eleven
Income Taxes

Deferred income taxes reflect the net tax effects of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

The Company's income tax (provision) benefit for continuing operations for the years ended December 31 consisted of the following:

In millions	Federal	State	Total
1998:			
Current	**$(197.3)**	**$(41.4)**	**$(238.7)**
Deferred	**(51.2)**	**(25.0)**	**(76.2)**
	$(248.5)	**$(66.4)**	**$(314.9)**
1997:			
Current	$(182.5)	$(68.5)	$(251.0)
Deferred	82.1	28.1	110.2
	$(100.4)	$(40.4)	$(140.8)
1996:			
Current	$(195.6)	$(54.9)	$(250.5)
Deferred	(17.7)	(2.8)	(20.5)
	$(213.3)	$(57.7)	$(271.0)

Following is a reconciliation of the statutory income tax rate to the Company's effective tax rate for the years ended December 31:

	1998	1997	1996
Statutory income tax rate	**35.0%**	35.0%	35.0%
State income taxes, net of federal tax benefit	**5.8**	6.6	5.5
Goodwill and other	**1.2**	1.4	1.6
Effective tax rate before merger-related costs	**42.0**	43.0	42.1
Merger-related costs(1)	**2.3**	21.8	—
Effective tax rate	**44.3%**	64.8%	42.1%

(1) Includes state tax effect.

Income taxes paid (refunded) were $102.6 million, $258.9 million and $(33.8) million during the years ended December 31, 1998, 1997 and 1996, respectively.

Following is a summary of the significant components of the Company's deferred tax assets and liabilities as of December 31:

In millions	**1998**	1997
Deferred tax assets:		
Employee benefits	**$ 84.5**	$119.0
Other assets	**185.5**	253.8
Total deferred tax assets	**$270.0**	$372.8
Deferred tax liabilities:		
Property and equipment	**$(44.0)**	$(27.0)
Inventories	**(1.6)**	(29.9)
Other liabilities	**—**	(10.7)
Total deferred tax liabilites	**(45.6)**	(67.6)
Net deferred tax assets	**$224.4**	$305.2

Based on historical pre-tax earnings, the Company believes it is more likely than not that the deferred tax assets will be realized.

As of December 31, 1998, the Company had federal net operating loss carryforwards ("NOLs") of $3.7 million that are attributable to Revco for periods prior to its emergence from Chapter 11. The benefits realized from these NOLs should reduce reorganization goodwill. Accordingly, the tax benefit of such NOLs utilized during the three years ended December 31, 1998, $7.2 million, $69.4 million and $15.3 million for 1998, 1997 and 1996, respectively, has not been included in the computation of the Company's income tax provision, but instead has been reflected as reductions of reorganization goodwill.

On October 12, 1996, the Company completed the Footstar Distribution which is believed to be tax-free to the Company and its shareholders based on a legal opinion provided by outside counsel. However, since opinions of counsel are not binding on the Internal Revenue Service or the courts, it could ultimately be determined that the Footstar Distribution does not qualify as a tax-free distribution. If such occurred, the Company would be required to recognize a capital gain for tax purposes equal to the difference between the fair market value of the shares of Footstar stock distributed and the Company's basis in such shares. The Company, however, believes the likelihood of the Footstar Distribution not qualifying as a tax-free distribution to be remote.

Notes to Consolidated Financial Statements *(continued)*

twelve Business Segments

The Company currently operates a Retail segment and a Pharmacy Benefit Management ("PBM") segment. The Company's business segments are operating units that offer different products and services, and require distinct technology and marketing strategies.

The Retail segment, which is described in Note 1, is the Company's only reportable segment.

The PBM segment provides a full range of prescription benefit management services to managed care and other organizations. These services include plan design and administration, formulary management, mail order pharmacy services, claims processing and generic substitution.

The accounting policies of the segments are substantially the same as those described in Note 1. The Company evaluates segment performance based on operating profit, before the effect of nonrecurring charges and gains and intersegment profits.

Following is a reconciliation of the significant components of each segment's sales to consolidated net sales for the years ended December 31:

	1998	1997	1996
Pharmacy(1)	**57.6%**	54.7%	51.6%
Front store	**42.4**	45.3	48.4
Consolidated net sales	**100.0%**	100.0%	100.0%

(1) Pharmacy sales includes the Retail segment's pharmacy sales, the PBM segment's total sales and the effect of the intersegment sales elimination discussed in the table below.

Following is a reconciliation of the Company's business segments to the consolidated financial statements:

In millions	Retail Segment	PBM Segment	Intersegment Eliminations(1)	Other Adjustments(2)	Consolidated Totals
1998:					
Net sales	**$15,081.1**	**$ 488.4**	**$(295.9)**	**$ —**	**$15,273.6**
Operating profit	**927.8**	**12.7**	**—**	**(168.3)**	**772.2**
Depreciation and amortization	**248.6**	**1.1**	**—**	**—**	**249.7**
Total assets	**6,652.1**	**119.6**	**(35.5)**	**—**	**6,736.2**
Capital expenditures	**498.0**	**4.3**	**—**	**—**	**502.3**
1997:					
Net sales	$13,649.4	$ 320.7	$(220.5)	$ —	$13,749.6
Operating profit	771.2	7.9	—	(517.7)	261.4
Depreciation and amortization	237.8	0.4	—	—	238.2
Total assets	5,937.3	60.6	(19.0)	—	5,978.9
Capital expenditures	339.6	2.0	—	—	341.6
1996:					
Net sales	$11,766.3	$ 208.9	$(143.6)	$ —	$11,831.6
Operating profit	602.5	2.2	—	(12.8)	591.9
Depreciation and amortization	205.2	0.2	—	—	205.4
Total assets	6,003.5	32.8	(21.4)	—	6,014.9
Capital expenditures	326.9	2.0	—	—	328.9

(1) Intersegment eliminations relate to intersegment sales and accounts receivables that occur when a PBM segment customer uses a Retail segment store to purchase covered merchandise. When this occurs, both segments record the sale on a stand-alone basis.

