“I’m just starting my own business and I’m not sure what kind of phone system is right for me.” “I’m looking for accounting software.” “I need paper clips, lots of them.”

Responding to growing business needs

“I really need to organize my office space.” “Can you help me set up a network for five or six computers?” “What’s the fastest, most efficient way for my office to get supplies?”

ANNUAL 1998 REPORT

Company Profile

Staples pioneered the office products superstore industry and is a leading office products distributor with a total of 913 retail stores located in the United States, Canada, the United Kingdom and Germany as of January 30, 1999. In addition, the Company has catalog operations under the names Staples Direct and Quill, a contract stationer business operating under the names Staples Business Advantage and Staples National Advantage, and Internet businesses operating under the names Staples.com and Quillcorp.com.

Financial Highlights

Fiscal Year	1998	1997	1996	1995*	1994
(dollar amounts in thousands, except per share amounts)					
Statement of Income					
Sales	$7,123,189	$5,732,145	$4,493,589	$3,565,235	$2,418,793
Gross Profit	1,757,387	1,378,984	1,083,326	826,639	567,914
Net Income	185,370(1)	167,914(2)	144,742	108,428	72,071
Pro forma Net Income(3)	183,556	153,128	129,413	94,539	59,219
Historical Basic Earnings per common share(4)	0.43	0.41	0.36	0.28	0.21
Historical Diluted Earnings per common share(4)	0.41	0.39	0.35	0.27	0.20
Pro forma Basic Earnings per common share(3) (4)	0.43	0.38	0.32	0.24	0.17
Pro forma Diluted Earnings per common share(3) (4)	0.41	0.36	0.31	0.23	0.16
Stores Open	913	742	557	443	350
Balance Sheet Data					
Working capital	$ 798,768	$ 803,660	$ 623,835	$ 580,244	$ 355,639
Total assets	3,179,266	2,638,862	1,955,636	1,552,199	1,141,496
Total long-term debt, less current portion	205,015	518,959	402,985	351,508	257,122
Stockholders' equity	1,656,886	1,094,485	875,823	712,141	472,215

* Fiscal year 1995 was a 53 week year

(1) *Net income for the year ended January 30, 1999 includes a pre-tax charge of $41,000 resulting from the costs incurred in connection with the acquisition of Quill and a $49,706 charge relating to store closure costs.*

(2) *Net income for the year ended January 31, 1998 includes a pre-tax charge of $29,665 resulting from the costs incurred in connection with the proposed merger with Office Depot, Inc.*

(3) *Pro forma net income and pro forma earnings per share include a provision for income taxes on the previously untaxed earnings of Quill, which had been an S Corporation prior to its acquisition by Staples.*

(4) *Earnings per common shares have been restated to reflect 3 to 2 stock splits effective January 1999, January 1998, March 1996, July 1995 and October 1994.*

Sales
($ in billions)
CAGR 31%**

Pro Forma Net Income
($ in millions)
CAGR 33%**

Earnings Per Share***
CAGR 33%**

*** CAGR=Compound Annual Growth Rate*

****Pro forma EPS before merger related costs and store closure charge.*

"Yeah, we've got that!"

Staples pioneered the office products superstore industry in May 1986 with the belief that small businesses should have access to discounted office supplies as do big corporations. Our first store opened in Brighton, Massachusetts with a very simple purpose — "Slashing the cost and hassle of running your office!"

Our core purpose has stayed the same, but the needs of our customers — and our capabilities — have expanded dramatically. Today, we offer an extensive assortment of technology products, services and furniture — in addition to thousands of office supplies — through convenient retail, mail-order catalog, Internet, and contract businesses. Our 44,000 dedicated associates help make sure that no matter what our customers ask for, we can say — "Yeah, we've got that."

To Our Stakeholders:

We are extremely pleased to tell you that 1998 was another great year. We delivered outstanding financial performance for shareholders while aggressively investing in new businesses, markets, customers, and distribution channels. As evidence of our industry-leading vision and execution we were added to the distinguished Standard & Poors 500 Stock Index.

The end of 1998 marked 19 consecutive quarters of earnings per share growth greater than 30 percent. Earnings per share for the year increased 33 percent to $.53.* Net income improved 39 percent to $238 million from $171 million.* Sales for the year rose 24 percent to $7.1 billion compared to $5.7 billion in the prior year. Comparable sales for stores and delivery hubs that have been open more than one year grew 11 percent, the best performance in the office products industry. And return on equity reached 17 percent, trending upward toward our goal of 20 percent , as we made the investments of our shareholders work harder.

Staples also continued to lead the industry in unit growth. We added stores at a record pace in 1998, opening on average one store every 50 hours, for a total of 174 new locations. This included 130 units in the U.S. — supported in part by new distribution centers in Killingly, Connecticut and Rialto, California — 28 in Canada, eight in the United Kingdom, and eight in Germany, all of which are expected to fuel our future earnings growth.

Ronald L. Sargent (left)
Thomas G. Stemberg (right)

Staples' STRONG GROWTH and earning power are the results of a smart, driven customer focus. We understand who our customers are, what they want and how they want to reach us.

Staples operates the most office superstores of anyone in the world with 913 locations at year end, and we expect to pass the 1,000-unit mark by the fall. Our Canadian operation, Staples Business Depot, now has a true national presence with stores in every province. The chain became one of the top ten non-food retailers in Canada by passing the $1 billion (Canadian dollars) mark in retail revenue last year.

* All references to earnings per share calculations reflect a three-for-two stock split effective January 28, 1999. All references to net income and earnings per share exclude a one-time store relocation charge in the fourth quarter of 1998, and merger-related charges in both 1997 and 1998. Historical data has also been restated to reflect the merger with Quill Corporation under the pooling of interests method of accounting.

Momentum is building for our European operation, where profitability is near. Despite a difficult operational year, we think this business has enormous potential to become a consistent grower like its North American counterparts.

Expansion is More Than Geography

We often talk about "expansion" in terms of new store openings and market penetration. But when we talk of expansion we also mean brand power and capabilities. We are broadening our assortment of products and services to serve the rapidly and dramatically changing needs of our customers.

In 1998, we focused on improving our offering to small- and medium-sized business customers. Our enormously successful acquisition of Quill Corporation, the premier direct marketer of office supplies in the United States, added the brand flexibility we need to capture the business of small- and medium-sized delivery customers.

Quill had an outstanding operational year, exceeding both sales and profit targets. We have already achieved greater than expected cost efficiencies in buying, marketing and indirect product costs for Quill and Staples — without endangering the uniqueness of each brand. Building on a strong track record of successfully integrating new operations, we are sharing our best demonstrated practices to increase the overall potential across brands.

The combined expertise of Quill and Staples Direct in catalog production, database marketing and direct mail has lowered expenses and boosted growth for both operations. In addition, an increased investment in prospecting and a strong management partnership have led to more aggressive financial targets for Quill. And we expect to realize additional benefits from this merger when we unveil Quill in Europe this spring.

Prospects are equally exciting for Staples.com, which we launched in 1998. Our conviction that we should serve customers the way they want to be served resulted in a user-friendly and feature-rich site that was well received by the marketplace. We are growing this business rapidly by leveraging our advertising, catalogs, and retail outlets as vehicles for building brand awareness, and utilizing our purchasing power and low-cost distribution infrastructure.

Early customer response has been so encouraging that we have increased our investment in the site, adding a strong and experienced management team that will continuously upgrade features and functionality. We strongly believe that Staples.com, which is a small part of our overall business today, has great potential to retain and expand our existing customer base and market share.

The Internet is just one indication of a rapidly changing business world. As technology progresses, Staples is building a brand that is known for convenience — even offering local and long distance phone service, on a pilot basis, as a natural extension of computer, phone, or fax sales. Our objective is to meet the increasingly sophisticated needs of small business customers while creating growth vehicles for the future.

We took a major step last year in expanding the technology and service sides of our business by acquiring Claricom Holdings, a $200 million provider of advanced telecommunications and network services for business customers nationwide. Claricom's expertise and technical infrastructure combined with Staples' marketing resources are expected to provide a major convenience for contract, Quill and Staples Direct customers.

We continue to offer the latest technology services through our retail network as well. Our current store prototype includes Technology Centers, which offer technology sales and support. Since introducing these centers, we have steadily refined their capabilities to solve — and prevent — problems for our small business customers.

In 1998, we piloted computer network design and installation services, including on-site network maintenance and 24-hour help. We also added build-to-order PCs to our product line-up so customers can choose exactly what they want from the latest hardware and software. And we can offer these customized machines without the cost of carrying inventory, or subjecting Staples to the risks of obsolescence.

Strengthening our Internal Capabilities

Contributing to our confidence in Staples' future are several important investments in internal capabilities we made over the past year.

We hired an experienced leader to oversee Staples Contract and Commercial in North America. Joseph Doody will manage the growth of each of these businesses as we integrate their distribution systems and networks to improve service and efficiency. He will also expand the reach of Claricom to our millions of delivery customers.

We hired another seasoned executive to improve the efficiency of our supply chain and develop an infrastructure capable of supporting a much larger business. David Crosier, our new Executive Vice President of Supply Chain Management, came to us with 25 years of accomplishment in process engineering and logistics.

We continue to build a pan-European infrastructure that will allow us to expand our presence overseas. We suffered some growing pains during the year — particularly in Germany, where our transition in names from Maxi Papier to Staples Der Büro-Megamarkt and merchandising changes caused some disruption for our customers. However, Jack Bingleman continues to instill a stronger sense of customer service and operational effectiveness and we remain optimistic about the opportunities presented by the European market.

We also continued investing in our most important internal capabilities — our 44,000 associates. We launched several work-life initiatives to make Staples an employer-of-choice — from offering on-site child care at our new corporate center in Framingham, Massachusetts to adding adoption assistance, child care and education referrals through our expanded Employee Assistance Program, and an improved tuition reimbursement program. And we continued to build a comprehensive management development program, Staples University, to develop leaders for our future. All of these initiatives are part of our commitment to a set of priorities we call "C.A.R.E."— Customers, Associates, Real Communication, and Execution.

Finally, our Board strengthened its capabilities with two important additions. Former U.S. Senator George Mitchell, a prominent leader in politics and diplomacy, brings extensive knowledge and experience that will be invaluable in our relations with the U.S. and foreign governments as we expand our business beyond North America. Meg Whitman, Chief Executive Officer of eBay, has extensive retail and Internet experience, and is expected to provide terrific insight as we invest in e-commerce across the company.

Prospects Brighter Than Ever

Staples was founded 13 years ago with a driving passion to cut the cost and hassle of running a small business. From a single store in Brighton, Massachusetts, we have grown to serve the needs of millions of customers through nearly 1,000 retail stores, a contract business, two catalog businesses, three Internet sites and four countries. We have extended our vision beyond basic office supplies to an ever-expanding array of products and services that today's small businesses demand.

The past year was extremely exciting and rewarding for Staples customers, associates and shareholders. But our long-term growth prospects are even more exciting than our strong record of recent success. Our mission is deliberately broad, leaving ample room for growth. In 1999 and beyond, we will continue to execute our proven business model and leverage the Staples brand to meet our customers' growing needs.

We have consistently underestimated the potential for Staples retail outlets in new U.S. markets — especially in suburban and rural areas. We once thought that the state of New Hampshire lacked a concentration of small businesses sufficient to support an office superstore. Today, we have 14 locations in that state. In Salem, New Hampshire we have two stores a mile apart. And we have been adding stores in markets like Bangor, Maine and Nanaimo, British Columbia, where we thought our plan for even one store was ambitious.

We have successfully contended with many of the challenges of our European business, and we remain convinced that the path we are taking for international growth is the right one.

We are adopting e-commerce technology across our company to become more nimble, drive costs down, and position ourselves to enter new countries and lines of business without constraints. Staples.com complements our retail and delivery businesses, providing another important growth platform.

In every area of our business — retail, contract, catalog, and e-commerce — there is much more room for growth. But while we are confident, we are not complacent. With the enormous energy of our 44,000 associates, who serve customers so well, and the continually improving power of our brand and infrastructure, we have every reason to believe the best opportunities to fulfill our mission — and produce generous rewards — still lie ahead of us.

Ron Sargent

Thomas G. Stemberg
Chairman and Chief Executive Officer
April 2, 1999

Ronald L. Sargent
President and Chief Operating Officer

Review of Operations

The following review of operations discusses how each of our businesses has performed beyond expectations, broadened and customized its relationship with customers, and invested in organizational capabilities for the future.

Performing

Staples has one of the most exciting stories and track records in retailing. We started in 1986 with the simple philosophy that small businesses should have the opportunity to buy office supplies at discounted prices just as big businesses do. It soon became clear that we could offer far more than low-priced supplies. We knew we could dramatically slash the cost and hassle of running an office, and that became our mission.

That single-minded focus has no boundaries. It is our core purpose as we bring our compelling concept to new customers, and deepen our relationship with existing ones. Our customer-focused vision has resulted in an outstanding and consistent track record of sales and earnings growth. For the past 19 quarters, earnings per share have risen more than 30 percent over the same quarter in the prior year.

Contributing to our exciting results is a business model designed to drive present value and future earnings. For instance, while already generating impressive sales per new store, the 174 locations we opened in 1998 will reach maturity in approximately three years. If the Class of '98 converts the way our typical stores do, they will add more than $100 million in incremental operating profit at that time.

In fact, with the youngest average store age in the industry, we would expect earnings to grow at least 30 percent annually for several more years even if we stopped opening new stores today. However, to the contrary, we are investing

"The Online Office Manager℠ on Staples.com reminds me when it's time to re-order supplies – now I can save money DAY OR NIGHT!"

Online Opportunity

Staples.com offers the convenience of online shopping combined with a high level of customization. Customers can compare products, create shopping lists of frequently purchased items, and place their order at the touch of a button. Small business owners and office managers can set up accounts that allow employees to request supplies, while maintaining final control over the order.

earnings today to continue swift unit growth and expand the scope of what we can offer to delivery and retail customers.

