Notes to Consolidated Financial Statements

One Significant Accounting Policies

Description of business ~ CVS Corporation ("CVS" or the "Company") is principally in the retail drugstore business. As of December 31, 1998, the Company operated 4,122 retail drugstores, located in 24 Northeast, Mid-Atlantic, Southeast and Midwest states and the District of Columbia. See Note 12 for further information about the Company's business segments.

Basis of presentation ~ The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All material intercompany balances and transactions have been eliminated. As a result of the Company's strategic restructuring program, the results of operations of the former Footwear, Apparel, and Toys and Home Furnishings segments have been classified as discontinued operations in the accompanying consolidated statements of operations. See Note 4 for further information about the Company's strategic restructuring program and discontinued operations.

Stock split ~ On May 13, 1998, the Company's shareholders approved an increase in the number of authorized common shares from 300 million to one billion. Also on that date, the Board of Directors authorized a two-for-one common stock split, which was effected by the issuance of one additional share of common stock for each share of common stock outstanding. These shares were distributed on June 15, 1998 to shareholders of record as of May 25, 1998. All share and per share amounts presented herein have been restated to reflect the effect of the stock split.

Cash and cash equivalents ~ Cash and cash equivalents consist of cash and temporary investments with maturities of three months or less when purchased.

Accounts receivable ~ Accounts receivable are stated net of an allowance for uncollectible accounts of $39.8 million and $39.2 million as of December 31, 1998 and 1997, respectively. The balance primarily includes trade receivables due from managed care organizations, pharmacy benefit management companies, insurance companies, governmental agencies and vendors.

Inventories ~ Inventories are stated at the lower of cost or market using the first-in, first-out method.

Financial instruments ~ The Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and short-term borrowings. Due to the short-term nature of these instruments, the Company's carrying value approximates fair value. The Company also utilizes letters of credit to guarantee certain foreign purchases. As of December 31, 1998 and 1997, approximately $62.4 million and $58.2 million, respectively, was outstanding under letters of credit.

Property and equipment ~ Depreciation of property and equipment is computed on a straight-line basis, generally over the estimated useful lives of the asset or, when applicable, the term of the lease, whichever is shorter. Estimated useful lives generally range from 10 to 40 years for buildings and improvements, 3 to 10 years for fixtures and equipment, and 3 to 10 years for leasehold improvements. Maintenance and repair costs are charged directly to expense as incurred. Major renewals or replacements that substantially extend the useful life of an asset are capitalized and depreciated.

Impairment of long-lived assets ~ The Company primarily groups and evaluates assets at an individual store level, which is the lowest level at which individual cash flows can be identified. When evaluating assets for potential impairment, the Company considers historical performance and estimated undiscounted future cash flows. If the carrying amount of the related assets exceed the expected future cash flows, the Company considers the assets to be impaired and records an impairment loss.

Deferred charges and other assets ~ Deferred charges and other assets primarily include beneficial leasehold costs, which are amortized on a straight-line basis over the shorter of 15 years or the remaining life of the leasehold acquired, and reorganization goodwill, which is amortized on a straight-line basis over 20 years. The reorganization goodwill is the value of Revco D.S., Inc., in excess of identifiable assets, as determined during its 1992 reorganization under Chapter 11 of the United States Bankruptcy Code. See Note 11 for further information about reorganization goodwill.

Goodwill ~ Goodwill, which represents the excess of the purchase price over the fair value of net assets acquired, is amortized on a straight-line basis generally over periods of 40 years. Accumulated amortization was $85.6 million and $65.6 million at December 31, 1998 and 1997, respectively. The Company evaluates goodwill for impairment whenever events or circumstances indicate that the carrying amount may not be recoverable. If the carrying amount of the goodwill exceeds the expected undiscounted future cash flows, the Company records an impairment loss.

Store opening and closing costs ~ New store opening costs are charged directly to expense when incurred. When the Company closes a store, the estimated unrecoverable costs, including the remaining lease obligation, are charged to expense in the year of the closing.

Advertising costs ~ External costs incurred to produce media advertising are expensed when the advertising takes place.

Income taxes ~ Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes as well as for the deferred tax effects of tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

Stock-based compensation ~ During 1996, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." Under SFAS No. 123, companies can elect to account for stock-based compensation using a fair value based method or continue to measure compensation expense using the intrinsic value method prescribed in Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees." The Company has elected to continue to account for its stock-based compensation plans under APB No. 25. See Note 7 for further information about the Company's stock incentive plans.

