six Leases

The Company and its subsidiaries lease retail stores, warehouse facilities and office facilities under noncancelable operating leases over periods ranging from 5 to 20 years, and generally have options to renew such terms over periods ranging from 5 to 15 years.

Following is a summary of the Company's net rental expense for operating leases for the years ended December 31:

In millions	**1998**	1997	1996
Minimum rentals	**$459.1**	$409.6	$337.4
Contingent rentals	**60.3**	60.2	73.6
	519.4	469.8	411.0
Less sublease income	**(14.0)**	(9.5)	(12.8)
	$505.4	$460.3	$398.2

Following is a summary of the future minimum lease payments under capital and operating leases, excluding lease obligations for closed stores, at December 31, 1998:

In millions	Capital Leases	Operating Leases
1999	$0.4	$ 402.6
2000	0.4	381.1
2001	0.4	348.3
2002	0.2	323.3
2003	0.2	297.7
Thereafter	1.3	2,485.7
	2.9	$ 4,238.7
Less imputed interest	(1.4)	
Present value of capital lease obligations	$1.5	

seven Stock Incentive Plans

As of December 31, 1998, the Company had the following stock incentive plans (including the pre-merger plans of Arbor and Revco). Effective with the Mergers, outstanding Arbor and Revco stock options were exchanged for options to purchase CVS common stock.

1997 Incentive Compensation Plan

The 1997 Incentive Compensation Plan (the "1997 ICP"), superseded the 1990 Omnibus Stock Incentive Plan, the 1987 Stock Option Plan and the 1973 Stock Option Plan (collectively, the "Preexisting Plans"). Upon approval of the 1997 ICP, authority to make future grants under the Preexisting Plans was terminated, although previously granted awards remain outstanding in accordance with their terms and the terms of the Preexisting Plans.

As of December 31, 1998, the 1997 ICP provided for the granting of up to 23,321,821 shares of common stock in the form of stock options, stock appreciation rights ("SARs"), restricted shares, deferred shares and performance-based awards to selected officers, employees and directors of the Company. All grants under the 1997 ICP are awarded at fair market value on the date of grant. The right to exercise or receive these awards generally commences between one and five years from the date of the grant and expires not more than ten years after the date of the grant, provided that the holder continues to be employed by the Company. As of December 31, 1998, there were 19,730,690 shares available for grant under the 1997 ICP.

Restricted shares issued under the 1997 ICP may not exceed 3.6 million shares. In 1998, 1997 and 1996, 155,400, 44,610 and 633,100 shares of restricted stock were granted at a weighted average grant date fair value of $37.80, $23.02 and $13.14, respectively. Participants are entitled to vote and receive dividends on their restricted shares, although they are subject to certain transfer restrictions. Performance-based awards, which are subject to the achievement of certain business performance goals, totaled 56,346 at a weighted average grant date fair value of $36.70 in 1998. No awards were granted in 1997 and 1996. Compensation cost, which is based on the fair value at the date of grant, is recognized over the restricted or performance period. This cost totaled $3.1 million in 1998, $3.5 million in 1997 and $3.9 million in 1996.

The 1996 Directors Stock Plan

The 1996 Directors Stock Plan (the "1996 DSP"), provides for the granting of up to 346,460 shares of common stock to the Company's non-employee directors (the "Eligible Directors"). The 1996 DSP allows the Eligible Directors to elect to receive shares of common stock in lieu of cash compensation. Eligible Directors may also elect to defer compensation payable in common stock until their service as a director concludes. The 1996 DSP replaced the Company's 1989 Directors Stock Option Plan. As of December 31, 1998, there were 263,554 shares available for grant under the 1996 DSP.

Notes to Consolidated Financial Statements *(continued)*

Following is a summary of the fixed stock option activity under the 1997 ICP, the Preexisting Plans and the pre-merger plans of Arbor and Revco for the years ended December 31:

	1998		1997		1996	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	**16,070,146**	**$16.95**	23,569,930	$13.96	25,782,040	$14.06
Granted	**3,119,410**	**37.16**	3,695,530	23.62	6,609,229	14.80
Exercised	**(7,137,027)**	**15.01**	(10,756,726)	12.99	(3,534,729)	11.62
Canceled	**(70,407)**	**26.48**	(438,588)	14.48	(5,286,610)	17.35
Outstanding at end of year	**11,982,122**	**23.31**	16,070,146	16.95	23,569,930	13.96
Exercisable at end of year	**6,127,402**		11,729,688		10,011,179	

Following is a summary of the fixed stock options outstanding and exercisable as of December 31, 1998:

	Options Outstanding			*Options Exercisable*	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 5.00 to $20.00	6,024,451	5.5	$16.29	5,358,465	$16.24
20.01 to 35.00	2,857,611	7.1	23.10	697,787	22.20
35.01 to 46.50	3,100,060	9.1	37.16	71,150	37.45
$ 5.00 to $46.50	11,982,122	6.8	$23.31	6,127,402	$17.16

The Company applies APB Opinion No. 25 to account for its stock incentive plans. Accordingly, no compensation cost has been recognized for stock options granted. Had compensation cost been recognized based on the fair value of stock options granted consistent with SFAS No. 123, net earnings and net earnings per common share ("EPS") would approximate the pro forma amounts shown below for the years ended December 31.