The opportunities seem endless. In North America, the $225+ billion market for office products is highly fragmented — the top 6 players control less than 20 percent of the market — and it is growing at 10 percent annually. As part of that, the profitable market for consumable office supplies is growing 7 percent annually. Worldwide, the market is estimated to be more than twice the size it is in North America.

We are steadfastly determined to increase our share of the worldwide market by positioning the Staples brand as the premier provider of office products and services, at the lowest prices, with the best customer service. At the same time, we are focused on developing an extremely efficient global purchasing system and distribution network designed to increase our leverage every step of the way.

With a growing customer base, a business model that translates easily into new domestic and foreign markets, and a customer- and returns-focused corporate culture, we believe there are ample opportunities to extend our growth.

Broadening

Originally conceived to help small businesses succeed, Staples has built the capability to serve customers of all sizes. By leveraging our purchasing power and infrastructure, we provide significant benefits for each of them. Now we are broadening that advantage to encompass other areas in which our customers are under-served.

Last year, we made significant progress by expanding the number of channels in which Staples customers can shop, while enhancing the assortment of products and services available within each of those channels.

Staples.com is attracting first-time and long-time customers with a user-friendly and always-available shopping experience. Initial results were a pleasant surprise — partly because many customers know our brand and have an existing relationship with us. Another reason for this early success was our commitment to actively promote Staples.com across each of our businesses. Customers have responded very positively to the convenience and access offered by multiple channels, awarding more of their office-related spending to Staples.

Office products, especially frequently replenished supplies, are extremely well-suited for on-line sales. But Staples.com promises to be more than an on-line supply cabinet. As more and more small businesses migrate to the Web, we foresee Staples.com as a tool to help them take the cost out of processes such as payroll administration, for which they might not have support staff. Future generations of the site will include a host of value-added features specifically designed to support small businesses.

Another way we are extending our relationship with small business customers is through our exciting acquisition of Claricom Holdings, a provider of telecommunications hardware and services to small- and medium-sized businesses. By bringing Claricom's capabilities to our millions of business customers, we will serve a tremendous unmet need. And, as we market comprehensive packages of telephone hardware, telecommunications network service, and local and long distance telephone service — all with simplified billing and pricing — we are expanding the strength of the Staples brand and creating a promising growth vehicle for the future.

Our retail network is also broadening its relationships with small businesses, especially in the area of technology, laying the foundation for future growth. The lifeline of many small business customers is their computer, and when something goes wrong they usually do not have a help desk to call. Therefore, we continued rolling out our in-store Tech Centers, ending the year with more than 250.

Staples Tech Centers

Staples Technology Centers provide sales and support for computers and other technology products. Specially trained Staples associates perform tasks such as software installation and memory upgrades. We continue to expand the capabilities of our Technology Centers to solve — and prevent — problems for small business customers. In 1998, we piloted network design services, on-site installation, and a 24-hour help desk.

“Staples helped me find the right computers and software for my business. Now it’s helping me upgrade. I provide the problem, STAPLES RESPONDS.”

Staples Technology Centers, staffed with specially-trained associates, help keep small businesses running by performing upgrades, installing software, and testing and configuring PCs. As we enhance our reputation as a trusted advisor to small businesses, we plan to offer additional services such as network installation and PC support — both of which we piloted last year in a limited number of stores. In addition to improving our footing in technology services, the Tech Centers are helping us drive sales throughout our assortment of technology products.

There is much more room to extend the services of our copy and print centers as well. Last year, we expanded the space allocated to our copy centers and added digital technology to meet the increasingly sophisticated needs of our customers. Copy centers are now staffed with specially-certified associates, trained as problem solvers, who are boosting customer satisfaction while driving sales of profitable color copying, binding, and specialty printing.

Customizing

The needs of retail customers are very different from those of regional or coast-to-coast contract customers. The preferences of European and Canadian customers vary from those of Americans. Each of our business units is leveraging Staples’ infrastructure and brand power in a continuous search for ways to deliver customized solutions and superior value to our customers.

The personalized features of Staples.com are a major part of the site’s appeal, positioning us to be the leading “e-tailer” in the industry. Upon entering the site, customers are prompted to choose the way they prefer to shop — by aisle, category, or browsing. The *Group Accounts Manager* helps companies with up to 100 employees

“Staples gives me MORE CHOICES than I’ve ever had before, at lower prices. That sounds **great in any language.**”

manage their office products spending. When enabled, this unique feature saves orders for processing until a designated manager approves them.

Customers can also setup e-mail reminders so they never run out of important products, and they can analyze their ordering patterns and expenses at any time by reviewing their purchase history. But one of the best features of Staples.com is that it is backed by strong retail and catalog operations to serve customers who need something immediately, want to touch a product before buying it, ask a question of a catalog sales representative, shop when they do not have on-line access, or conveniently return a Staples.com purchase without paying additional shipping charges.

On the retail side, our U.S. stores rolled out built-to-order personal computers designed to provide small business customers with exactly the right combination of hardware, software and services. For instance, the program allows customers to buy only the essential business software they need instead of an unnecessary bundle of entertainment software.

At the same time, built-to-order contributes significantly to our profitability by allowing us to sell PCs without the cost of carrying inventory, or the risk of obsolescence. Customer response to the program has been tremendously strong and in 1999 we will provide more brands from which to choose. We will continue to search for ways to give customers more choice in areas such as software and technology, peripherals and upgrades.

We are also increasing the number of alternatives in furniture. In 1998, we introduced a custom-order chair program that provides customers many more choices in fabric and color than we could display on our sales floor. In addition, we increased the number of desks and other furniture products available in multiple finishes. Additionally, we piloted a special-order furniture program that gives customers a dramatically enlarged selection.

For our contract customers, customization lies as much in the process as in the product. Contract customers are looking to control expenses with a no frills shopping experience. They want their employees to quickly find the items they need, order easily, and get back to business — without turning in a wish list of ancillary products.

Last year, we responded to these distinct preferences by launching Staples Network Advantage Plus (SNAP.) This electronic-commerce alternative offers simple order entry, with the control to choose which items are available, and individualized contract pricing. For customers who cannot support electronic commerce, we provide the ability to order by fax or telephone keypad.

In 1998, we launched a system to drive customized savings for contract customers. Named “Advantage,” the system analyzes the ordering patterns of individual customers. When we find a systemic problem with a customer’s ordering system, we help develop a more cost-effective process — saving the customer money while lowering our expenses.

When Staples acquired Quill Corporation last year, we obtained a world leader in customized database marketing. Quill is a big business, but feels like a small merchant who knows every customer well. Using extensive and sophisticated data sets, Quill is able to target special messages and offers to customers who are most likely to respond. The company’s precision accounts for maximum sales and satisfaction, and minimum catalog circulation costs.

Quill also has a unique niche that Staples did not previously target — medium-sized businesses in specific industries. To attract this business, Quill offers a broader product selection with more market-specific products. We will take this winning model to Europe in 1999. With no ties to the Staples brand, Quill will increase our flexibility to operate like a traditional European mail order house — but with far better pricing and service.

Integration of Quill

The integration of Quill Corporation into Staples’ business has already been extremely successful. Quill is a world-class direct marketer extremely skilled at targeting specific markets such as legal and medical offices through mail-order catalogs and Quillcorp.com. Quill is to be launched in Europe in the spring of 1999.

QUILL®

Delivering Efficiently

Staples is building a multi-channel distribution network to improve service to delivery customers while lowering our costs. In 1998, we opened our first consolidated distribution center. The Putnam, Connecticut facility serves contract, catalog, and Staples.com customers.

Our business north of the U.S. border is a prime example of what we can do with the right balance between economies of scale and local flexibility. Operating under the names Business Depot, Staples Business Depot, and Bureau en Gros, our Canadian unit has its own buying organization so it can accommodate local preferences in categories such as furniture. In conjunction with this local buying, we continue to drive down costs through global purchasing contracts. With a customized furniture assortment and layout, our Canadian stores lead the company in that category.

Across the Atlantic, we made several adjustments in 1998 to accommodate the local preferences of the United Kingdom and Germany. After buying most of the remaining interest of our joint-venture partners in 1997, we were able to refine the best parts of Staples for the European marketplace.

For instance, we have learned that the U.K. is a lot like U.S. in terms of how to present the store. But the size of our store was problematic in a culture that is not as receptive to the proliferation of shopping centers. We therefore tightened our store design and have been seeing better results — at a lower rent. We know also that British customers have a higher propensity for shopping by catalog than by retail, so we have prepared for rising mail order sales in 1999.

We remain optimistic about growth opportunities in Germany, the largest economy in Europe, where our earnings last year helped us refine our business model. In the process of reconfiguring our selection from local to global brands, we disrupted some customer relationships. We identified a handful of items particular to German preferences that we must continue to stock. Now, we strongly believe we are poised to succeed because we have a product mix and store design suitable for German customers. As a reflection of our confidence, and another step in building a global brand, we even changed the name of our German operation from Maxi-Papier to Staples, Der Büro-Megamarkt (The Office Superstore.)

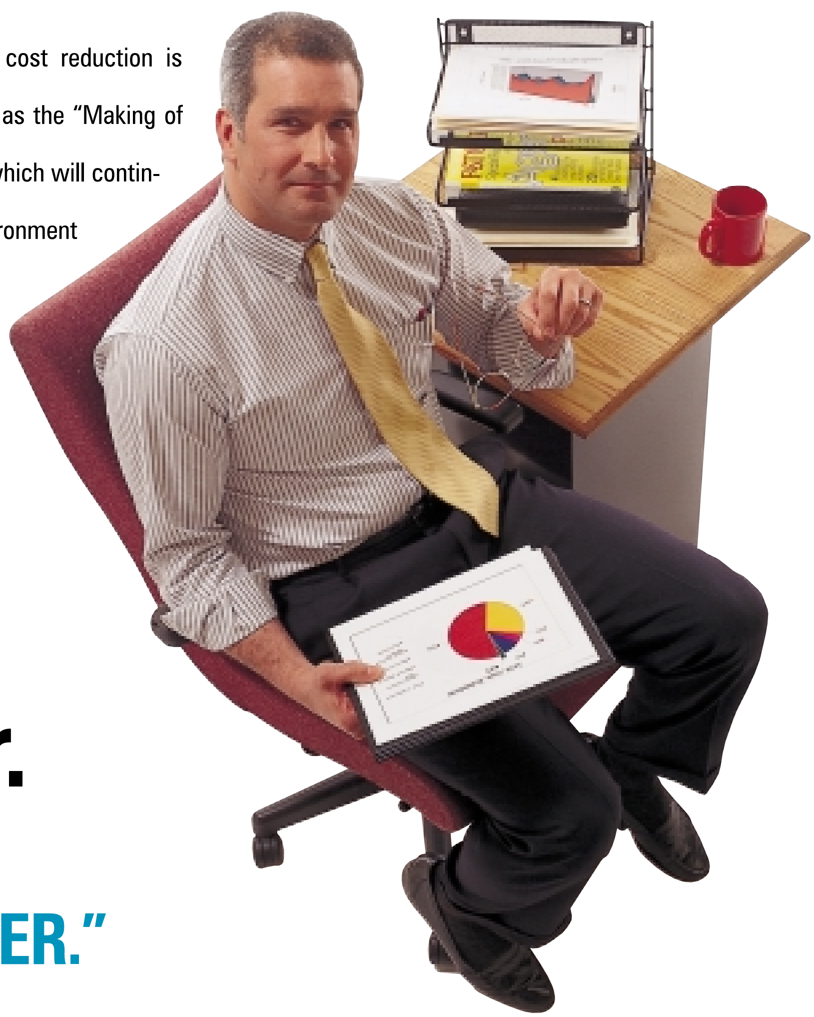
By successfully customizing our model, while capturing efficiencies from global buying and infrastructure, we think we will reap the benefits of a European market that has the potential for an estimated 2,000 office superstores. We are following the same principle in every area of our business — each business unit must be nimble enough to make and execute decisions quickly, according to the needs of its primary customers, while building a powerful global brand.

Investing

In addition to investing in major growth vehicles such as Quill, Claricom and new store openings, we are building scalable information systems and infrastructure designed to ensure our continuing ability to serve customer needs and sustain rapid and profitable growth. Equally important to our future success are the investments we are making to prepare our 44,000 associates and entrench our core values in everything we do. During the past year, we had several important accomplishments in each of these areas.

Many improvements stemmed from a tightened focus on strengthening the performance and reliability of our supply chain. Working cross-functionally, internally and with our suppliers, we identified several major opportunities to improve service quality and responsiveness, lower operating expenses and support our growth and expansion. Consequently, we continued to analyze and develop one of the most efficient distribution networks in retail.

The most immediate impact on customer service and cost reduction is expected to come from an undertaking dubbed internally as the "Making of Contract and Commercial." The end result of the project, which will continue into 1999, will be a powerful information systems environment



"We learned how much we could save per employee just by **changing the way we order.** Staples is not just a supplier, it's A PARTNER."

"There are already enough hassles in **managing a small business.** Staples makes sure that running my office ISN'T ONE OF THEM."

and delivery network linking all of the contract and commercial businesses we built and acquired in the U.S.

Until now, each contract and commercial distribution center maintained its own ordering software and distribution facilities. As a result of the rapid growth of our delivery business, we had far-reaching opportunities to improve our back-end efficiency while maintaining unique interfaces with catalog, regional delivery and coast-to-coast contract customers.

In 1998, we integrated the ordering systems of three of the five regional stationers we acquired previously. Subsequently, we opened our first multi-channel distribution center. The consolidated facility, located in Putnam, Connecticut, is now serving delivery customers of all sizes — significantly lowering distribution and transportation expenses while improving fulfillment of our next-day delivery promise. In 1999, we will continue building this cost-effective multi-channel distribution network.