Insurance ~ The Company is self-insured up to certain limits for general liability, workers compensation and automobile liability claims. The Company accrues for projected losses in the year the claim is incurred based on actuarial assumptions followed in the insurance industry and the Company's past experience.

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

Reclassifications ~ Certain reclassifications have been made to the consolidated financial statements of prior years to conform to the current year presentation.

Earnings per common share ~ During the fourth quarter of 1997, the Company adopted SFAS No. 128, "Earnings Per Share" and restated previously reported earnings per common share. Basic earnings per common share is computed by dividing: (i) net earnings, after deducting the after-tax dividends on the ESOP Preference Stock, by (ii) the weighted average number of common shares outstanding during the year (the "Basic Shares").

Diluted earnings per common share normally assumes that the ESOP Preference Stock is converted into common stock and all dilutive stock options are exercised. Diluted earnings per common share is computed by dividing: (i) net earnings, after accounting for the difference between the current dividends on the ESOP Preference Stock and the common stock and after making adjustments for certain non-discretionary expenses that are based on net earnings such as incentive bonuses and profit sharing by (ii) Basic Shares plus the additional shares that would be issued assuming that all dilutive stock options are exercised and the ESOP Preference Stock is converted into common stock. In 1997, the assumed conversion of the ESOP Preference Stock would have increased diluted earnings per common share and, therefore, was not considered.

New accounting pronouncements ~ During 1998, the Company adopted: (i) SFAS No. 130, "Reporting Comprehensive Income," which established standards for the reporting and display of comprehensive income and its components, (ii) SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," which requires companies to report financial information based on how management internally organizes data to make operating decisions and assess performance and (iii) SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," which revises the disclosure requirements for pensions and other postretirement benefit plans. Adoption of the above disclosure standards did not affect the Company's financial results. Comprehensive income does not differ from the consolidated net earnings presented in the accompanying consolidated statements of operations.

Notes to Consolidated Financial Statements *(continued)*

two Business Combinations

Merger Transactions
On March 31, 1998, CVS completed a merger with Arbor Drugs, Inc. ("Arbor"), pursuant to which 37.8 million shares of CVS common stock were exchanged for all the outstanding common stock of Arbor (the "CVS/Arbor Merger"). Each outstanding share of Arbor common stock was exchanged for 0.6364 shares of CVS common stock. In addition, outstanding Arbor stock options were converted at the same exchange ratio into options to purchase 5.3 million shares of CVS common stock.

On May 29, 1997, CVS completed a merger with Revco D.S., Inc. ("Revco"), pursuant to which 120.6 million shares of CVS common stock were exchanged for all the outstanding common stock of Revco (the "CVS/Revco Merger"). Each outstanding share of Revco common stock was exchanged for 1.7684 shares of CVS common stock. In addition, outstanding Revco stock options were converted at the same exchange ratio into options to purchase 6.6 million shares of CVS common stock.

The CVS/Arbor Merger and CVS/Revco Merger (collectively, the "Mergers") constituted tax-free reorganizations and have been accounted for as pooling of interests under Accounting Principles Board Opinion No. 16, "Accounting for Business Combinations." Accordingly, all prior period financial statements presented have been restated to include the combined results of operations, financial position and cash flows of Arbor and Revco as if they had always been owned by CVS.

Prior to the Mergers, Arbor's fiscal year ended on July 31 and Revco's fiscal year ended on the Saturday closest to May 31. These fiscal year-ends have been restated to a December 31 year-end to conform to CVS' fiscal year-end. Arbor's and Revco's cost of sales and inventories have been restated from the last-in, first-out method to the first-in, first-out method to conform to CVS' accounting method for inventories. The impact of the restatement was to increase earnings from continuing operations by $0.5 million in 1998, $1.2 million in 1997 and $15.5 million in 1996.

There were no material transactions between CVS, Arbor and Revco prior to the Mergers. Certain reclassifications have been made to Arbor's and Revco's historical stand-alone financial statements to conform to CVS' presentation.