In millions, except per share amounts	**1998**	1997	1996
Net earnings:			
As reported	**$396.4**	$76.9	$208.2
Pro forma	**370.9**	58.7	196.2
Basic EPS:			
As reported	**$ 0.99**	$0.17	$ 0.53
Pro forma	**0.92**	0.12	0.50
Diluted EPS:			
As reported	**$ 0.98**	$0.16	$ 0.52
Pro forma	**0.91**	0.12	0.49

Beginning with grants made on or after January 1, 1995, the fair value of each stock option grant was estimated using the Black-Scholes Option Pricing Model with the following assumptions:

	1998	1997	1996
Dividend yield	**0.40%**	0.70%	1.07%
Expected volatility	**22.49%**	22.77%	20.51%
Risk-free interest rate	**5.75%**	5.50%	7.00%
Expected life	**7.0**	5.5	5.0

eight Pension Plans and Other Postretirement Benefits

The Company sponsors various retirement programs, including defined benefit, defined contribution and other plans that cover most full-time employees.

Defined Benefit Plans

The Company sponsors a non-contributory defined benefit pension plan that covers certain full-time employees of Revco who are not covered by collective bargaining agreements. On September 20, 1997, the Company suspended future benefit accruals under this plan. As a result of the plan's suspension, the Company realized a $6.0 million curtailment gain in 1997. Benefits paid to retirees are based upon age at retirement, years of credited service and average compensation during the five-year period ending September 20, 1997. It is the Company's policy to fund this plan based on actuarial calculations and applicable federal regulations.

Pursuant to various labor agreements, the Company is required to make contributions to certain union-administered pension plans that totaled $1.5 million in 1998, $1.6 million in 1997 and $1.2 million in 1996. The Company may be liable for its share of the plans' unfunded liabilities if the plans are terminated. The Company also has non-qualified supplemental executive retirement plans ("SERPs") in place for certain key employees for whom it has purchased cost recovery variable life insurance.

Defined Contribution Plans

The Company sponsors a Profit Sharing Plan and a 401(k) Savings Plan that cover substantially all employees who meet plan eligibility requirements. The Company also maintains a non-qualified, unfunded Deferred Compensation Plan for certain key employees. The Company's contributions under the above defined contribution plans totaled $26.4 million in 1998, $24.1 million in 1997 and $19.5 million in 1996.

The Company also sponsors an Employee Stock Ownership Plan. See Note 9 for further information about this plan.

Other Postretirement Benefits

The Company provides postretirement healthcare and life insurance benefits to retirees who meet eligibility requirements. The Company's funding policy is generally to pay covered expenses as they are incurred.

Following is a reconciliation of the benefit obligation, fair value of plan assets and funded status of the Company's defined benefit and other postretirement benefit plans:

	Defined Benefit Plans		*Other Postretirement Benefits*	
In millions	**1998**	1997	**1998**	1997
Change in benefit obligation:				
Benefit obligation at beginning of year	**$253.3**	$255.1	**$ 14.4**	$ 15.5
Service cost	**0.5**	7.6	**—**	—
Interest cost	**19.5**	19.2	**1.0**	1.0
Actuarial loss (gain)	**49.3**	(10.4)	**0.5**	(0.7)
Benefits paid	**(25.0)**	(18.2)	**(1.9)**	(1.4)
Benefit obligation at end of year	**$297.6**	$253.3	**$ 14.0**	$ 14.4
Change in plan assets:				
Fair value at beginning of year	**$201.5**	$172.8	**$ —**	$ —
Actual return on plan assets	**28.4**	20.0	**—**	—
Company contributions	**18.2**	26.9	**1.9**	1.4
Benefits paid	**(25.0)**	(18.2)	**(1.9)**	(1.4)
Fair value at end of year(1)	**$223.1**	$201.5	**$ —**	$ —
Funded status:				
Funded status	**$ (74.5)**	$(51.8)	**$(14.0)**	$(14.5)
Unrecognized prior service cost	**1.3**	1.6	**(1.0)**	(1.1)
Unrecognized net loss (gain)	**1.6**	(8.4)	**(0.3)**	(1.0)
Accrued pension costs	**$ (71.6)**	$(58.6)	**$(15.3)**	$(16.6)
Weighted average assumptions:				
Discount rate	**6.75%**	7.25%	**6.75%**	7.25%
Expected return on plan assets	**9.00%**	9.00%	**—**	—
Rate of compensation increase	**4.50%**	4.50%	**—**	—

(1) Plan assets consist primarily of mutual funds, common stock and insurance contracts.

