarter and first nine months, respectively, due primarily to our reduced ownership in Fuji Xerox. Our share of total Fuji Xerox net income of \$4 million and \$27 million in the 2001 third quarter and first nine months, respectively, decreased by \$11 million and \$39 million from the 2000 periods.

In the first nine months of 2001, we retired \$340 million of debt through the exchange of 37.4 million shares of common stock valued at \$283 million, resulting in pre-tax extraordinary gains of \$59 million (\$36 million after taxes) for a net equity increase of approximately \$319 million.

In the 2001 second quarter, we sold our leasing businesses in four European countries to Resonia Leasing AB for proceeds of approximately \$370 million. These sales are part of an agreement under which Resonia will provide on-going, exclusive equipment financing to our customers in those countries.

In July 2001, we completed the offering of \$513 million of floating rate asset backed notes. In conjunction with this offering, we received cash proceeds of \$480 million net of \$3 million paid in expenses and fees. The remaining cash proceeds of approximately \$30 million will be held in reserve over the term of the asset backed notes. As part of the transaction we sold approximately \$639 million of domestic finance receivables to a qualified special purpose entity in which we have a retained interest of approximately \$159 million, including the cash proceeds held in reserve. The transaction was accounted for as a sale of finance receivables at approximately book value.

In September 2001 Xerox and GE Capital announced a framework agreement for GE Capital's Vendor Financial Services Unit to become the primary equipment financing provider for Xerox customers in the United States. The two companies also agreed to the principal terms of a financing arrangement under which Xerox will receive from GE Capital approximately \$1 billion secured by portions of Xerox's finance receivables in the United States.

As part of this transaction, Xerox will transition nearly all of its U.S. customer administration operations into a co-managed joint venture with GE Capital Vendor Financial Services. It is anticipated that Xerox employees who work in Xerox customer financing and administration offices will join the new joint venture on January 2, 2002. Their work, which includes order processing, credit approval, financing programs, billing and collections, is expected to continue in the current locations, ensuring further continuity for Xerox customers and employees. The arrangements are expected to close in the fourth quarter subject to the negotiation of definitive agreements and satisfaction of closing conditions, including completion of due diligence.

In October 2001, we announced a manufacturing agreement with Flextronics, a \$12 billion global electronics manufacturing services company. The agreement includes a five-year supply contract for Flextronics to manufacture certain office equipment and components, payment of approximately \$220 million to Xerox for inventory, property and equipment at a modest premium over book value, and the assumption of certain liabilities. The premium will be amortized over the life of the five-year supply contract. As a result of these actions, we expect to incur restructuring charges in the fourth quarter of 2001.

Flextronics will purchase four Xerox office products manufacturing operations

including selected manufacturing assets and inventory. The approximately 3,650 current Xerox employees in these operations are expected to transfer to Flextronics. We will also stop production by the end of the second quarter 2002 at our printed circuit board factory in El Segundo, California, and our customer replaceable unit plant in Utica, New York. Flextronics will build this work into its global network of manufacturing plants. In addition, we have begun consultations with European works councils regarding the sale of our office manufacturing operations in Venray, The Netherlands, and the transfer to Flextronics of some production work currently performed at our site in Mitcheldean, England. In total, the agreement with Flextronics represents approximately 50 percent of our overall manufacturing operations. The first sales are expected to close in the fourth quarter, beginning a one-year transition period for Flextronics to assume manufacturing of Xerox-designed office products and related components. The actual cash proceeds will vary, based upon the actual net asset levels at the time of the closings.

We adopted Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS No. 133), as of January 1, 2001. Upon adoption of SFAS No. 133 we recorded a net cumulative after-tax loss of \$2 million in the first quarter Income Statement and a net cumulative after-tax loss of \$19 million in Accumulated Other Comprehensive Income. The adoption of SFAS No. 133 is expected to increase the future volatility of reported earnings and other comprehensive income. In general, the amount of volatility will vary with the level of derivative and hedging activities and the market volatility during any period.

Additional details regarding the effects of SFAS No. 133 on the quarter and year-to-date results are included in Note 9 of the "Notes to Consolidated Financial Statements".

The \$21 million gain on affiliate's sale of stock in the first quarter 2000 reflected our proportionate share of the increase in equity of Scansoft Inc. (NASDAQ:SSFT) resulting from Scansoft's issuance of stock in connection with an acquisition. This gain was partially offset by a \$5 million charge reflecting our share of Scansoft's write-off of in-process research and development associated with this acquisition, which is included in Equity in net income of unconsolidated affiliates.