Following are the results of operations for the separate companies prior to the Mergers and the combined amounts presented in the consolidated financial statements:

	Three Months Ended		*Years Ended*	
	March 28,	*March 29,*	*December 31,*	
In millions	1998	1997	1997	1996
Net sales:				
CVS	$3,333.6	$1,515.0	$12,738.2	$ 5,528.1
Arbor	267.9	237.0	1,011.4	886.8
Revco	—	1,645.8	—	5,416.7
	$3,601.5	$3,397.8	$13,749.6	$11,831.6
Earnings from continuing operations:				
CVS	$ 121.3	$ 58.5	$ 37.3	$ 239.6
Arbor	10.7	9.4	39.2	31.6
Revco	—	24.2	—	101.2
	$ 132.0	$ 92.1	$ 76.5	$ 372.4

Purchase Transactions
On December 23, 1996, the Company completed the cash purchase of Big B, Inc. ("Big B") by acquiring all the outstanding shares of Big B common stock. The aggregate transaction value, including the assumption of $49.3 million of Big B debt, was $423.2 million. The Big B acquisition was accounted for as a purchase business combination. The resulting excess of purchase price over net assets acquired, $248.9 million, is being amortized on a straight-line basis over 40 years. For financial reporting purposes, Big B's results of operations have been included in the consolidated financial statements since November 16, 1996.

The Company also acquired other retail drugstore businesses that were accounted for as purchase business combinations. These acquisitions did not have a material effect on the consolidated financial statements either individually or in the aggregate. The results of operations of these companies have been included in the consolidated financial statements since their respective dates of acquisition.

three Merger & Restructuring Charges

In accordance with Emerging Issues Task Force ("EITF") Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)" and SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," the Company recorded the following charges in connection with the Mergers.

In connection with the CVS/Arbor Merger, the Company recorded a $158.3 million charge to operating expenses during the second quarter of 1998 for direct and other merger-related costs pertaining to the merger transaction and certain restructuring activities (the "CVS/Arbor Charge"). Asset write-offs included in this charge totaled $41.2 million. The balance of the charge, $117.1 million, will require cash outlays of which $60.1 million had been incurred as of December 31, 1998. The remaining cash outlays primarily include noncancelable lease commitments and severance. The Company also recorded a $10.0 million charge to cost of goods sold during the second quarter of 1998 to reflect markdowns on noncompatible Arbor merchandise (the "Arbor Inventory Markdown").

In connection with the CVS/Revco Merger, the Company recorded a $411.7 million charge to operating expenses during the second quarter of 1997 for direct and other merger-related costs pertaining to the merger transaction and certain restructuring activities (the "CVS/Revco Charge"). Asset write-offs included in this charge totaled $82.2 million. The balance of the charge, $329.5 million, will require cash outlays of which $269.3 million had been incurred as of December 31, 1998. The remaining cash outlays primarily include noncancelable lease commitments and severance. The Company also recorded a $75.0 million charge to cost of goods sold during the second quarter of 1997 to reflect markdowns on noncompatible Revco merchandise (the "Revco Inventory Markdown").

Merger transaction costs included in the above charges primarily relate to fees for investment bankers, attorneys, accountants, financial printing and other related charges. Restructuring activities primarily relate to the consolidation of administrative functions. These actions resulted in the reduction of approximately 200 Arbor employees and 1,000 Revco employees, all of which had occurred as of December 31, 1998. Noncancelable lease obligations and duplicate facilities primarily include noncancelable lease commitments and shutdown costs. These costs did not provide future benefit to the retained stores or corporate facilities.

In accordance with EITF 94-3 and SFAS No. 121, the Company also recorded a $31.0 million charge to operating expenses during the first quarter of 1997 for certain costs associated with the restructuring of Big B (the "Big B Charge"). This charge included accrued liabilities related to certain exit plans for identified stores and duplicate corporate facilities, such as the cancellation of lease agreements and the write-down of unutilized fixed assets. Asset write-offs included in this charge totaled $5.1 million. The balance of the charge, $25.9 million, will require cash outlays of which $10.0 million had been incurred as of December 31, 1998. The remaining cash outlays primarily include noncancelable lease commitments. These exit plans did not provide future benefit to the retained stores or corporate facilities.

Following is a summary of the significant components of the above charges:

	CVS/Arbor Charge				*CVS/Revco and Big B Charges*			
In millions	Total 1998 Charge	Utilized to Date	Transfer	Balance at 12/31/98[1]	Total 1997 Charges	Utilized to Date	Transfer	Balance at 12/31/98[1]
Merger transaction costs	$ 15.0	$ (15.9)	$ 0.9	$ —	$ 35.0	$ (32.4)	$ (2.6)	$ —
Restructuring costs:								
Employee severence and benefits	27.1	(13.8)	0.3	13.6	89.8	(77.4)	—	12.4
Exit costs:								
Noncancelable lease obligations and duplicate facilities	67.5	(25.8)	(1.9)	39.8	211.6	(147.9)	—	63.7
Fixed asset write-offs	41.2	(41.2)	—	—	87.3	(87.3)	—	—
Contract cancellation costs	4.8	(1.2)	—	3.6	7.4	(7.4)	—	—
Other	2.7	(3.4)	0.7	—	11.6	(14.2)	2.6	—
	$ 158.3	$ (101.3)	$ —	$ 57.0	$ 442.7	$ (366.6)	$ —	$ 76.1

(1) The Company believes that the reserve balances at December 31, 1998 are adequate to cover the remaining liabilities associated with these charges.