For measurement purposes, future healthcare costs are assumed to increase at an annual rate of 6.5% during 1999, decreasing to an annual growth rate of 5.0% in 2002 and thereafter. A one percent change in the assumed healthcare cost trend rate would change the accumulated postretirement benefit obligation by $1.0 million and total service and interest costs by $0.1 million. Following is a summary of the net periodic pension cost for the defined benefit and other postretirement benefit plans:

	Defined Benefit Plans			*Other Postretirement Benefits*		
In millions	**1998**	1997	1996	**1998**	1997	1996
Service cost(1)	**$0.5**	$ 7.6	$ 9.2	**$ —**	$ —	$0.4
Interest cost on benefit obligation	**19.5**	19.2	16.8	**1.0**	1.0	2.5
Expected return on plan assets	**(16.4)**	(14.9)	(18.2)	**—**	—	—
Amortization of net loss (gain)	**1.2**	0.3	6.1	**(0.2)**	—	(1.1)
Amortization of prior service cost	**0.1**	0.3	0.4	**(0.1)**	(0.3)	—
Curtailment gain	**—**	(6.0)	(1.3)	**—**	—	—
Net periodic pension cost	**$4.9**	$ 6.5	$13.0	**$ 0.7**	$0.7	$1.8

(1) The decrease in total service cost is primarily due to the suspension of future benefit accruals under the Revco pension plan during 1997.

Notes to Consolidated Financial Statements *(continued)*

nine Employee Stock Ownership Plan

The Company sponsors a defined contribution Employee Stock Ownership Plan (the "ESOP") that covers full-time employees with at least one year of service.

In 1989, the ESOP Trust borrowed $357.5 million through a 20-year note (the "ESOP Note"). The proceeds from the ESOP Note were used to purchase 6.7 million shares of Series One ESOP Convertible Preference Stock (the "ESOP Preference Stock") from the Company. Since the ESOP Note is guaranteed by the Company, the outstanding balance is reflected as long-term debt and a corresponding Guaranteed ESOP obligation is reflected in shareholders' equity in the accompanying consolidated balance sheets.

Each share of ESOP Preference Stock has a guaranteed minimum liquidation value of $53.45, is convertible into 2.314 shares of common stock and is entitled to receive an annual dividend of $3.90 per share. The ESOP Trust uses the dividends received and contributions from the Company to repay the ESOP Note. As the ESOP Note is repaid, ESOP Preference Stock is allocated to participants based on: (i) the ratio of each year's debt service payment to total current and future debt service payments multiplied by (ii) the number of unallocated shares of ESOP Preference Stock in the plan. As of December 31, 1998, 5.2 million shares of ESOP Preference Stock were outstanding, of which 1.6 million shares were allocated to participants and the remaining 3.6 million shares were held in the ESOP Trust for future allocations.

Annual ESOP expense recognized is equal to (i) the interest incurred on the ESOP Note plus (ii) the higher of (a) the principal repayments or (b) the cost of the shares allocated, less (iii) the dividends paid. Similarly, the Guaranteed ESOP obligation is reduced by the higher of (i) the principal payments or (ii) the cost of shares allocated.

Following is a summary of the ESOP for the years ended December 31:

In millions	**1998**	1997	1996
ESOP expense recognized	**$25.8**	$13.8	$15.4
Dividends paid	**20.5**	20.8	21.8
Cash contributions	**25.8**	22.9	19.3
Interest costs incurred on ESOP loan	**24.9**	26.4	27.5
ESOP shares allocated	**0.4**	0.4	0.4

ten Supplemental Information

Following are the components of amounts included in the consolidated balance sheets as of December 31:

In millions	**1998**	1997
Other current assets:		
Deferred income taxes	**$ 248.7**	$ 304.2
Supplies	**16.8**	13.6
Other	**62.4**	47.0
	$ 327.9	$ 364.8
Property and equipment:		
Land	**$ 91.0**	$ 78.7
Buildings and improvements	**290.2**	231.5
Fixtures and equipment	**1,178.4**	938.9
Leasehold improvements	**477.4**	443.7
Capital leases	**2.8**	3.3
	2,039.8	1,696.1
Accumulated depreciation and amortization	**(688.6)**	(623.8)
	$1,351.2	$1,072.3
Accrued expenses:		
Taxes other than federal income taxes	**$ 130.8**	$ 127.5
Salaries and wages	**99.4**	99.6
Rent	**92.2**	84.8
Strategic restructuring reserve	**84.7**	102.8
Employee benefits	**82.7**	84.3
CVS/Revco/Big B reserve	**76.1**	233.0
CVS/Arbor reserve	**57.0**	—
Other	**488.4**	436.6
	$1,111.3	$1,168.6

Following is a summary of the Company's non-cash financing activities for the years ended December 31:

In millions	**1998**	1997	1996
Fair value of assets acquired	**$ 62.2**	$ —	$423.2
Cash paid	**62.2**	—	373.9
Liabilities assumed	**$ —**	$ —	$ 49.3
Equity securities or notes received from sale of businesses	**$ —**	$52.0	$172.4

Interest expense was $69.7 million in 1998, $59.1 million in 1997 and $84.7 million in 1996. Interest income was $8.8 million in 1998, $15.0 million in 1997 and $9.2 million in 1996.