Another important upgrade on the delivery side of our business is the roll-out of a Staples-owned delivery fleet. This is not only a more cost-effective way of doing things, but also an investment in customer satisfaction. We know that the driver is the one who leaves customers with a smile. This important part of our relationship with customers leaves them satisfied or unsatisfied, so we must manage it rather than rely solely on third-party delivery systems. The fleet made its mark in key regions in 1998 and will be rolled out nationally in 1999.

We took our retail capabilities a step further in 1998 with the help of a new replenishment system that came on-line in late 1997. As one of several noteworthy technology initiatives to drive costs out of our business, the system is freeing much of our managers' time so they can focus on the fun and entrepreneurial part of our business — sales and service, developing their people, and community involvement. The highly sophisticated and automated system contributed to an average in-stock level of 99 percent for the year, and 99.5 percent on core "never-out" supplies.

Technology was also a focal point of our European operations in 1998 as we designed new systems for merchandising, replenishment, warehouse management, financial operations and point-of-sale transactions. In 1999, the new systems will automate the ordering process for stores, reduce inventory levels and enable much faster expansion in Europe. And, for the first time, our European and U.S. businesses will have direct and easy communication and data sharing, leading to greater opportunities for learning and growth.

Finally, we made several important investments in our associates and our culture because nothing has a greater impact on the future of our business. With a clearly expressed need for management development, we formally launched Staples University to establish a stimulating learning environment for our associates — and enhance our ability to grow from within.

The University had a remarkably successful freshman year, piloting courses mostly with corporate managers. Designed to teach our managers to think like the business owners and managers they serve, Staples University is now beginning to reach associates in the field with training in customer service, selling skills and operations. Our satellite network is enabling us to provide real-time, simultaneous interactive learning for thousands of associates.

We ended the year with a corporate culture that is playing an increasingly important role. Summarized succinctly by the acronym "C.A.R.E.," our core values rest on four pillars — Customers, Associates, Real Communication, and Execution. Simply put, we value every customer, support our associates as valuable resources, share information with people when they need it — and ultimately achieve our business goals. C.A.R.E., which was written and embraced by Staples associates, is a great point of differentiation, and a competitive advantage that is hard to imitate.

Collectively, these investments in our infrastructure and associates have positioned Staples for continuing success.

Growing With Our Customers

Staples' main focus continues to be retailing. We opened more than 170 stores this year and plan to celebrate the opening of our 1000th store during the summer of 1999. In addition to expanding the geographic penetration of our retail network, we are expanding our circle of products and services to respond to the growing needs of business.

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

Results of Operations

Comparison of Fiscal Years Ended January 30, 1999, January 31, 1998, and February 1, 1997

General

During the fiscal year ended January 30, 1999, Staples acquired, in a pooling of interests transaction, Quill Corporation and certain related entities (collectively referred to as "Quill") with 1997 net sales of approximately $551 million. The financial information set forth below includes adjustments to give effect to the acquisition of Quill for all periods presented. Prior to its acquisition by Staples, Quill elected to be treated as an S Corporation under the Internal Revenue Code, and accordingly, its earnings were not subject to taxation at the corporate level. Pro forma adjustments have been made to reflect a provision for income taxes on such previously untaxed earnings for each period presented at an assumed rate of 40%. The statements of income combine Staples' historical operating results for the fiscal years ended January 31, 1998 and February 1, 1997 with corresponding Quill operating results for the years ended December 31, 1997 and 1996.

Sales

Sales increased 24% to $7,123,189,000 in the fiscal year ended January 30, 1999 from $5,732,145,000 in the fiscal year ended January 31, 1998. Sales increased 28% in the fiscal year ended January 31, 1998 from $4,493,589,000 in the fiscal year ended February 1, 1997. The growth in each year was attributable to an increase in the number of open stores, increased sales in existing stores and increased sales in delivery operations. In addition, sales for the fiscal years ended January 30, 1999 and January 31, 1998 (beginning in May 1997) include the consolidation of Staples UK and Staples (Deutschland) GmbH ("Staples Germany," formerly MAXI-Papier-Markt-GmbH). Comparable store and delivery sales for the fiscal year ended January 30, 1999 increased 11% over the fiscal year ended January 31, 1998. Comparable store and delivery hub sales for the year ended January 31, 1998 increased 10% over the year ended February 1, 1997. As of January 30, 1999, January 31, 1998, and February 1, 1997, Staples had 913, 742, and 557 open stores, respectively. The January 30, 1999 total includes 174 stores opened and 3 stores closed during the twelve months ended January 30, 1999.

Gross Profit

Gross profit as a percentage of sales was 24.7%, 24.1%, and 24.1% for the fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. The gross profit rate was increased by continually improving margins in the retail and delivery business segments due to lower product costs from vendors and increased buying as well as the leveraging of fixed distribution center and delivery costs over a larger sales base. This was offset by decreases in the margin rates due to price reductions as well as an increase in the sales of computer hardware (CPUs and laptops), which generate a lower margin rate than other categories, to 7.6% of total sales for the year ended January 30, 1999 from 7.4% in the year ended January 31, 1998 and 6.0% in the year ended February 1, 1997.

Operating and Selling Expenses

Operating and selling expenses, which consist of payroll, advertising and other operating expenses, were 14.4%, 14.5%, and 14.5% of sales for the fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. The decrease as a percentage of sales for the year ended January 30, 1999 was primarily due to decreased advertising as a percentage of sales and increased leveraging of fixed store payroll expenses and store operating costs as store sales have increased. These factors were partially offset by increases in store labor and costs incurred for Staples' store remodel program in which significant investments have been made in store layouts and signing to improve shopability and enhance customer service. In addition, operating and selling expenses for the year ended January 30, 1999 and the year ended January 31, 1998 (beginning in May 1997) include the results of Staples UK and Staples Germany, which have higher costs as a percentage of sales.

Pre-Opening Expenses

Pre-opening expenses relating to new store openings, consisting primarily of salaries, supplies, marketing and occupancy costs, are expensed by Staples as incurred and therefore fluctuate from period to period depending on the timing and number of new store openings. Pre-opening expenses averaged $80,000, $73,000, and $72,000 per store for the stores opened in the years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. The increase during the fiscal year ended January 30, 1999 was due primarily to increased openings outside of the United States which generally involve higher pre-opening expenses per store.

General and Administrative Expenses

General and administrative expenses as a percentage of sales were 4.2%, 3.9%, and 3.9% in the years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. The increase as a percentage of sales for the year ended January 30, 1999 as compared to the years ended January 31, 1998 and February 1, 1997 was primarily due to costs incurred for Year 2000 compliance projects. In addition, Staples has made other investments in its information systems' ("IS") staffing and infrastructure, which Staples believes will reduce costs as a percentage of sales in future years. In addition, general and administrative expenses for the years ended January 30, 1999 and January 31, 1998 include the results of Staples UK and Staples Germany, which have higher costs as a percentage of sales. The overall increase in general and administrative costs were partially offset by Staples' ability to increase sales without proportionately increasing overhead expenses in its core retail and direct business.

Merger-Related and Integration Costs

In connection with the acquisition of Quill, Staples recorded a charge to operating expense of $41,000,000 during the year ended January 30, 1999. These costs consist of direct merger-related and integration costs from the transaction. The merger transaction costs of approximately $10,500,000 consist primarily of fees for investment bankers, attorneys, accountants, and other related charges. The integration costs primarily include employee costs of approximately $7,000,000, contract and lease termination costs of approximately $14,100,000, and the write-down of leasehold improvements of approximately $3,500,000 and other merger-related costs of approximately $5,900,000. Staples paid approximately $14,000,000 in fiscal year 1998, which consists primarily of transaction and employee related costs. During the year ended January 31, 1998, Staples charged to expense non-recurring costs in connection with the proposed merger with Office Depot, Inc. of $29,665,000.

Store Closure Charge

In December 1998, Staples committed to a plan to close and relocate stores which cannot be expanded and upgraded to the Company's "Concept 97" model. In connection with this plan, Staples recorded a charge to operating expense of $49,706,000. This charge includes $29,620,000 for future rental payments under operating lease agreements that will be paid after the store is closed and will not be subsidized by subtenant income, $4,966,000 in fees, settlement costs and other expenses related to store closure and $15,120,000 in asset impairment charges. Lease agreements for the relocation of sites will be executed during fiscal year 1999 and the stores will be closed and relocated during fiscal years 1999 and 2000. Staples made no payments in fiscal year 1998 related to the store closure charge.

Interest and Other Expense, Net

Net interest and other expense totaled $17,370,000, $21,955,000, and $22,962,000 in the fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. The interest expense relates primarily to existing borrowings which were used to fund the increase in store inventories related to new store openings and improvements in in-stock levels; the acquisition of fixed assets for new stores opened and remodeled; continued investments in the information systems and distribution center infrastructure; and additional investments in Staples UK and Staples Germany as well as the purchase of them during the fiscal year ended January 31, 1998. The decrease in interest expense during the year ended January 30, 1999 is due primarily to the conversion of the Company's $300,000,000 of 4½% Debentures into common stock in December 1998.

Equity in Loss of Affiliates

Staples' Equity in Loss of Affiliates was $5,953,000 and $11,073,000 respectively, in the years ended January 31, 1998 and February 1, 1997. Staples recorded no equity in loss of affiliates for the year ended January 30, 1999, due to the acquisition of Staples UK and Staples Germany on May 6, 1997 and May 7, 1997, respectively. As a result of the acquisitions, Staples' ownership interest of Staples UK increased to 100% and its ownership of Staples Germany increased to approximately 92% which was increased to 100% in December 1998. The transactions were accounted for in accordance with the purchase method of accounting and accordingly, the consolidated results of these entities are reflected in Staples' financial statements since the respective dates of acquisition. Prior to the acquisitions, Staples UK and Staples Germany were accounted for under the equity method which resulted in Staples' share of losses from operations being included in Equity in Loss of Affiliates. As of January 30, 1999, Staples UK and Staples Germany operated 48 and 25 stores, respectively.

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

Income Taxes

The provision for income taxes as a percentage of pre-tax income was 39.5%, 32.8%, and 31.5% for the years ended January 30, 1999, January 31, 1998, and February 1, 1997. On a pro forma basis, to reflect a provision for income taxes on previously untaxed earnings of Quill, Staples' effective tax rate would have been 40.1%, 38.7%, and 38.8%, respectively for the same periods. The increase in the pro forma tax rate in fiscal year 1998 was primarily due to non-deductible merger-related costs.

Liquidity and Capital Resources

Staples has traditionally used a combination of cash generated from operations and debt or equity offerings to fund its expansion and acquisition activities. During the years ended January 30, 1999, January 31, 1998, and February 1, 1997, Staples also utilized its revolving credit facility to support its various growth initiatives.

Staples opened 174 stores, 130 stores, and 115 stores in the years January 30, 1999, January 31, 1998, and February 1, 1997, respectively, and closed three stores in the fiscal year ended January 30, 1999 and one store in each of the fiscal years ended January 31, 1998 and February 1, 1997. In addition, in the fiscal year ended January 31, 1998, 56 stores were added as a result of the acquisition of Staples UK and Staples Germany. As the store base matures and becomes more profitable, cash generated from store operations is expected to provide a greater portion of funds required for new store inventories and other working capital requirements. Sales generated by the contract stationer business segment are made under regular credit terms, which requires that Staples carry its own receivables from these sales. Staples also utilized capital equipment financings to fund current working capital requirements. During the year ended January 30, 1999, Staples paid mortgages in full on five distribution centers acquired from Quill of approximately $14 million.

As of January 30, 1999, cash, cash equivalents, and short-term investments totaled $375,421,000, a decrease of $11,569,000 from the January 31, 1998 balance of $386,990,000. The principal sources of funds were primarily cash from operations, including an increase in accounts payable and accrued expenses of $363,988,000, which financed the increase in merchandise inventory of $211,052,000 related to new store openings, expanded product assortment and improvements in in-stock levels. These sources were partially offset by the acquisition of property and equipment of $322,308,000 and cash used in the acquisition of Quill of $48,102,000.

Staples expects to open approximately 170 stores during fiscal 1999. Management estimates that the Company's cash requirements, including pre-opening expenses, leasehold improvements and fixtures, will be approximately $1,400,000 for each new store (excluding the cost of any acquisitions of lease rights). Accordingly, Staples expects to use approximately $238,000,000 for store openings during this period. Staples plans to begin a stock repurchase program during fiscal 1999 intended to provide shares for employee stock programs. Staples expects to repurchase approximately six million shares annually. In addition, Staples plans to continue to make investments in information systems, distribution centers and store remodels to improve operational efficiencies and customer service, and may expend additional funds to acquire businesses or lease rights from tenants occupying retail space that is suitable for a Staples store. Staples expects to meet these cash requirements through a combination of available cash, operating cash flow and borrowings from its existing revolving line of credit. In a subsequent event on February 26, 1999, Staples completed the acquisition of Claricom Holdings, Inc. and certain related entities for a purchase price of approximately $140,000,000.

Staples issued $200,000,000 of senior notes (the "Notes") on August 12, 1997 with an interest rate of 7.125% payable semi-annually on February 15 and August 15 of each year commencing on February 15, 1998. Net proceeds of approximately $198,000,000 from the sale of the Company's Notes were used for repayment of indebtedness under Staples' revolving credit agreement and for general working capital purposes, including the financing of new store openings, distribution facilities, and corporate offices.

Staples also maintains a revolving credit facility, effective through November 2002, with a syndicate of banks which provides up to $350,000,000 of available borrowings. Borrowings made pursuant to this facility will bear interest at either the lead bank's prime rate, the federal funds rate plus 0.50%, the LIBOR rate plus a percentage spread based upon certain defined ratios, a competitive bid rate or a swing line loan rate. This agreement, among other conditions, contains certain restrictive covenants including net worth maintenance, minimum fixed charge interest coverage and limitations on indebtedness and sales of assets. As of January 30, 1999, no borrowings were outstanding under the revolving credit agreement. Staples also has available $35,000,000 in uncommitted, short-term bank credit lines, of which no borrowings were outstanding as of January 30,1999. Staples UK has a $50,000,000 line of credit which had an outstanding balance of $29,849,000 at January 30, 1999 and Business Depot has a $16,545,000 line of credit with no outstanding balance at January 30, 1999. Total cash, short-term investments and available revolving credit amounts totaled $826,966,000 as of January 30, 1999.