See footnote No. 13 in the Notes to Consolidated Financial Statements for a discussion of the impact of recently issued accounting standards.

Capital Resources and Liquidity

Xerox and its material subsidiaries and affiliates have cash management systems and internal policies and procedures for managing the availability of worldwide cash, cash equivalents and liquidity resources. They are subject to (i) statutes, regulations and practices of the local jurisdictions in which the companies operate, (ii) legal requirements of the agreements to which the companies are parties and (iii) the policies and continuing cooperation of the financial institutions utilized by the companies to maintain such cash management systems.

At September 30, 2001, cash on hand was \$2,427 million versus \$1,741 million at December 31, 2000, and total debt was \$16,076 million versus \$18,097 million at December 31, 2000. Total debt net of cash on hand (Net Debt) decreased by \$2,707 million in the first nine months of 2001 versus an increase of \$2,168 million in the first nine months of 2000. As of September 30, 2001, Net Debt has decreased by \$3,394 million since our Turnaround Program was initiated on September 30, 2000. The consolidated ratio of total debt to common and preferred equity was 4.4:1 as of both September 30, 2001 and December 31, 2000. This ratio reflects our decision, beginning in the fourth quarter of 2000, to accumulate cash to maintain financial flexibility, rather than continue our historical practice of using available excess cash to pay down debt. Had our cash balance at September 30, 2001 and December 31, 2000 been reduced to historical levels by paying off debt, the debt to equity ratio would have been approximately 3.7:1 and 4.0:1, respectively.

We historically managed the capital structures of our non-financing operations and our captive financing operations separately. We are in the process of exiting the customer equipment financing business, and we are no longer managing our liquidity on a financing / non-financing basis. Accordingly, we believe that a review of operating cash flow and earnings before interest, income taxes, depreciation, amortization and special items (EBITDA) provides the most meaningful understanding of our changes in cash and debt balances.

The following is a summary of EBITDA, operating and other cash flows for the nine months ended September 30, 2001 and 2000:

	2001	2000
Net Loss	\$ (289)	\$ (237)
Income tax provision (benefit)	209	(84)

Depreciation and amortization	794	794
Restructuring charges	452	594
Interest expense	683	739
Gains on sales of businesses	(754)	(63)
Other items	26	(26)
	-----	-----
EBITDA	1,121	1,717
Less financing and interest income	(689)	(711)
	-----	-----
Adjusted EBITDA	432	1,006
Working capital and other changes	496	(669)
On-Lease equipment spending	(176)	(350)
Capital spending	(159)	(324)
Restructuring payments	(368)	(222)
Interest Payments	(819)	(739)
	-----	-----
Operating Cash Flow (Usage)*	(594)	(1,298)
Financing Cash Flow	1,568	(65)
Debt borrowings (repayments), net	(1,530)	2,619
Dividends and other non-operating items	(393)	(462)
Proceeds from sales of businesses	1,635	90
Acquisitions	-	(856)
	-----	-----
Net Change in Cash	\$ 686	\$ 28
	=====	=====

* The primary difference between this amount and the Cash Flows from Operations reported in our Statements of Cash Flows, is the inclusion of Capital Spending in, and the exclusion of Financing Cash Flow from, the amount shown above.

Operating cash usage in the first nine months of 2001 decreased by approximately \$700 million, to \$(594) million, versus \$(1,298) million usage in the prior year period. Excluding the effect of a \$315 million accounts receivable securitization in the third quarter of 2000, operating cash flow improved by over \$1 billion. The improvement was driven by significant reductions in working capital. Lower investments in on-lease equipment and capital spending only partially offset higher restructuring payments and the negative cash flow impacts of weak operating results on EBITDA. The working capital improvements stem largely from a significant reduction in inventories and lower tax payments in the first nine months of 2001 compared to the same period in 2000. The significant inventory reduction reflects management actions to improve inventory turns, and changes in the supply/demand and logistics processes. The decline in 2001 capital spending versus 2000 is due primarily to substantial completion of our Ireland projects as well as significant spending constraints. We expect full-year 2001 capital spending to be approximately 50 percent below 2000 levels. Investments in on-lease equipment reflect the growth in our document outsourcing business, which we expect will continue to grow in the remainder of 2001.

Cash restructuring payments of \$368 million reflect continued progress with respect to our Turnaround Program. The status of the restructuring reserves is discussed in Note 4 to the Consolidated Financial Statements.