Notes to Consolidated Financial Statements *(continued)*

four Strategic Restructuring Program & Discontinued Operations

In November 1997, the Company completed the final phase of its comprehensive strategic restructuring program, first announced in October 1995 and subsequently refined in May 1996 and June 1997. The strategic restructuring program included: (i) the sale of Marshalls, Kay-Bee Toys, Wilsons, This End Up and Bob's Stores, (ii) the spin-off of Footstar, Inc., which included Meldisco, Footaction and Thom McAn (the "Footstar Distribution"), (iii) the initial and secondary public offerings of Linens 'n Things and (iv) the elimination of certain corporate overhead costs.

The strategic restructuring program was completed without significant changes to the Board approved plan. As part of completing this program, the Company recorded, as a component of discontinued operations, an after-tax charge of $20.7 million during the second quarter of 1997 and $148.1 million during the second quarter of 1996 to finalize original liability estimates. The Company believes that the remaining pre-tax reserve balance of $84.7 million at December 31, 1998 is adequate to cover the remaining liabilities associated with this program. Following is a summary of the strategic restructuring reserve:

In millions	Total Reserve	Utilized to Date	Transfer	Balance
Loss on disposal	$ 721.8	$ (710.6)	$38.8	$50.0
Lease obligations	187.4	(124.6)	(32.8)	30.0
Severance	58.6	(47.9)	(6.0)	4.7
Other	174.2	(174.2)	—	—
	$1,142.0	$(1,057.3)	$ —	$84.7

Following is a summary of discontinued operations by reporting segment for the years ended December 31:

In millions	1997	1996
Net sales:		
Footwear	$ —	$1,391.1
Apparel	348.3	526.4
Toys and Home Furnishings	—	900.3
	$348.3	$2,817.8
Operating (loss):		
Footwear	$ —	$ (12.4)
Apparel	—	(171.3)
Toys and Home Furnishings	—	(49.7)
	$ —	$ (233.4)

As of December 31, 1998 and 1997, there were no assets or liabilities of the discontinued operations reflected in the accompanying consolidated balance sheets.

five Borrowings and Credit Agreements

Following is a summary of the Company's borrowings at December 31:

In millions	**1998**	1997
Commercial paper	**$ 736.6**	$ 450.0
ESOP note payable[(1)]	**270.7**	292.1
Uncommitted lines of credit	**34.5**	16.4
9.125% senior notes	**—**	19.2
Mortgage notes payable	**16.1**	17.1
Capital lease obligations and other	**3.5**	3.9
	1,061.4	798.7
Less:		
Short-term borrowings	**(771.1)**	(466.4)
Current portion of long-term debt	**(14.6)**	(41.9)
	$ 275.7	$ 290.4

(1) See Note 9 for further information about the Company's ESOP Plan.

The Company's commercial paper program is supported by a $670 million, five-year unsecured revolving credit facility, which expires on May 30, 2002 and a $460 million, 364-day unsecured revolving credit facility, which expires on June 26, 1999 (collectively, the "Credit Facilities"). The Credit Facilities require the Company to pay a quarterly facility fee of 0.07%, regardless of usage. The Company can also obtain up to $35.0 million of short-term financing through various uncommitted lines of credit. The weighted average interest rate for short-term borrowings was 5.7% as of December 31, 1998 and 1997.

The Company was not obligated under any formal or informal compensating balance agreements.

During the second quarter of 1997, the Company extinguished $865.7 million of the debt it absorbed as part of the CVS/Revco Merger using cash on hand and commercial paper borrowings. As a result, the Company recorded an extraordinary loss, net of income taxes, of $17.1 million, which consisted of early retirement premiums and the write-off of unamortized deferred financing costs. On January 15, 1998, the Company redeemed the remaining $19.2 million of 9.125% senior notes.

At December 31, 1998, the aggregate long-term debt maturing during the next five years is as follows: $14.6 million in 1999, $17.3 million in 2000, $21.6 million in 2001, $26.5 million in 2002, $32.3 million in 2003, $178.0 million in 2004 and thereafter. Interest paid was approximately $70.7 million in 1998, $58.4 million in 1997 and $79.8 million in 1996.