Staples expects that its current cash and cash equivalents and funds available under its revolving credit facility will be sufficient to fund its planned store openings and other recurring operating cash needs for at least the next twelve to eighteen months. Staples continually evaluates financing possibilities, and it may seek to raise additional funds through any one or a combination of public or private debt or equity-related offerings, dependent upon market conditions, or through an additional commercial bank debt arrangement.

Inflation and Seasonality

While inflation or deflation has not had, and Staples does not expect it to have, a material impact upon operating results, there can be no assurance that Staples' business will not be affected by inflation or deflation in the future. Staples believes that its business is somewhat seasonal, with sales and profitability slightly lower during the first and second quarters of its fiscal year.

Future Operating Results

This annual report contains forward-looking statements that involve risks and uncertainties. Any statement (including statements to the effect that Staples "believes", "expects", "anticipates", "plans" and similar expressions) that are not statements relating to historical matters should be considered forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements as a result of numerous important factors, including those discussed below.

Staples Operates in a Highly Competitive Market. Staples competes in a highly competitive marketplace with a variety of retailers, dealers and distributors. In most of our geographic markets, we compete with other high-volume office supply chains, such as Office Depot, OfficeMax and Office World, that have store formats, pricing strategies and product selections that are similar to ours. Staples also competes with mass merchants (such as Wal-Mart), warehouse clubs, computer and electronics superstores, and other discount retailers. In addition, our retail stores and delivery and contract businesses compete with numerous mail order firms, contract stationer businesses and direct manufacturers. Many of our competitors, including Office Depot, OfficeMax and Wal-Mart, have in recent years significantly increased the number of stores they operate within our markets. Some of our current and potential competitors are larger than we are and have substantially greater financial resources. It is possible that increased competition or improved performance by our competitors may reduce our market share, may force us to charge lower prices than we otherwise would, and may adversely affect our business and financial performance in other ways.

Our Success Depends on Our Ability to Successfully Open New Stores. An important part of our business plan is to aggressively increase the number of our stores. Staples opened 174 stores in the United States, Canada and Europe in fiscal 1998 and plans to open approximately 170 new stores in fiscal 1999. For our growth strategy to be successful, Staples must identify and lease favorable store sites, hire and train employees and adapt our management and operational systems to meet the needs of our expanded operations. These tasks may be difficult to accomplish successfully. If we are unable to open new stores as quickly as we plan, our future sales and profits could be materially adversely affected. Even if Staples succeeds in opening new stores, new stores may not achieve the same sales or profit levels as our existing stores. Also, our expansion strategy includes opening new stores in markets where Staples already has a presence so that we can take advantage of economies of scale in marketing, distribution and supervision costs. However, these new stores may result in the loss of sales in existing stores in nearby areas.

Our Operating Results May Vary from Quarter to Quarter. Our operating results have fluctuated from quarter to quarter in the past, and we expect that they will continue to do so in the future. Our earnings may not continue to grow at rates similar to the growth rates achieved in recent years and may fall short of either a prior fiscal period or investors' expectations. Factors that could cause these quarterly fluctuations include the following:

- the number of new store openings (pre-opening expenses are expensed as incurred and newer stores are less profitable than mature stores);
- the extent to which sales in new stores result in the loss of sales in existing stores;
- the mix of products sold;
- pricing actions of competitors;
- the level of advertising and promotional expenses;
- seasonality (the sales and profitability of our stores are typically slightly lower in the first and second quarter of our fiscal year than in other quarters); and
- one-time charges associated with acquisitions.

Most of our operating expenses, such as rent expense, advertising expense and employee salaries, do not vary directly with the amount of our sales and are difficult to adjust in the short term. As a result, if sales in a particular quarter are below our expectation for that quarter, Staples could not proportionately reduce operating expenses for that quarter, and therefore this sales shortfall would have a disproportionate effect on our expected net income for the quarter.

The market price of our Common Stock is based in large part on professional securities analysts' expectations that our business will continue to grow and that Staples will achieve certain levels of new income. If our financial performance in a particular quarter does not meet the expectations of securities analysts, this may adversely affect the views of those securities analysts concerning our growth potential and future financial performance. If the securities analysts that regularly follow us lower their ratings of our Common Stock or lower their projections for our future growth and financial performance, the market price of our Common Stock is likely to drop significantly. In addition, in those circumstances the decrease in Common Stock price would probably be disproportionate to the shortfall in our financial performance.

Rapid Growth Could Strain Our Operations. Our business, including sales, number of stores and number of employees, has grown dramatically over the past several years. In addition, Staples has acquired a number of significant companies in the last few years and may make additional acquisitions in the future. This growth has placed significant demands on our management and operational systems. If we are not successful in upgrading our operational and financial systems, expanding our management team and increasing and effectively managing our employee base, this growth is likely to result in operational inefficiencies and ineffective management of our business and employees, which will in turn adversely affect our business and financial performance.

Our International Operations are Subject to Additional Risks. Staples currently operates in international markets through The Business Depot Ltd. in Canada, Staples UK in the United Kingdom and Staples Germany in Germany. Staples may seek to expand into other international markets in the future. Our foreign operations encounter risks similar to those faced by our U.S. stores, as well as risks inherent in foreign operations, such as local customs and competitive conditions and foreign currency fluctuations. Our European operations are currently unprofitable, and we cannot guarantee that they will become profitable.

The Terms and Timing of Future Financings are Uncertain. Staples currently expects that current cash and cash equivalents and funds available under our revolving credit facility will be sufficient to fund our planned new store openings and other operating cash needs for at least the next twelve to eighteen months. However, it is possible that Staples will require additional sources of financing earlier than anticipated, as a result of unexpected cash needs or opportunities, an expanded growth strategy or disappointing operating results. Additional funds may not be available on satisfactory terms when needed, whether within the next twelve to eighteen months or thereafter.

Year 2000 Compliance

Staples has completed a comprehensive assessment of its internal computer systems and applications to identify those that might be affected by computer programs using two digits rather than four to define the applicable year (the "Year 2000 issue"). Staples has used internal personnel as well as external contractors and consultants to identify those systems and applications which are affected by the Year 2000 issue. Those systems and applications identified as needing remediation will be replaced or modified and tested for compliance. Remediation of the most critical Information Technology (IT) related systems and applications remain on schedule for completion during the first quarter of 1999 and it is anticipated that testing will be completed by the end of the second quarter of 1999. These systems include Merchandising/Logistics, Distribution, Store Point of Sale, and Corporate Finance. The remediation of the less critical IT systems is expected to be completed during the second quarter of 1999. These systems and applications include Marketing Systems and Non-Mission Critical Desktop Applications. Testing of these less critical IT systems and applications is expected to be finished during the third quarter of 1999.

Staples has also finished its assessment of non-IT-related systems and applications and is continuing to assess the status of third parties with regard to Year 2000 compliance. The non-IT-related systems and applications include telephone systems, store security systems, and electrical systems, among others. The remediation of these systems is expected to be completed during the first quarter of 1999 with testing to be finished by the end of the second quarter of 1999. Staples is also working with third parties, primarily major vendors, but also customers to ensure that they will be Year 2000 compliant as Staples' schedule requires. Responses have been received from the majority of vendors, but not all vendors have assured Staples that they will be compliant in time. As a contingency, alternative lists of third party vendors have been created in case a critical third party does not achieve compliance. Staples has completed its enterprise-wide inventory review and has completed the most critical aspects of a comprehensive risk assessment relative to vendor-provided products, devices and/or services. The balance of this risk assessment will be completed during the first quarter of 1999. Comprehensive due diligence and monitoring with respect to vendors with the greatest impact on Staples will be performed on a continuous basis throughout 1999.

Staples has estimated that the total cost of Year 2000 compliance will be between $20 and $30 million, $14 million of which had been spent as of January 30, 1999. While Staples has purchased hardware and software, it has done so in support of configuration management and growth and these purchases have not been capitalized. Most of the costs to be incurred are related to remediation and testing of software using outside contracted services. The costs of compliance have been included in Staples' current 1999 IT budgets. The inclusion of Year 2000 compliance in the IT budget has not caused any critical IT projects to be delayed or eliminated.

Staples currently does not have a formal contingency plan in the event that an area of its operations does not become Year 2000 compliant. A formal plan will be adopted if it becomes more evident that there will be an area of non-compliance in its systems or at a critical third party. Staples is developing procedures for all its sites, listing those to contact in the event a "Y2K suspected" issue is encountered. Although Staples expects to achieve Year 2000 compliance as scheduled, there are potential risks if the company does not become or is late in becoming Year 2000 compliant. Such risks include impairing the Company's ability to process and deliver customer orders and payments, procure saleable merchandise, and perform other critical business functions which could have a material impact on financial performance. Staples has yet to make an analysis of the effect that an instance of critical non-compliance by the Company or a third party would have on revenues and expenses since a worst case scenario has not been identified. Further, there is also the risk that claims may be made against Staples in the event of its non-compliance or the non-compliance of the products and services which it sells. The costs of defending and settling such claims could have a material impact on the financial statements of the Company. Staples is preparing a "Y2K Preparedness Guide" for its customers so the Company can be proactive in assisting them with vendor contacts to answer their Y2K questions.

The information presented above is based on management's estimates which were made using assumptions of future events. Uncontrollable factors such as the compliance of the systems of third parties and the availability of resources could materially increase the cost or delay the estimated date of Year 2000 compliance.

Euro Currency

On January 1, 1999, certain member countries of the European Union established fixed conversion rates between their existing currencies and the European Union's common currency ("the euro"). The former currencies of the participating countries are scheduled to remain legal tender as denominations of the euro until January 1, 2002 when the euro will be adopted as the sole legal currency.

Staples has evaluated the potential impact on its business including the ability of its information systems to handle euro-denominated transactions and the impact on exchange costs and currency exchange rate risks. The conversion to the euro is not expected to have a material impact on Staples' operations or financial position.

Quantitative and Qualitative Disclosures about Market Risks

Staples is exposed to market risk from changes in interest rates and foreign exchange rates. Staples does not use these derivative instruments for trading purposes. Staples initiated a risk management control process to monitor the foreign exchange and interest rate risks. The risk management process uses analytical techniques including market value, sensitivity analysis, and value at risk estimates. Staples does not believe that the potential exposure is significant in light of the size of the Company and its business. In addition, the foreign exchange rate can move in Staples' favor. Recent experience has demonstrated that gains on certain days are offset by losses on other days. Therefore, Staples does not expect to incur material losses.

This risk management discussion, and the effects of changes in interest rates and foreign exchange rates, are forward-looking statements. Actual results in the future may differ materially from these projected results due to actual developments in the global financial markets. The analytical methods used by Staples to assess and mitigate risk discussed above should not be considered projections of future events or losses.

Consolidated Balance Sheets

(dollar amounts in thousands, except share data)

	January 30, 1999	January 31, 1998
Assets		
Current Assets:		
Cash and cash equivalents	$ 357,993	$ 381,088
Short-term investments	17,428	5,902
Merchandise inventories	1,340,432	1,124,642
Receivables, net	221,836	203,143
Deferred income taxes	75,261	33,108
Prepaid expenses and other current assets	51,150	38,257
Total current assets	2,064,100	1,786,140
Property and Equipment:		
Land and buildings	231,378	150,947
Leasehold improvements	372,451	292,128
Equipment	400,225	304,177
Furniture and fixtures	239,755	173,711
Total property and equipment	1,243,809	920,963
Less accumulated depreciation and amortization	403,520	310,701
Net property and equipment	840,289	610,262
Other Assets:		
Lease acquisition costs, net of amortization	75,127	43,244
Investments	—	16,450
Goodwill, net of amortization	148,201	139,753
Deferred income taxes	28,735	15,451
Other	22,814	27,562
Total other assets	274,877	242,460
	$3,179,266	$2,638,862
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	$ 794,427	$ 672,956
Accrued expenses and other current liabilities	438,311	266,023
Debt maturing within one year	32,594	43,501
Total current liabilities	1,265,332	982,480
Long-Term Debt	205,015	218,959
Other Long-Term Obligations	52,033	42,803
Convertible Debentures	—	300,000
Minority Interest	—	135
Stockholders' Equity:		
Preferred stock, $.01 par value-authorized 5,000,000 shares; no shares issued		
Common stock, $.0006 par value-authorized 1,000,000,000 shares; issued 461,538,061 shares at January 30, 1999 and 417,238,962 shares at January 31, 1998	277	167
Additional paid-in capital	1,043,194	593,883
Cumulative foreign currency translation adjustments	(11,675)	(10,315)
Unrealized gain on investments	7	1,056
Retained earnings	633,321	510,040
Less: treasury stock at cost, 488,922 shares at January 30, 1999 and 88,724 shares at January 31, 1998	(8,238)	(346)
Total stockholders' equity	1,656,886	1,094,485
	$3,179,266	$2,638,862

See notes to consolidated financial statements.