The increase in financing cash flow in 2001 includes the sale of asset-backed securities in July 2001 for net proceeds of \$480 million. The remaining cash flow improvement reflects the lower equipment sales in the first nine months of 2001 versus the year-ago period, which resulted in a lower level of finance receivable originations.

Dividends and other non-operating items in the first nine months of 2001 totaled \$(393) million, including a premium payment of \$45 million to Ridge Reinsurance, a payment of \$255 million related to our funding of trusts to replace Ridge Reinsurance letters of credit, and dividends of \$93 million. The 2000 amount of \$(462) million includes dividends of \$441 million. The improvement in 2001 versus 2000 is due to our elimination of dividends which we announced in July 2001, offset by the Ridge Reinsurance trust funding requirement.

In the first nine months of 2001, we generated approximately \$1.6 billion of cash from the sale of half our interest in Fuji Xerox and the sale of our leasing businesses in four European countries as discussed below. These asset sales, together with the significant improvements in operating and financing cash flows and the absence in 2001 of acquisitions, which used cash of \$856 million in the first nine months of 2000, funded debt repayments of \$1.5 billion in 2001, versus incremental borrowings of \$2.6 billion in 2000, and generated a net cash increase of \$658 million.

Liquidity and Funding Plans for 2001

Historically, our primary sources of funding have been cash flows from operations, borrowings under our commercial paper and term funding programs,

and securitizations of finance and trade receivables. Our overall funding requirements have been to finance customers' purchases of our equipment, to fund working capital and capital expenditure requirements, and to finance acquisitions.

During 2001 and 2000, the agencies that assign ratings to our debt downgraded the Company's debt several times. As of October 31, 2001, senior and short-term debt ratings by Moody's are Ba1 and Not Prime, respectively, and the outlook is negative; ratings by Fitch are BB and B, respectively, and the outlook is stable; and ratings by Standard and Poors (S&P) are BB and B, respectively, and the outlook is stable. Since October 2000, uncommitted bank lines of credit and the unsecured capital markets have been, and are expected to continue to be, largely unavailable to us. We expect this to result in higher borrowing costs going forward, and this may also result in Xerox Corporation having to increase its level of intercompany lending to affiliates. In addition, the Company does not expect to be able to access the capital markets in registered public offerings pending resolution of the review of the Company's accounting practices by the Securities and Exchange Commission referred to in Note 12 to the Consolidated Financial Statements.

As a result of the debt downgrades described above, in the fourth quarter 2000 we drew down the entire \$7.0 billion available to us under our Revolving Credit Agreement (the "Revolver"), primarily to maintain financial flexibility and pay down debt obligations as they came due. We are in compliance with the covenants, terms and conditions in the Revolver, which matures on October 22, 2002. The only financial covenant in the Revolver requires us to maintain a minimum of \$3.2 billion of Consolidated Tangible Net Worth, as defined ("CTNW").

At September 30, 2001, our CTNW was \$182 million in excess of the minimum requirement, a decrease of approximately \$330 million from the December 31, 2000 level. The decrease is due to operating and restructuring losses and unfavorable foreign currency translation during that period of time, offset partially by the favorable impacts of gains on asset sales and debt-for-equity exchanges described below. Further operating losses, restructuring costs and adverse currency translation adjustments would erode this excess, while operating income, gains on asset sales, favorable currency translation, and exchanges of debt for equity would increase this excess. We expect to be in continued compliance with the covenant.

The Company has recently initiated discussions with its agent banks to refinance a portion of the Revolver and extend its maturity beyond October 2002. Failure to successfully refinance and extend the maturity of the Revolver or a breach of the CTNW covenant could have a serious adverse effect on our liquidity.

In the first nine months of 2001, we retired \$340 million of long-term debt through the exchange of 37.4 million shares of common stock of the Company, which increased CTNW by approximately \$319 million. Since September 30, 2001 we have retired an additional \$35 million of debt through the exchange of 3.8 million additional shares, which increased our CTNW by an estimated \$32 million.

As of September 30, 2001, we had approximately \$1.3 billion of debt obligations expected to be repaid during the remainder of 2001, and \$9.0 billion maturing in 2002, as summarized below (in billions):

	2001	2002
First Quarter		\$0.3
Second Quarter		1.0
Third Quarter		0.1
Fourth Quarter	\$1.3	7.6*
	-----	-----
Full Year	\$1.3	\$9.0
	=====	=====

* Includes \$7.0 billion maturity under the Revolver

In 2000 we announced a global Turnaround Program which includes initiatives to sell certain assets, improve operations and liquidity, and reduce annual costs by at least \$1 billion. As of September 30, 2001 we had made significant progress toward these objectives, which we believe will positively affect our capital resources and liquidity position when completed.