(2) Other adjustments relate to the merger and restructuring charges discussed in Note 3 and a $12.8 million charge that was recorded when Rite Aid Corporation withdrew its tender offer to acquire Revco. This event took place in 1996 before the CVS/Revco Merger. The merger and restructuring charges are not considered when management assesses the stand-alone performance of the Company's business segments.

thirteen Reconciliation of Earnings Per Common Share

Following is a reconciliation of basic and diluted earnings per common share for the years ended December 31:

In millions, except per share amounts	**1998**	1997	1996
Numerator for earnings per common share calculation:			
Earnings from continuing operations before extraordinary item	**$396.4**	$76.5	$372.4
Preference dividends, net of tax benefit	**(13.6)**	(13.7)	(14.5)
Earnings from continuing operations available to common shareholders, basic	**$382.8**	$62.8	$357.9
Earnings (loss) from discontinued operations	**—**	17.5	(164.2)
Extraordinary loss	**—**	(17.1)	—
Net earnings available to common shareholders, basic	**$382.8**	$63.2	$193.7
Earnings from continuing operations before extraordinary item	**$396.4**	$76.5	$372.4
Effect of dilutive securities:			
Preference dividends, net of tax benefit	**—**	(13.7)	—
Dilutive earnings adjustments	**(0.8)**	—	(7.5)
Earnings from continuing operations available to common shareholders, diluted	**$395.6**	$62.8	$364.9
Earnings (loss) from discontinued operations	**—**	17.5	(164.2)
Extraordinary loss	**—**	(17.1)	—
Net earnings available to common shareholders, diluted	**$395.6**	$63.2	$200.7
Denominator for earnings per common share calculation:			
Weighted average common shares, basic	**387.1**	377.2	366.9
Effect of dilutive securities:			
Preference stock	**10.5**	—	11.7
Stock options	**7.6**	7.9	5.0
Weighted average common shares, diluted	**405.2**	385.1	383.6
Basic earnings per common share:			
Earnings from continuing operations before extraordinary item	**$ 0.99**	$0.17	$ 0.98
Earnings (loss) from discontinued operations	**—**	0.05	(0.45)
Extraordinary item, net of tax benefit	**—**	(0.05)	—
Net earnings	**$ 0.99**	$0.17	$ 0.53
Diluted earnings per common share:			
Earnings from continuing operations before extraordinary item	**$ 0.98**	$0.16	$ 0.95
Earnings (loss) from discontinued operations	**—**	0.05	(0.43)
Extraordinary item, net of tax benefit	**—**	(0.05)	—
Net earnings	**$ 0.98**	$0.16	$ 0.52

Notes to Consolidated Financial Statements *(continued)*

fourteen Commitments & Contingencies

In connection with certain business dispositions completed between 1991 and 1997, the Company continues to guarantee lease obligations for approximately 1,600 former stores. The Company is indemnified for these obligations by the respective purchasers. Assuming that each respective purchaser became insolvent, an event which the Company believes to be highly unlikely, management estimates that it could settle these obligations for approximately $1.1 billion as of December 31, 1998.

In the opinion of management, the ultimate disposition of these guarantees will not have a material adverse effect on the Company's consolidated financial condition, results of operations or future cash flows.

The Company is also a defendant in various lawsuits arising in the ordinary course of business. In the opinion of management and the Company's outside counsel, the ultimate disposition of these lawsuits, exclusive of potential insurance recoveries, will not have a material adverse effect on the Company's consolidated financial condition, results of operations or future cash flows.

fifteen Quarterly Financial Information (Unaudited)

In millions, except per share amounts		1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Net sales:					
1998		$3,601.5	$3,755.9	$3,725.1	$4,191.1
1997		3,397.8	3,406.8	3,328.7	3,616.3
Gross margin:					
1998		$1,006.9	$1,020.5	$ 995.3	$1,106.5
1997		967.9	873.0	905.6	971.8
Earnings (loss) from continuing operations before extraordinary item:					
1998		$ 132.0	$ 16.2	$ 102.4	$ 145.8
1997		92.1	(221.4)	82.2	123.6
Net earnings (loss):					
1998		$ 132.0	$ 16.2	$ 102.4	$ 145.8
1997		92.2	(221.1)	82.2	123.6
Earnings (loss) per common share from continuing operations before extraordinary item:					
1998:	Basic	$ 0.34	$ 0.03	$ 0.25	$ 0.37
	Diluted	0.33	0.03	0.25	0.36
1997:	Basic	0.24	(0.60)	0.21	0.31
	Diluted	0.23	(0.60)	0.20	0.31
Net earnings (loss) per common share:					
1998:	Basic	$ 0.34	$ 0.03	$ 0.25	$ 0.37
	Diluted	0.33	0.03	0.25	0.36
1997:	Basic	0.24	(0.60)	0.21	0.31
	Diluted	0.23	(0.60)	0.20	0.31
Market price per common share (New York Stock Exchange):					
1998:	High	$ 37 7/16	$ 39 5/8	$ 46 1/2	$55 11/16
	Low	31 1/16	33 3/8	36 3/8	42 1/16
1997:	High	24	26 7/8	30	35
	Low	19 1/2	22 1/8	25 7/16	27 5/16
Dividends declared per common share:					
1998		$ 0.0550	$ 0.0550	$ 0.0575	$0.0575
1997		0.0550	0.0550	0.0550	0.0550
Number of registered common shareholders at year-end:					
1998					10,500