Consolidated Statements of Income

(dollar amounts in thousands, except share data)

	Fiscal Years Ended		
	January 30, 1999	January 31, 1998	February 1, 1997
Sales	$7,123,189	$5,732,145	$4,493,589
Cost of goods sold and occupancy costs	5,365,802	4,353,161	3,410,263
Gross profit	1,757,387	1,378,984	1,083,326
Operating and other expenses:			
Operating and selling	1,023,848	833,046	651,634
Pre-opening	13,836	9,443	8,299
General and administrative	301,627	225,587	175,704
Amortization of goodwill	3,739	3,581	2,291
Merger-related and integration costs	41,000	29,665	—
Store closure charge	49,706	—	—
Interest and other expense, net	17,370	21,955	22,962
Total operating and other expenses	1,451,126	1,123,277	860,890
Income before equity in loss of affiliates and income taxes	306,261	255,707	222,436
Equity in loss of affiliates	—	(5,953)	(11,073)
Income before income taxes	306,261	249,754	211,363
Income tax expense	121,026	81,924	66,621
Net income before minority interest	185,235	167,830	144,742
Minority interest	135	84	—
Net income	$ 185,370	$ 167,914	$ 144,742
Basic earnings per common share			
Historical net income per common share	$ 0.43	$ 0.41	$ 0.36
Diluted earnings per common share			
Historical net income per common share	$ 0.41	$ 0.39	$ 0.35
Pro forma:			
Historical net income	$ 185,370	$ 167,914	$ 144,742
Provision for income taxes on previously untaxed earnings of pooled S-Corporation income	1,814	14,786	15,329
Pro forma net income	$ 183,556	$ 153,128	$ 129,413
Basic earnings per common share			
Pro forma net income per common share	$ 0.43	$ 0.38	$ 0.32
Diluted earnings per common share			
Pro forma net income per common share	$ 0.41	$ 0.36	$ 0.31

See notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

(dollar amounts in thousands, except share data)

	For the Fiscal Years Ended January 30, 1999, January 31, 1998, and February 1, 1997						
	Common Stock	Additional Paid-In Capital	Cumulative Foreign Currency Translation Adjustments	Unrealized Gain (Loss) on Investments	Retained Earnings	Treasury Stock	Comprehensive Income
Balances at February 3, 1996	$159	$ 466,660	$ (2,073)	$ 32	$247,709	$ (346)	
Issuance of common stock for stock options exercised	3	13,726					
Tax benefit on exercise of options		16,773					
Contribution of common stock to Employees' 401(k) Savings Plan		1,998					
Sale of common stock under Employee Stock Purchase Plan		8,980					
Issuance of Performance Accelerated Restricted Stock		532					
Unrealized loss on short-term investments, net of tax				(12)			(12)
Translation adjustments			1,926				1,926
Issuance of common stock for acquisitions and other transactions		164			(242)		
Dividends to shareholders of acquired S-Corp					(24,908)		
Net income for the year					144,742		144,742
Balances at February 1, 1997	$162	$ 508,833	$ (147)	$ 20	$367,301	$ (346)	$146,656
Issuance of common stock for stock options exercised	5	32,178					
Tax benefit on exercise of options		32,873					
Contribution of common stock to Employees' 401(k) Savings Plan		2,318					
Sale of common stock under Employee Stock Purchase Plan		10,499					
Issuance of Performance Accelerated Restricted Stock		7,182					
Unrealized gain on investments, net of tax				1,036			1,036
Translation adjustments			(10,168)				(10,168)
Dividends to shareholders of acquired S-Corp					(25,175)		
Net income for the year					167,914		167,914
Balances at January 31, 1998	$167	$ 593,883	$ (10,315)	$ 1,056	$510,040	$ (346)	$158,782
Issuance of common stock for stock options exercised	5	50,118					
Issuance of common stock for conversion of debentures, net of interest and deferred charges	13	298,520					
Stock split and cash paid in lieu of fractional shares	92	(607)					
Tax benefit on exercise of options		74,157					
Contribution of common stock to Employees' 401(k) Savings Plan		3,288					
Sale of common stock under Employee Stock Purchase Plan		13,210					
Issuance of Performance Accelerated Restricted Stock		10,654					
Unrealized loss on investments, net of tax				(1,049)			(1,049)
Translation adjustments			(1,360)				(1,360)
Purchase and retirement of S-Corporation shares		(29)			(48,073)		
Dividends to shareholders of acquired S-Corp					(15,904)		
Adjustment to conform fiscal year of Quill Corporation					1,888		
Net income for the year					185,370		185,370
Purchase of treasury shares						(7,892)	
Balances at January 30, 1999	$277	$1,043,194	$ (11,675)	$ 7	$633,321	$ (8,238)	$182,961

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(dollar amounts in thousands)

	Fiscal Years Ended		
	January 30, 1999	January 31, 1998	February 1, 1997
Operating activities:			
Net income	$ 185,370	$ 167,914	$ 144,742
Adjustments to reconcile net income to net cash provided by operating activities:			
Minority interest	(135)	(84)	—
Depreciation and amortization	99,207	90,714	61,497
Merger-related and integration costs	41,000	29,665	—
Store closure charge	49,706	—	—
Expense from 401(k) and PARS stock contribution	12,764	10,409	2,715
Equity in loss of affiliates	—	5,953	11,073
Deferred income taxes (benefit)/expense	(55,569)	3,877	3,137
Change in assets and liabilities, net of companies acquired using purchase accounting:			
Increase in merchandise inventories	(211,052)	(227,076)	(171,593)
Decrease (increase) in receivables	(15,993)	17,569	(41,905)
Increase in prepaid expenses and other assets	(9,839)	(5,026)	(7,026)
Increase in accounts payable, accrued expenses and other current liabilities	273,280	293,831	179,803
Increase in other long-term obligations	9,597	5,074	6,303
	192,966	224,906	44,004
Net cash provided by operating activities	378,336	392,820	188,746
Investing activities:			
Acquisition of property and equipment	(322,308)	(190,659)	(212,007)
Acquisition of businesses, net of cash acquired	(13,500)	(79,325)	—
Proceeds from sales and maturities of short-term investments	10,338	13,618	8,800
Purchase of short-term investments	(22,913)	(4,500)	(9,595)
Proceeds from sales and maturities of long-term investments	18,995	265	—
Purchase of long-term investments	(2,545)	(5,714)	(10,036)
Investment in affiliates	—	(3,788)	(18,629)
Acquisition of lease rights	(37,182)	(2,717)	(5,534)
Other	1,208	(11,998)	2,657
Net cash used in investing activities	(367,907)	(284,818)	(244,344)
Financing activities:			
Proceeds from sale of capital stock	63,996	48,043	21,773
Proceeds from borrowings	392,261	965,921	1,171,174
Payments on borrowings	(417,323)	(830,018)	(1,120,670)
Purchase of dissenting shareholder S-Corporation stock	(48,102)	—	—
Purchase of treasury stock	(7,892)	—	—
Dividends to shareholders of acquired S-Corp	(15,904)	(25,175)	(24,908)
Net cash (used in) provided by financing activities	(32,964)	158,771	47,369
Effect of exchange rate changes on cash	(560)	(2,720)	643
Net (decrease) increase in cash and cash equivalents	(23,095)	264,053	(7,586)
Cash and cash equivalents at beginning of period	381,088	117,035	124,621
Cash and cash equivalents at end of period	$ 357,993	$ 381,088	$ 117,035

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

A. Summary of Significant Accounting Policies

Nature of Operations

Staples, Inc. and subsidiaries ("Staples" or "the Company") operates a chain of office supply stores and contract stationer/delivery warehouses throughout North America and in the United Kingdom and Germany.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions are eliminated in consolidation.

Fiscal Year

Staples' fiscal year is the 52 or 53 weeks ending the Saturday closest to January 31. Fiscal years 1998, 1997, and 1996, consisted of the 52 weeks ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. As more fully described in Note L, the statements of income combine Staples' historical operating results for the fiscal years with the corresponding Quill Corporation ("Quill") operating results for the calendar years ended December 31, 1997 and 1996. Accordingly, to conform fiscal years for 1998, an adjustment for Quill's operating results for January 1998 was made to retained earnings.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management of Staples to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents

Staples considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Short-Term Investments

Staples' securities are classified as available for sale and consist principally of high-grade state and municipal securities having an original maturity of more than three months. The investments are carried at fair value, with the unrealized holding gains and losses reported as a component of Staples' stockholders' equity. The cost of securities sold is based on the specific identification method. No individual issue in the portfolio constitutes greater than one percent of the total assets of Staples.

Merchandise Inventories

Merchandise inventories are valued at the lower of weighted-average cost or market.

Receivables

Receivables relate principally to amounts due from vendors under various incentive and promotional programs and trade receivables financed under regular commercial credit terms. Concentrations of credit risk with respect to trade receivables are limited due to Staples' large number of customers and their dispersion across many industries and geographic regions.

Advertising

Staples expenses the production costs of advertising the first time the advertising takes place, except for the direct-response advertising, which is capitalized and amortized over its expected period of future benefits. Direct-response advertising consists primarily of the direct catalog production costs. The capitalized costs of the advertising are amortized over the six month period following the publication of the catalog in which it appears. Direct catalog production costs included in prepaid and other assets totaled $9,854,000 at January 30, 1999 and $7,667,000 at January 31, 1998. Total advertising and marketing expense was $356,928,000, $288,838,000, and $221,000,000 for the years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively.

Notes to Consolidated Financial Statements

Property and Equipment

Property and equipment are recorded at cost. Depreciation and amortization, which includes the amortization of assets recorded under capital lease obligations, are provided using the straight-line method over the estimated useful lives of the assets or the terms of the respective leases. Depreciation and amortization periods are as follows:

Buildings	40 years
Leasehold improvements	10 years or term of lease
Furniture and fixtures	5 to 10 years
Equipment	3 to 10 years

Lease Acquisition Costs

Lease acquisition costs are recorded at cost and amortized on the straight-line method over the respective lease terms, including option renewal periods if renewal of the lease is probable, which range from 5 to 40 years. Accumulated amortization at January 30, 1999 and January 31, 1998 totaled $24,674,000 and $19,483,000, respectively.

Goodwill

Goodwill arising from business acquisitions is amortized on a straight-line basis over 40 years. Accumulated amortization was $13,053,000 and $10,622,000 as of January 30, 1999 and January 31, 1998, respectively. Management periodically evaluates the recoverability of goodwill, which would be adjusted for a permanent decline in value, if any, as measured by the recoverability from projected future cash flows from the acquired businesses.

Pre-opening Costs

Pre-opening costs, which consist primarily of salaries, supplies, marketing, and occupancy costs, are charged to expense as incurred.

Private Label Credit Card Receivables

Staples offers a private label credit card which is managed by a financial services company. Under the terms of the agreement, Staples is obligated to pay fees which approximate the financial institution's cost of processing and collecting the receivables, which are primarily non-recourse to Staples.

Foreign Currency Translation

The assets and liabilities of Staples' foreign subsidiaries, The Business Depot Ltd. ("Business Depot"), Staples UK, and Staples Germany, are translated into U.S. dollars at current exchange rates as of the balance sheet date, and revenues and expenses are translated at average monthly exchange rates. The resulting translation adjustments, and the net exchange gains and losses resulting from the translation of investments in Staples' foreign subsidiaries during the years ended January 30, 1999, January 31, 1998, and February 1, 1997, are recorded in a separate section of stockholders' equity titled "Cumulative foreign currency translation adjustments."

Stock Option Plans

Staples has adopted Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("FAS 123"). As permitted by FAS 123, Staples continues to account for its stock-based plans under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and provides pro forma disclosures of the compensation expense determined under the fair value provisions of FAS 123.

Notes to Consolidated Financial Statements

Earnings Per Share

Staples calculates earnings per share in accordance with Statement of Financial Accounting Standards No. 128 "Earnings per Share" ("FAS 128") which requires disclosure of basic and diluted earnings per share. Basic earnings per share excludes any dilutive effects of options, warrants, and convertible securities, while diluted earnings per share includes such effects. See Note K for the computation of earnings per share for the years ended January 30, 1999, January 31, 1998, and February 1, 1997.

Fair Value of Financial Instruments

Pursuant to Statement of Financial Accounting Standards No. 107, "Disclosure About Fair Value of Financial Instruments" ("FAS 107"), Staples has estimated the fair value of its financial instruments using the following methods and assumptions:

- The carrying amount of cash and cash equivalents, receivables and accounts payable approximates fair value;
- The fair values of short-term investments and the 4½% Convertible Subordinated Debentures are based on quoted market prices;
- The carrying amounts of Staples' debt approximates fair value, estimated by discounted cash flow analyses based on Staples' current incremental borrowing rates for similar types of borrowing arrangements.

Long-Lived Assets

Staples adopted Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of" ("FAS 121"), which requires impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flow estimated to be generated by those assets are less than the assets' carrying amount. Staples' policy is to evaluate long-lived assets for impairment at a store level.

Comprehensive Income

Effective February 1, 1998, Staples adopted SFAS No. 130 "Reporting Comprehensive Income" ("SFAS 130"). SFAS 130 establishes new rules for the reporting and display of comprehensive income and its components. The adoption of SFAS 130 had no impact on Staples' net income or shareholders' equity. SFAS 130 requires Staples to report comprehensive income which includes net income, foreign currency translation adjustments and unrealized gains and losses on short-term investments, to be reported separately in stockholders' equity.

Segment Reporting

Effective February 1, 1998, Staples adopted the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("Statement 131"). Statement 131 superseded FASB Statement No. 14, "Financial Reporting for Segments of a Business Enterprise." Statement 131 establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports. Statement 131 also establishes standards for related disclosures about products and services, geographic areas, and major customers. The adoption of Statement 131 did not affect the results of operations or financial position, but did affect the disclosure of segment information. See Note N.