With respect to asset sale initiatives, in the fourth quarter of 2000 we sold our China operations to Fuji Xerox Co., Ltd. ("Fuji Xerox"), generating \$550 million of cash and transferring \$118 million of debt to Fuji Xerox. In March 2001, we sold half of our interest in Fuji Xerox to Fuji Photo Film Co., Ltd. for \$1,283 million in cash. On October 2, 2001, we announced an agreement under which Flextronics, a Singapore company, will purchase certain assets and assume certain liabilities related to our office-segment manufacturing facilities in

several locations around the world. We expect to receive cash proceeds of approximately \$220 million in phases over the next year, including a significant portion in the fourth quarter 2001, as each of the applicable locations is sold. Under this agreement, Flextronics will manufacture certain of our office-segment equipment and components for a period of five years.

We have initiated discussions to implement third-party vendor financing programs which will significantly reduce our debt and finance receivables levels going forward. In addition, we are in discussions to consider selling portions of our existing finance receivables portfolios, and we continue to actively pursue alternative forms of financing including securitizations and secured borrowings. In connection with these initiatives, in January 2001, we received \$435 million in financing from an affiliate of GE Capital, secured by our portfolio of lease receivables in the United Kingdom. In the second quarter of 2001, we sold our leasing businesses in four Nordic countries to Resonia Leasing AB for \$352 million in cash plus retained interests in certain finance receivables for total proceeds of approximately \$370 million. These sales are part of an agreement under which Resonia will provide on-going, exclusive equipment financing to our customers in those countries. In July 2001, we sold \$513 million of floating-rate asset-backed notes for cash proceeds of \$480 million net of \$3 million of expenses and fees. An additional \$30 million of proceeds will be held in reserve until the notes are repaid, which we currently estimate will occur in August 2003. As part of the transaction, we sold approximately \$639 million of domestic finance receivables to a qualified special-purpose entity in which we have a retained interest of \$159 million, which includes the \$30 million cash reserve. The transaction was accounted for as a sale of finance receivables.

On September 11, 2001, we announced a Framework Agreement with GE Capital's Vendor Financial Services group, under which GE Capital will become the primary equipment-financing provider for our U.S. customers. We also announced an agreement under which we will receive a loan of approximately \$1 billion from GE Capital, secured by certain of our lease receivables in the United States. We expect both of these agreements to be completed in the fourth quarter 2001.

On June 5, 2001, we had announced our receipt of a commitment letter from Bankers Trust Company, a subsidiary of Deutsche Bank, for a fully underwritten secured revolving borrowing facility of \$500 million. As a result of the commencement of discussions to refinance the Revolver, as well as the progress we have made to-date on the global initiatives discussed above, we have allowed the Bankers Trust loan commitment to expire unutilized.

With \$2.4 billion of cash on hand at September 30, 2001, we believe our liquidity is presently sufficient to meet current and anticipated needs going forward, subject to timely implementation and execution of the various global initiatives discussed above and our ability to successfully refinance a portion of the Revolver and extend its maturity beyond October, 2002. Should we be unable to successfully complete these initiatives or refinance and extend the maturity of the Revolver on a timely or satisfactory basis, we will need to obtain additional sources of funds through further operating improvements, financing from third parties, additional asset sales including sales or securitizations of our receivables portfolios, or a combination thereof. The adequacy of our continuing liquidity depends on our ability to successfully generate positive cash flow from an appropriate combination of these sources.

On December 1, 2000, Moody's reduced its rating of our senior debt to below investment grade, significantly constraining our ability to enter into new foreign-currency and interest rate derivative agreements, and requiring us to immediately repurchase certain of our then-outstanding derivative agreements. On October 23, 2001, S&P reduced its rating of our senior debt to below investment grade, further constraining our ability to enter into new derivative agreements, and requiring us to immediately repurchase certain of our then-outstanding out-of-the-money interest-rate and cross-currency interest-rate derivative agreements for a total of \$148 million. To minimize the resulting interest and currency exposures, we replaced two of the terminated derivatives with a derivative contract involving a new counterparty. That contract will require us to collateralize any out-of-the-money positions going forward. Our remaining consolidated derivative portfolio at October 31, 2001, included \$15 million of out-of-the-money contracts which are contractually subject to termination by the related counterparties. The fair market values of all of our derivative contracts change with fluctuations in interest rates and currency rates where applicable, as discussed in the Risk Management section below.