B. Investments

The following is a summary of available-for-sale investments as of January 30, 1999 and January 31, 1998 *(in thousands)*:

January 30, 1999	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Short-term:				
Municipal obligations	$10,515	$ 46	$ —	$10,561
Agency Bonds	6,902	7	(42)	6,867
Total short-term	$17,417	$ 53	$(42)	$17,428

January 31, 1998	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Short-term:				
Certificates of deposit	$ 3,236	$ —	$ —	$ 3,236
Debt securities	2,659	7	—	2,666
Total short-term	$ 5,895	$ 7	$ —	$ 5,902
Long-term:				
Municipal obligations	$ 9,986	$ 125	$ (7)	$10,104
Equity securities	4,061	950	(15)	4,996
Money market instruments	1,350	—	—	1,350
Total long-term	$15,397	$1,075	$(22)	$16,450

Proceeds from the sale of investment securities were $14,599,000 and $265,000 during the years ended January 30, 1999 and January 31, 1998, respectively. Other reductions in the cost balance resulted from maturities of securities. The net adjustment to unrealized holding gains and losses on available-for-sale investments included as a separate component of stockholders' equity totaled $(1,049,000) and $1,036,000 for the years ended January 30, 1999 and January 31, 1998, respectively.

The amortized cost and estimated fair value of debt and marketable equity securities at January 30, 1999, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because the issuers of securities may have the right to prepay obligations without prepayment penalties.

	Cost	Estimated Fair Value
Due in one year or less	$17,417	$17,428

Notes to Consolidated Financial Statements

C. Accrued Liabilities

Accrued liabilities consist of the following *(in thousands)*:

	January 30, 1999	January 31, 1998
Taxes	$114,179	$ 76,118
Acquisition and store closure reserves	91,484	16,596
Employee related	88,551	63,126
Advertising and direct marketing	30,543	24,845
Other	113,554	85,338
Total	$438,311	$266,023

D. Long-Term Debt and Credit Agreement

Long-term debt consists of the following *(in thousands)*:

	January 30, 1999	January 31, 1998
Capital lease obligations and other notes payable in monthly installments with effective interest rates from 4% to 16%; collateralized by the related equipment	$ 7,760	$ 14,909
Note payable with a fixed rate of 6.16%	—	25,000
Senior notes with a fixed rate of 7.125%	200,000	200,000
Mortgage notes at various rates	—	13,805
Lines of credit	29,849	8,746
	$237,609	$262,460
Less current portion	32,594	43,501
	$205,015	$218,959

Aggregate annual maturities of long-term debt and capital lease obligations are as follows *(in thousands)*:

Fiscal year:	Total
1999	$ 32,594
2000	1,579
2001	434
2002	308
2003	311
Thereafter	202,383
	$237,609

Included in property and equipment are capital lease obligations for equipment recorded at the net present value of the minimum lease payments of $20,664,000. Future minimum lease payments of $3,001,000 excluding $201,000 of interest, are included in aggregate annual maturities shown above. Staples did not enter into any new capital lease agreements during the fiscal year ended January 30, 1999. New capital lease agreements totaling $2,770,000 were entered into during the fiscal year ended January 31, 1998.

Senior Notes

Staples issued $200,000,000 of senior notes (the "Notes") on August 12, 1997 with an interest rate of 7.125% payable semi-annually on February 15 and August 15 of each year commencing on February 15, 1998. The Notes are due August 15, 2007. Net proceeds of approximately $198,000,000 from the sale of Staples' Notes were used for repayment of indebtedness under Staples' revolving credit facility and for general working capital purposes, including the financing of new store openings, distribution facilities, and corporate offices.

Credit Agreements

Effective November 13, 1997, Staples entered into a revolving credit facility, effective through November 2002, with a syndicate of banks, which provides up to $350,000,000 of borrowings. Borrowings made pursuant to this facility will bear interest at either the lead bank's prime rate, the federal funds rate plus 0.50%, the LIBOR rate plus a percentage spread based upon certain defined ratios, a competitive bid rate, or a swing line loan rate. This agreement, among other conditions, contains certain restrictive covenants including net worth maintenance, minimum fixed charge interest coverage and limitations on indebtedness and sales of assets. As of January 30, 1999, no borrowings were outstanding under the revolving credit facility. Staples also has available $35,000,000 in uncommitted, short-term bank credit lines, of which no borrowings were outstanding as of January 30, 1999. Staples UK has a $50,000,000 line of credit which had an outstanding balance of $29,849,000 at January 30, 1999 and Business Depot has a $16,545,000 line of credit with no outstanding balance at January 30, 1999.

Interest paid by Staples totaled $29,600,000, $23,012,000, and $22,501,000 for the fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. Capitalized interest totaled $2,254,000, $1,387,000 and $611,000 in the years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively.

E. Convertible Debentures

On October 5, 1995, Staples issued $300,000,000 of 4½% Convertible Subordinated Debentures due October 1, 2000 with interest payable semi-annually (the "4½% Debentures"). During fiscal 1998, $299,995,000 of Staples' $300,000,000 of 4½% Debentures were converted into an aggregate of 30,674,276 shares of common stock at a conversion price of $9.78 per share. The remaining $5,000 were called at par value plus a premium of 1.8% and accrued interest. The total principal amount converted was credited to common stock and additional paid-in capital, net of unamortized expenses of the original debt issue and accrued but unpaid interest.

F. Stockholders' Equity

On November 12, 1998, December 30, 1997, March 5, 1996, and June 29, 1995, the Board of Directors approved three-for-two splits of Staples' common stock to be effected in the form of 50% stock dividends. The dividends were distributed on January 28, 1999 to shareholders of record as of January 18, 1999, January 30, 1998 to shareholders of record as of January 20, 1998, March 25, 1996 to shareholders of record as of March 15, 1996, and July 24, 1995 to shareholders of record as of July 14, 1995, respectively. The consolidated financial statements have been retroactively restated to give effect to these stock splits.

During fiscal year 1998, Staples purchased treasury stock of $7,892,000 from employees and directors to fund the income taxes incurred by those employees and directors associated with the vesting of performance accelerated restricted stock (PARS).

At January 30, 1999, 72,614,501 shares of common stock were reserved for issuance under Staples' stock option, 401(k), employee stock purchase and director stock option plans.

G. Employee Benefit Plans

Staples elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under FASB Statement No. 123, "Accounting for Stock-Based Compensation" requires use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, since the exercise price of Staples' employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Employee Stock Purchase Plan

Staples' 1998 Employee Stock Purchase Plan authorizes a total of up to 6,000,000 shares of Staples' common stock to be sold to participating employees. Participating employees may purchase shares of common stock at 85% of its fair market value at the beginning or end of an offering period, whichever is lower, through payroll deductions in an amount not to exceed 10% of an employee's base compensation. Staples' 1994 Employee Stock Purchase Plan expired during 1998.

Stock Option Plans

Under Staples' 1992 Equity Incentive Plan ("1992 Plan") Staples may grant to management and key employees incentive and nonqualified options to purchase up to 87,750,000 shares of common stock and Performance Accelerated Restricted Stock ("PARS"). This amount was approved by the shareholders of Staples on June 18, 1997. As of February 27, 1997, Staples' 1987 Stock Option Plan (the "1987 Plan") expired; unexercised options under this plan however remain outstanding. The exercise price of options granted under the plans may not be less than 100% of the fair market value of Staples' common stock at the date of grant. Options generally have an exercise price equal to the fair market value of the common stock on the date of grant. Some options outstanding are exercisable at various percentages of the total shares subject to the option starting one year after the grant, while other options are exercisable in their entirety three to five years after the grant date. All options expire ten years after the grant date, subject to earlier termination in the event of employment termination.

Staples' 1990 Director Stock Option Plan ("Director's Plan") authorizes shares of common stock to be issued to non-employee directors. The exercise price of options granted is equal to the fair market value of Staples' common stock at the date of grant. Options become exercisable in equal amounts over four years and expire ten years from the date of grant, subject to earlier termination, in certain circumstances, in the event the optionee ceases to serve as a director.

Pro forma information regarding net income and earnings per share is required by FAS 123, which also requires that the information be determined as if Staples has accounted for its employee stock options granted subsequent to January 28, 1995 under the fair valued method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 1996, 1997, and 1998: risk-free interest rates ranging from 5.21% to 6.12%; volatility factor of the expected market price of Staples' common stock of .30 for fiscal year 1996, .35 for fiscal year 1997, and .36 for fiscal year 1998; and a weighted-average expected life of the option of 4.0 years for the 1987 Plan and the 1992 Plan and 2.0 to 5.0 years for the Director's Plan.

Notes to Consolidated Financial Statements

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. For purposes of FAS 123's disclosure requirements, the Employee Stock Purchase Plan is considered a compensatory plan. The expense was calculated based on the fair value of the employees' purchase rights. Staples' pro forma information, which includes the pro forma results of Quill, follows *(in thousands except for earnings per share information)*:

	January 30, 1999	January 31, 1998	February 1, 1997
Pro forma net income	$156,265	$138,983	$122,116
Pro forma basic earnings per common share	$ 0.36	$ 0.34	$ 0.31
Pro forma diluted earnings per common share	$ 0.35	$ 0.33	$ 0.30

This pro forma impact only takes into account options granted since January 28, 1995 and is likely to increase in future years as additional options are granted and amortized ratably over the vesting period.

Information with respect to options granted under the above plans is as follows:

	Number of Shares	Weighted-Average Exercise Price Per Share
Outstanding at February 3, 1996	47,220,579	$ 3.29
Granted	7,171,937	8.82
Exercised	(6,140,543)	2.29
Canceled	(2,357,118)	4.89
Outstanding at February 1, 1997	45,894,855	$ 4.26
Granted	9,656,558	10.43
Exercised	(10,147,409)	2.78
Canceled	(2,807,883)	7.43
Outstanding at January 31, 1998	42,596,121	$ 5.34
Granted	13,698,644	20.22
Exercised	(13,965,713)	3.64
Canceled	(1,938,669)	11.55
Outstanding at January 30, 1999	40,390,383	$11.58

Notes to Consolidated Financial Statements

The following table summarizes information concerning currently outstanding and exercisable options:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$ 0.53 - $ 3.56	5,083,310	4.14	$ 2.76	5,083,310	$ 2.76
$ 3.65 - $ 5.56	4,542,693	5.67	$ 4.10	4,509,999	$ 4.09
$ 5.70 - $ 8.30	4,800,123	6.45	$ 8.06	3,392,963	$ 8.12
$ 8.37 - $ 9.17	4,623,599	7.56	$ 9.11	22,627	$ 8.57
$ 9.47 - $ 9.83	229,980	8.10	$ 9.64	0	$ 0.00
$10.28 - $10.28	5,734,482	8.57	$10.28	1,125	$10.28
$10.44 - $19.42	3,004,779	8.72	$12.92	26,928	$10.82
$20.08 - $20.08	10,699,422	9.42	$20.08	0	$ 0.00
$20.75 - $27.71	1,511,123	9.83	$23.10	0	$ 0.00
$29.13 - $29.13	160,872	10.01	$29.13	0	$ 0.00
$ 0.53 - $29.13	40,390,383	7.60	$11.58	13,036,952	$ 4.64

The weighted-average fair values of options granted during the years ended January 30, 1999, January 31, 1998, and February 1, 1997 were $7.18, $3.80 and $3.81 respectively. Exercise prices for the options outstanding as of January 30, 1999 ranged from $0.53 to $29.13.

Performance Accelerated Restricted Stock ("PARS")

PARS are shares of Staples' Common Stock granted outright to employees and non-employee directors without cost to the employee or director. The shares, however, are restricted in that they are not transferable (e.g. they may not be sold) by the employee or director until they vest, generally after the end of five years. Such vesting date may accelerate if Staples achieves certain compound annual earnings per share growth over a certain number of interim years. If the employee leaves Staples, or the director ceases to serve as a director of Staples, prior to the vesting date for any reason, the PARS shares will be forfeited by the employee or director, as the case may be, and will be returned to Staples. Once the PARS have vested, they become unrestricted and may be transferred and sold like any other Staples shares.

PARS issued in the fiscal year ended January 30, 1999 totaling approximately 1,381,000 shares which have a weighted-average fair value of $17.56, initially vest on February 1, 2003 or will accelerate on May 1, in 2000, 2001, or 2002 upon attainment of certain compound annual earnings per share targets in the prior fiscal year. PARS totaling approximately 798,000 shares which have a weighted-average fair value of $12.47, issued in fiscal year 1997 will vest on May 1, 1999 as a result of Staples achieving its target earnings goal for the fiscal year ended January 30, 1999.

In connection with the issuance of the PARS, Staples included $9,796,000, $7,496,000, and $532,000 in compensation expense for the fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively.

Employees' 401(k) Savings Plan

Under Staples' Employees' 401(k) Savings Plan (the "401(k) Plan"), and Supplemental Executive Retirement Plan (the "SERP Plan"), Staples may contribute up to a total of 2,503,125 shares of common stock to these plans. The 401(k) Plan is available to all employees of Staples who meet minimum age and length of service requirements. Company contributions are based upon a matching formula applied to employee contributions, with additional contributions made at the discretion of the Board of Directors. In connection with these plans Staples included approximately $3,000,000 in expense for fiscal year ended January 30, 1999 and $2,000,000 in expense for each of the fiscal years ended January 31, 1998 and February 1, 1997.

H. Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components and the approximate tax effect of Staples' deferred tax assets and liabilities as of January 30, 1999 and January 31, 1998, are as follows *(in thousands)*:

	January 30, 1999	January 31, 1998
Deferred tax assets:		
Inventory	$ 27,328	$20,116
Deferred rent	19,713	14,797
Acquired NOLs	8,743	7,132
Other net operating loss carryforwards	27,259	22,907
Insurance	7,639	5,967
Employee benefits	9,746	5,569
Merger-related charges	10,823	—
Store closure charge	20,274	—
Other–net	17,711	13,660
Total deferred tax assets	149,236	90,148
Deferred tax liabilities:		
Depreciation	(2,312)	(6,687)
Other–net	(5,164)	(4,835)
Total deferred tax liabilities	(7,476)	(11,522)
Total valuation allowance	(37,765)	(30,067)
Net deferred tax assets	$103,995	$48,559

Net deferred tax assets of approximately $4,500,000 attributable to businesses acquired during the fiscal year ended January 31, 1998 were allocated directly to reduce goodwill generated by these acquisitions. The deferred tax assets disclosed as acquired NOLs and other net operating loss carryforwards, totaling $36,002,000, have been fully reserved due to the uncertainty of the realization of the asset within the local country jurisdiction. Further, if this asset is utilized when income is earned within the foreign jurisdiction, Staples will not have a consolidated tax benefit, as Staples will be required to pay U.S. income taxes on the income offset by the foreign NOL.

Notes to Consolidated Financial Statements

For financial reporting purposes, income before taxes includes the following components *(in thousands)*:

Fiscal Year Ended	January 30, 1999	January 31, 1998	February 1, 1997
Pretax income:			
United States	$262,067	$213,549	$187,644
Foreign	44,194	36,205	23,719
	$306,261	$249,754	$211,363

The provision for income taxes consists of the following *(in thousands)*:

Fiscal Year Ended	January 30, 1999	January 31, 1998	February 1, 1997
Current tax expense:			
Federal	$135,922	$ 53,248	$ 50,546
State	18,875	10,707	12,337
Foreign	21,798	14,092	601
	176,595	78,047	63,484
Deferred tax expense (benefit)	(55,569)	3,877	3,137
Total	$121,026	$ 81,924	$ 66,621

A reconciliation of the federal statutory tax rate to Staples' effective tax rate on historical net income is as follows:

Fiscal Year Ended	January 30, 1999	January 31, 1998	February 1, 1997
Federal statutory rate	35.0%	35.0%	35.0%
State taxes, net of federal benefit	6.0%	6.0%	6.3%
Tax exempt interest	(0.5%)	(0.5%)	(0.4%)
Tax benefit of loss carryforward	(0.0%)	(0.0%)	(0.2%)
Income of S-Corporation	(0.6%)	(5.7%)	(7.0%)
Other	(0.4%)	(2.0%)	(2.2%)
Effective tax rate	39.5%	32.8%	31.5%

A reconciliation of the federal statutory tax rate to Staples' effective tax rate on pro forma net income is as follows:

Fiscal Year Ended	January 30, 1999	January 31, 1998	February 1, 1997
Federal statutory rate	35.0%	35.0%	35.0%
State taxes, net of federal benefit	6.0%	6.0%	6.3%
Tax exempt interest	(0.5%)	(0.5%)	(0.4%)
Tax benefit of loss carryforward	(0.0%)	(0.0%)	(0.2%)
Other	(0.4%)	(1.8%)	(1.9%)
Effective tax rate	40.1%	38.7%	38.8%

Notes to Consolidated Financial Statements

Income tax payments were $94,729,602, $23,487,877, and $45,925,276, during fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively. Staples has net operating losses of approximately $101,300,000 that can be carried forward indefinitely, $21,900,000 of which is attributable to Staples' increased ownership in Staples UK and Staples Germany.

Undistributed earnings of Staples' foreign subsidiaries amounted to approximately $54,700,000 at January 30, 1999. Those earnings are considered to be indefinitely reinvested and, accordingly, no provision for U.S. federal and state income taxes has been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, Staples would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the various foreign countries. Determination of the amount of unrecognized deferred U.S. income tax liability is not practicable because of the complexities associated with its hypothetical calculation. Withholding taxes of approximately $1,800,000 would be payable upon remittance of all previously unremitted earnings at January 30, 1999.

I. Leases and Other Off- Balance Sheet Commitments

Staples leases certain retail and support facilities under long-term noncancellable lease agreements. Most lease agreements contain renewal options and rent escalation clauses and require Staples to pay real estate taxes in excess of specified amounts and, in some cases, allow termination within a certain number of years with notice and a fixed payment. Certain agreements provide for contingent rental payments based on sales.

Other long-term obligations at January 30, 1999 include $49,000,000 relating to future rent escalation clauses and lease incentives under certain existing store operating lease arrangements. These rent expenses are recognized following the straight-line basis over the respective terms of the leases. Future minimum lease commitments for retail and support facilities (including lease commitments for 116 retail stores not yet opened at January 30, 1999) under noncancellable operating leases are due as follows *(in thousands)*:

Fiscal year	
1999	$ 271,741
2000	294,675
2001	290,547
2002	280,104
2003	276,425
Thereafter	2,439,592
	$3,853,084

Rent expense approximated $234,609,000, $193,990,000, and $142,508,000, for the fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997, respectively.

Letters of credit are issued by Staples during the ordinary course of business through major financial institutions as required by certain vendor contracts. As of January 30, 1999, Staples had available open letters of credit totaling $7,923,000.

Notes to Consolidated Financial Statements

J. Quarterly Summary (Unaudited)

(in thousands, except per share amounts)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Fiscal Year Ended January 30, 1999				
Sales	$1,670,611	$1,475,705	$1,899,770	$2,077,103
Gross Profit	388,015	354,925	475,913	538,534
Net income	35,950	8,974(1)	69,186	71,260(4)
Pro forma net income	34,136(2)	8,974(1)	69,186	71,260(4)
Basic earnings per share				
Historical net income per common share	$ 0.09	$ 0.02	$ 0.16	$ 0.16(4)
Pro forma net income per common share	$ 0.08	$ 0.02	$ 0.16	$ 0.16(4)
Number of shares used in computing earnings per common share	419,027	423,959	426,184	448,074
Diluted earnings per share				
Historical net income per common share	$ 0.08(3)	$ 0.02	$ 0.15(3)	$ 0.15(4)
Pro forma net income per common share	$ 0.08(3)	$ 0.02	$ 0.15(3)	$ 0.15(4)
Number of shares used in computing earnings per common share	461,616(3)	436,550	469,768(3)	473,490
Fiscal Year Ended January 31, 1998				
Sales	$1,292,721	$1,192,339	$1,552,393	$1,694,692
Gross Profit	304,666	286,621	375,471	412,226
Net income	19,777(1)	22,759(1)	52,030	73,348
Pro forma net income	15,229(2)	19,577(2)	48,602(2)	69,720(2)
Basic earnings per share				
Historical net income per common share	$ 0.05	$ 0.06	$ 0.13	$ 0.18
Pro forma net income per common share	$ 0.04	$ 0.05	$ 0.12	$ 0.17
Number of shares used in computing earnings per common share	403,570	405,233	409,231	414,358
Diluted earnings per share				
Historical net income per common share	$ 0.05	$ 0.05	$ 0.12(3)	$ 0.17(3)
Pro forma net income per common share	$ 0.04	$ 0.05	$ 0.11(3)	$ 0.16(3)
Number of shares used in computing earnings per common share	416,026	418,787	452,352(3)	458,508(3)

(1) *Net income for the quarter ended August 1, 1998 includes a pre-tax charge of $41,000 resulting from costs incurred in connection with the merger with Quill Corporation. Net income for the quarters ended May 3, 1997 and August 2, 1997 include a pre-tax charge of $20,562 and $9,103, respectively, resulting from costs incurred in connection with the then proposed merger with Office Depot, Inc.*

(2) *Pro forma net income includes the earnings of Quill with provision for income taxes on previously untaxed earnings of pooled S-Corporation income.*

(3) *Earnings per share—assuming dilution is calculated considering the $300 million of 4½% Convertible Subordinated Debentures as common stock equivalents for the quarters ended January 30, 1999, October 31, 1998, May 2, 1998, January 31, 1998, and November 1, 1997. The Debentures are not considered in the calculation of the earnings per share for the other quarters above as the effect is antidilutive.*

(4) *Net income for the quarter ended January 30, 1999 includes a pre-tax charge of $49,706 resulting from a store closure charge.*

K. Computation of Earnings Per Common Share

The computation of basic earnings per common share and diluted earnings per common share, for the fiscal years ended January 30, 1999, January 31, 1998, and February 1, 1997 is as follows *(amounts in thousands, except for per share data)*:

Historical Earnings Per Share	January 30, 1999	January 31, 1998	February 1, 1997
Numerator:			
Net income	$ 185,370	$ 167,914	$ 144,742
Effect of dilutive securities:			
4½% convertible debentures[1]	7,451	9,365	9,373
Numerator for diluted earnings per common share—income available to common stockholders after assumed conversion	$ 192,821	$ 177,279	$ 154,115
Denominator:			
Weighted-average shares	429,308,638	408,095,647	399,620,073
Performance accelerated restricted stock	2,314	2,330	—
Denominator for basic earnings per common share—weighted-average shares	429,310,952	408,097,977	399,620,073
Effect of dilutive securities:			
Incremental and windfall shares	12,648,979	12,769,769	14,270,139
Performance accelerated restricted stock	208,300	209,592	—
4½% convertible debentures	25,856,165	30,681,819	30,681,819
Dilutive potential common shares	38,713,444	43,661,180	44,951,958
Denominator for diluted earnings per common share—adjusted weighted-average shares and assumed conversions	468,024,396	451,759,157	444,572,031
Basic earnings per common share	$ 0.43	$ 0.41	$ 0.36
Diluted earnings per common share	$ 0.41	$ 0.39	$ 0.35

Pro forma Earnings Per Share	January 30, 1999	January 31, 1998	February 1, 1997
Numerator:			
Net income	$ 183,556	$ 153,128	$ 129,413
Effect of dilutive securities:			
4½% convertible debentures(1)	7,451	9,365	9,373
Numerator for diluted earnings per common share—income available to common stockholders after assumed conversion	$ 191,007	$ 162,493	$ 138,786
Denominator:			
Weighted-average shares	429,308,638	408,095,647	399,620,073
Performance accelerated restricted stock	2,314	2,330	—
Denominator for basic earnings per common share—weighted-average shares	429,310,952	408,097,977	399,620,073
Effect of dilutive securities:			
Incremental and windfall shares	12,648,979	12,769,769	14,270,139
Performance accelerated restricted stock	208,300	209,592	—
4½% convertible debentures	25,856,165	30,681,819	30,681,819
Dilutive potential common shares	38,713,444	43,661,180	44,951,958
Denominator for diluted earnings per common share—adjusted weighted-average shares and assumed conversions	468,024,396	451,759,157	444,572,031
Basic earnings per common share	$ 0.43	$ 0.38	$ 0.32
Diluted earnings per common share	$ 0.41	$ 0.36	$ 0.31

(1) *The 4½% Debentures were substantially converted into common stock on December 2, 1998 (see Note D). For the computation of earnings per common share, this conversion of 30,674,276 shares is assumed to have occurred at the beginning of the fiscal year (February 1, 1998), and is included in the weighted-average shares outstanding for the year. Therefore, the interest expense and amortization of deferred charges related to the 4½% Debentures incurred by Staples through December 2, 1998, net of tax, is added back to reported net income to compute earnings per common share for each fiscal year presented above.*

L. Business Acquisitions

On May 21, 1998, Staples acquired Quill. The Merger was structured as an exchange of shares in which the stockholders of Quill received approximately 26 million shares of Staples' common stock, at an exchange ratio established at a combination of fixed and variable prices, and cash paid to dissenting shareholder of approximately $48,000,000, which equates to a purchase price of approximately $690,000,000. The Merger was accounted for as a pooling of interests and, accordingly, Staples' consolidated financial statements have been restated to include the operations of Quill for all periods prior to the merger. The statements of income combine Staples' historical operating results for the fiscal years ended January 31, 1998 and February 1, 1997 with the corresponding Quill operating results for the years ended December 31, 1997 and 1996, respectively. Prior to the acquisition, Quill elected to be taxed as an S Corporation under the Internal Revenue Code. Accordingly, the current taxable income of Quill was taxable to its shareholders who were responsible for the payment of taxes thereon. Quill will be included in Staples' U.S. federal income tax return subsequent to the date of the acquisition. Pro forma adjustments have been made to the restated statements of operations to reflect the income taxes that would have been provided had Quill been subject to income taxes.

In connection with the acquisition of Quill, Staples committed to a plan that results in the integration of the two businesses. As a result of the acquisition and integration plan, Staples recorded a charge to operating expense of $41,000,000 during the year ended January 30, 1999. These costs consist of direct merger-related and integration costs from the transaction. The merger transaction costs of approximately $10,500,000 consist primarily of fees for investment bankers, attorneys, accountants, and other related charges. The integration costs primarily include employee costs of approximately $7,000,000, contract and lease termination costs of approximately $14,100,000, the write-down of leasehold improvements of approximately $3,500,000 and other merger-related costs of approximately $5,900,000. Through January 30, 1999, Staples paid approximately $14,000,000 which consists primarily of transaction and employee related costs.

Separate net sales and net income of the merged entities prior to the merger are presented in the following table *(in thousands)*:

	January 31, 1998	February 1, 1997
Net sales:		
Staples	$5,181,035	$3,967,665
Quill	551,110	525,924
Combined	$5,732,145	$4,493,589
Net income		
Staples	$ 130,949	$ 106,420
Quill	36,965	38,322
Combined	$ 167,914	$ 144,742
Pro forma net income		
Staples	$ 130,949	$ 106,420
Quill(1)	22,179	22,993
Combined	$ 153,128	$ 129,413

(1) *Reflects adjustment for provision for income taxes on previously untaxed earnings.*

M. Store Closure Charge

In the fourth quarter 1998, Staples committed to a plan to relocate certain stores which cannot be expanded and upgraded to Staples "Concept 97" model and reported a pre-tax store closure charge of $49,706,000. The charge includes $29,620,000 for future rental payments under operating lease agreements that will be paid after the store is closed and will not be subsidized by subtenant income, $4,966,000 in fees, settlement costs and other expenses related to store closure and $15,120,000 in asset impairment charges. Lease agreements for the relocation sites will be executed during fiscal year 1999 and the stores will be closed and relocated during fiscal years 1999 and 2000.

As a result of Staples' commitment to exit these stores, the Company evaluated the long-lived assets at each location in accordance with FAS 121. The analysis indicated that the long-lived assets of the designated stores were impaired. Accordingly, Staples estimated the fair value of these assets based on discounted cash flows and recorded an impairment charge of $15,120,000, which is included in the store closure charge. Staples will continue to depreciate these assets based on their revised useful life.