In the third quarter 2000, Xerox Credit Corporation (XCC) securitized certain finance receivables in the United States, generating gross proceeds of \$411 million. This facility was accounted for as a secured borrowing. In the third quarter 2000, Xerox Corporation securitized certain accounts receivable in the United States, generating gross proceeds of \$315 million. This revolving facility was accounted for as a sale of receivables. In December 2000, as a result of the senior debt downgrade by Moody's discussed above, Xerox

Corporation renegotiated the \$315 million accounts receivable securitization facility, reducing the facility size to \$290 million. The facility size will remain at \$290 million unless and until our senior debt is downgraded to or below a Ba2 rating by Moody's, at which time we would seek to renegotiate the terms of the facility.

In January 2001, we paid \$28 million to settle 0.8 million outstanding equity put options at their strike price of approximately \$41 per share, which we funded by issuing 5.9 million unregistered common shares.

On October 4, 2001, a European affiliate of Xerox Corporation convened a second meeting of holders of its 125 million GBP 8-3/4 percent Guaranteed Bonds, issued in 1993 and maturing in 2003 (the "Bonds"), in order to consider a proposal to repay the Bonds early at 103% of par plus accrued interest. At the meeting, Bondholders holding approximately 79% of the outstanding amount voted in favor of the proposal. On October 11, 2001, the Bonds were repaid for 129 million GBP (approximately \$184 million) plus accrued interest. Repaying the Bonds early has reduced outstanding indebtedness and eliminated certain restrictive covenants in the Bonds and related documents, thereby providing additional flexibility to Xerox and its subsidiaries and affiliates in connection with their cash management systems and practices. Repaying the bonds will also reduce future interest costs.

Risk Management

We are typical of multinational corporations because 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.

We have historically entered into certain derivative contracts, including interest rate swap agreements, forward exchange contracts and foreign currency swap agreements, to manage interest rate and foreign currency exposures. These instruments are held solely to hedge economic exposures; we do not enter into derivative instrument transactions for trading purposes, and we employ long-standing policies prescribing that derivative instruments are only to be used to achieve a set of very limited objectives. As described above, our ability to currently enter into new derivative contracts is severely constrained. Therefore, while the following paragraphs describe our overall risk management strategy, our current ability to employ that strategy effectively has been severely limited.

Currency derivatives are primarily arranged to manage the risk of exchange rate fluctuations associated with assets and liabilities that are denominated in foreign currencies. 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 have historically hedged a significant portion of all foreign-currency-denominated cash transactions. From time to time (when cost-effective) foreign-currency-denominated debt and foreign-currency derivatives have been used to hedge international equity investments.

Virtually all customer-financing assets earn fixed rates of interest. Therefore, we have historically sought to "lock in" an interest rate spread by arranging fixed-rate liabilities with similar maturities as the underlying assets, and we have funded the assets with liabilities in the same currency. As part of this overall strategy, pay-fixed-rate/receive-variable-rate interest rate swaps are often used in place of more expensive fixed-rate debt. Additionally, pay-variable-rate/receive-fixed-rate interest rate swaps are used from time to time to transform longer-term fixed-rate debt into variable-rate obligations. The transactions performed within each of these categories enable more cost-effective management of interest rate exposures by eliminating the risk of a major change in interest rates. We refer to the effect of these conservative practices as "match funding" customer financing assets.

Consistent with the nature of economic hedges, unrealized gains or losses from interest rate and foreign currency derivative contracts are designed to offset any corresponding changes in the value of the underlying assets, liabilities or debt. As described above, the downgrades of our debt during 2000 and 2001 and the ongoing SEC investigation have significantly reduced our access to capital markets. Furthermore, the specific downgrades of our debt on December 1, 2000, and October 23, 2001, required us to repurchase a number of derivative contracts which were then outstanding, and we could contractually be required to repurchase additional contracts which are currently outstanding. Therefore, we are largely precluded from utilizing derivative agreements to manage the risks associated with interest rate and foreign currency fluctuations, including our ability to continue effectively employing our match funding strategy, and we anticipate increased volatility in our results of operations due to market changes in interest rates and foreign currency rates.

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

XEROX CORPORATION
(Registrant)

/s/ Gary R. Kabureck

Date: November 15, 2001

By Gary R. Kabureck
Assistant Controller and
Chief Accounting Officer
(Principal Accounting Officer)