N. Description of the Types of Products and Services from Which Each Reportable Segment Derives Its Revenues

Staples has three reportable segments: North America Retail, North America Delivery Operations, and European Operations. Staples' North America Retail division consists of two operating units that operate stores throughout the U.S. and Canada. Staples' North America Delivery Operations division consists of four operating units that sell office products and supplies directly to businesses. The European Operations segment consists of two operating units which operate office supply stores and sell directly to businesses throughout the United Kingdom and Germany.

Notes to Consolidated Financial Statements

Measurement of Segment Profit or Loss and Segment Assets

Staples evaluates performance and allocates resources based on profit or loss from operations before income taxes, not including gains and losses on Staples' investment portfolio. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Intersegment sales and transfers are recorded at Staples' cost, therefore there is no intercompany profit or loss recognized on these transactions.

Factors Management Used to Identify the Enterprise's Reportable Segments

Staples' reportable segments are business units that distribute office products in different manners. The reportable segments are each managed separately because they distribute products to different classes of customer with different distribution methods. The European operations are considered a separate operating segment because of the significant difference in the operating environment from the North American operations.

Information about segment profit/loss and segment assets *(in thousands)*:

Year ended January 30, 1999:	N. America Retail	N. America Delivery Operations	European Operations	All Other[(1)]	Totals
Revenues from external customers	$4,867,124	$1,914,975	$341,090	$ —	$7,123,189
Merger and store closure	49,706	41,000	—	—	90,706
Depreciation expense	67,208	5,164	6,818	—	79,190
Segment profit (loss)	381,900	118,548	(17,077)	(177,110)	306,261
Segment assets	2,886,114	448,452	162,693	—	3,497,259
Expenditures for long-lived assets	307,817	1,362	13,129	—	322,308

Year ended January 31, 1998:	N. America Retail	N. America Delivery Operations	European Operations	All Other[(1)]	Totals
Revenues from external customers	$3,854,745	$1,652,215	$225,185	$ —	$5,732,145
Merger expenses	—	—	—	29,665	29,665
Depreciation expense	52,479	3,908	4,358	—	60,745
Segment profit (loss)	319,939	112,031	(8,049)	(174,167)	249,754
Segment assets	2,432,696	386,053	130,088	—	2,948,837
Expenditures for long-lived assets	173,767	7,527	43,932	—	225,226

(1) *All other includes corporate general and administrative expenses and in the year ended January 31, 1998 merger-related costs in connection with the then proposed merger with Office Depot, Inc. of $29,665,000.*

Assets	January 30, 1999	January 31, 1998
Total assets for reportable segments	$3,497,259	$2,948,837
Elimination of intercompany receivables	(89,664)	(114,504)
Elimination of intercompany investments	(228,329)	(195,471)
Total consolidated assets	$3,179,266	$2,638,862

Geographic Information

Year ended January 30, 1999:	Revenues	Long-Lived Assets
North America	$6,782,099	$1,027,704
Europe	341,090	35,913
Consolidated Total	$7,123,189	$1,063,617

Year ended January 31, 1998:	Revenues	Long-Lived Assets
North America	$5,506,959	$ 762,371
Europe	225,186	30,888
Consolidated Total	$5,732,145	$ 793,259

O. Guarantor Subsidiaries

The 7.125% senior notes due August 15, 2007 and the obligations under the $350,000,000 revolving credit facility effective through November, 2002 with a syndicate of banks are fully and unconditionally guaranteed on an unsecured, joint and several basis by certain wholly owned subsidiaries of Staples (the “Guarantor Subsidiaries”). The following condensed consolidating financial data illustrates the composition of Staples, Inc. (the “Parent Company”), Guarantor Subsidiaries, and non-guarantor subsidiaries as of and for the year ended January 30, 1999. Prior to February 1, 1998 the Company’s debt was registered with Staples, Inc., which held the assets and operations that guaranteed the related debt, therefore the consolidated financial statements represent those of Staples and separate disclosure is not necessary for the years ended January 31, 1998 and February 1, 1997. The non-guarantor subsidiaries represent more than an inconsequential portion of the consolidated assets and revenues of Staples. Separate complete financial statements of the respective Guarantors Subsidiaries would not provide additional information which would be useful in assessing the financial condition of the Guarantor Subsidiaries and thus, are not presented.

Investments in subsidiaries are accounted for by the Parent Company on the equity method for purposes of the supplemental consolidating presentation. Earnings of subsidiaries are, therefore, reflected in the Parent Company’s investment accounts and earnings. The principal elimination entries eliminate the Parent Company’s investment in subsidiaries and intercompany balances and transactions.

Notes to Consolidated Financial Statements

Condensed Consolidated Statement of Income

For the year ended January 30, 1999 *(in thousands)*	Staples, Inc. (Parent Co.)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidated
Sales	$ —	$5,428,414	$1,694,775	$7,123,189
Cost of goods sold and occupancy costs	1,477	4,079,847	1,284,478	5,365,802
Gross profit	(1,477)	1,348,567	410,297	1,757,387
Operating and other expenses	30,096	1,106,734	314,296	1,451,126
Income before income taxes	(31,573)	241,833	96,001	306,261
Provision for income taxes	24,057	(98,808)	(46,275)	(121,026)
Minority interest	—	—	135	135
Net income	$ (7,516)	$ 143,025	$ 49,861	$ 185,370

Condensed Consolidating Balance Sheet

As of January 30, 1999 *(in thousands)*	Staples, Inc. (Parent Co.)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash, cash equivalents and short-term investments	$ 219,426	$ 16,348	$ 139,647	$ —	$ 375,421
Merchandise inventories	(5,561)	1,095,906	250,087	—	1,340,432
Other current assets and Intercompany	780,629	396,920	552,395	(1,381,697)	348,247
Total current assets	994,494	1,509,174	942,129	(1,381,697)	2,064,100
Net property, equipment and other assets	271,129	710,049	362,178	(228,190)	1,115,166
Total assets	$1,265,623	$2,219,223	$1,304,307	$(1,609,887)	$3,179,266
Total current liabilities	$ 86,206	$ 830,728	$ 266,789	$ 81,609	$1,265,332
Total long-term liabilities	7,581	237,128	12,339	—	257,048
Total stockholders' equity	1,171,836	1,151,367	1,025,179	(1,691,496)	1,656,886
Total liabilities and stockholders' equity	$1,265,623	$2,219,223	$1,304,307	$(1,609,887)	$3,179,266

Condensed Consolidated Statement of Cash Flows

For the year ended January 30, 1999 *(in thousands)*	Staples, Inc. (Parent Co.)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidated
Net cash (used in)/provided by operating activities	$(136,712)	$ 336,445	$ 178,603	$ 378,336
Investing activities:				
Acquisition of property, equipment and lease rights	(62,535)	(261,575)	(35,380)	(359,490)
Other	211,299	(66,776)	(152,940)	(8,417)
Cash (used in)/provided by investing activities	148,764	(328,351)	(188,320)	(367,907)
Financing activities:				
Payments on borrowings	(393,713)	—	(23,610)	(417,323)
Other	411,835	—	(27,476)	384,359
Cash provided by/(used in) financing activities	18,122	—	(51,086)	(32,964)
Effect of exchange rate changes on cash	—	—	(560)	(560)
Net increase (decrease) in cash	30,174	8,094	(61,363)	(23,095)
Cash and cash equivalents at beginning of period	189,252	8,253	183,583	381,088
Cash and cash equivalents at end of period	$ 219,426	$ 16,347	$ 122,220	$ 357,993

P. Subsequent Events

On February 26, 1999, Staples completed the acquisition of Claricom Holdings, Inc. and certain related entities (“Claricom”) for a purchase price of approximately $140,000,000. The acquisition will be accounted for using the purchase method. Claricom is a full-service supplier of telecommunications services to small and medium sized businesses in the United States.

On March 4, 1999 the Board of Directors approved a stock repurchase program intended to provide shares for employee stock programs. Staples expects to repurchase approximately six million shares annually.

Report of Independent Auditors

Board of Directors and Shareholders
Staples, Inc.

We have audited the accompanying consolidated balance sheets of Staples, Inc. and subsidiaries as of January 30, 1999 and January 31, 1998, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended January 30, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the 1996 and 1997 financial statements of Quill Corporation, a wholly owned subsidiary, which statements reflect 6% of total assets as of January 31, 1998 and 20% and 25% of net income for the years ended January 31, 1998 and February 1, 1997, respectively. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to data included for Quill Corporation, is based solely on the report of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audits, for 1996 and 1997, and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Staples, Inc. and subsidiaries at January 30, 1999 and January 31, 1998 and the consolidated results of their operations and their cash flows for each of the three years in the period ended January 30, 1999 in conformity with generally accepted accounting principles.

Ernst & Young LLP

Boston, Massachusetts

March 4, 1999

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Executive Vice President and Chief Financial Officer of Campbell Soup Company
Board Committee: Audit

Mary Elizabeth Burton
President and Chief Executive Officer BB Capital, Inc.
Board Committee: Audit

W. Lawrence Heisey
Chairman Emeritus of Harlequin Enterprises Ltd.
Board Committee: Compensation

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Board Committee: Corporate Governance

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Board Committees: Executive and Corporate Governance

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Board Committee: Executive

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Board Committee: Audit

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Directors Emeritus

Leo Kahn
Chairman Emeritus, Co-Founder of Staples, Inc. Partner, United Properties Group and Chief Executive Officer Nature's Heartland

David G. Lubrano
Director Emeritus, Private Investor and Business Consultant

Management Team

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John K. Barton
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Larry R. Belcaster
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Jane E. Biering
Senior Vice President, Distribution and Transportation

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Laurie A. Clark
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Senior Vice President, Direct Delivery

Edward C. Harsant
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Executive Vice President, Human Resources

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Senior Vice President, SCC, Merchandise and Replenishment

Steve J. Krajewski
Senior Vice President, U.S. Retail, East

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Senior Vice President, Staples.com and New Business Development

Jeanne M. Lewis
Executive Vice President, Marketing

Brian T. Light
Senior Vice President and Chief Information Officer

John J. Mahoney
Executive Vice President and Chief Administrative Officer

Robert K. Mayerson
Senior Vice President, Corporate Controller

Jack Miller
President, Quill

Lawrence J. Morse
Senior Vice President, Operations, Quill

Richard A. Neff
Senior Vice President, U.S. Retail, West

Philo T. Pappas
Senior Vice President/General Merchandise Manager, Office Technology

Demos Parneros
Senior Vice President, U.S. Retail, South/Mid-Atlantic

James C. Peters
President, U.S. Stores

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Chairman of the Board and Chief Executive Officer

Evan P. Stern
President, National Accounts

Jack A. VanWoerkom
Senior Vice President, General Counsel and Corporate Secretary

Joseph S. Vassalluzzo
President, Staples Realty and Development

Corporate Information

Corporate Offices

Staples, Inc.
500 Staples Drive
Framingham, Massachusetts 01702
Telephone: 508.253.5000
Internet Address: www.staples.com

Investor Information

Account Questions

BankBoston is the Transfer Agent and Registrar for the Company's Common Stock and maintains shareholder accounting records. Please contact the Transfer Agent directly concerning changes in address, name or ownership, lost certificates and to consolidate multiple accounts. When corresponding with the Transfer Agent, shareholders should reference the exact names(s) in which the Staples stock is registered as well as the certificate number.

BankBoston, N.A.
c/o EquiServe - Boston Division
Post Office Box 8040
Boston, Massachusetts 02266-8040
Tel: 1.800.733.5001
Fax: 781.828.8813
For Hearing Impaired: 1.800.952.9245
Internet Address: www.equiserve.com

Financial Information

To request financial documents such as this annual report and form 10-K for the fiscal year ended January 30, 1999 as filed with the Securities and Exchange Commission, please visit our web site www.staples.com, call our toll-free investor hotline 1.800.INV.SPL1 (1.800.468.7751), or send a written request to the attention of Investor Relations at our corporate address.

Investor Relations

Investor inquiries may be directed to:

Diane J. Basile
Director, Investor Relations
Telephone: 508.253.7963
Fax: 508.253.8989
e-mail: diane.basile@staples.com

General Information

Members of the media and others seeking general information about Staples should contact the Corporate Communications Department at corporate headquarters, telephone 508.253.8727.

Independent Auditors

Ernst & Young LLP
200 Clarendon Street
Boston, Massachusetts 02116

Annual Meeting

The Annual Meeting of Stockholders of Staples, Inc. will be held on June 2, 1999 at 3:00 p.m. at Fleet Bank, 8th floor Conference Center, 75 State Street, Boston, Massachusetts.

Price Range of Common Stock and Dividend Policy

The Company's Common Stock is traded on the Nasdaq National Market under the symbol "SPLS."

As of January 30, 1999, the number of holders of record of the Company's Common Stock was 9,165.

The following table sets forth for the periods indicated the high and low sale prices per share of the Common Stock on the Nasdaq National Market, as reported by Nasdaq, retroactively adjusted for a three-for-two stock split in January 1999 and 1998.

Fiscal Year Ended		January 30, 1999
	High	Low
First Quarter	$17.13	$12.25
Second Quarter	22.83	15.67
Third Quarter	23.42	17.00
Fourth Quarter	32.50	21.13
Fiscal Year Ended		January 31, 1998
	High	Low
First Quarter	$11.72	$ 7.83
Second Quarter	11.67	8.55
Third Quarter	13.00	10.22
Fourth Quarter	13.39	10.59

The Company has never paid a cash dividend on its Common Stock. The Company presently intends to retain earnings for use in the operation and expansion of its business and, therefore, does not anticipate paying any cash dividends in the foreseeable future. In addition, the Company's revolving credit agreement restricts the payment of dividends.

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Staples, Inc. 500 Staples Drive Framingham, MA 01702 Telephone (508) 253-5000 www.staples.com

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