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Borrowings and Credit Agreements

Following is a summary of the Company's borrowings as of the respective balance sheet dates:

In millions	**January 1, 2000**	December 26, 1998
Commercial paper	**$ 451.0**	$ 736.6
ESOP note payable[1]	**257.0**	270.7
Uncommitted lines of credit	**—**	34.5
5.5% unsecured senior notes	**300.0**	—
Mortgage notes payable	**17.3**	16.1
Capital lease obligations	**1.5**	3.5
	1,026.8	1,061.4
Less:		
Short-term borrowings	**(451.0)**	(771.1)
Current portion of long-term debt	**(17.3)**	(14.6)
	$ 558.5	$ 275.7

(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 $530 million, 364-day unsecured revolving credit facility, which expires on June 21, 2000 (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 6.2% as of January 1, 2000, and 5.7% as of December 26, 1998.

In February 1999, the Company issued $300 million of 5.5% unsecured senior notes due February 15, 2004. The proceeds from the issuance were used to repay outstanding commercial paper borrowings.

The Credit Facilities and unsecured senior notes contain customary restrictive financial and operating covenants. The covenants do not materially affect the Company's financial or operating flexibility.

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.

At January 1, 2000, the aggregate long-term debt maturing during the next five years is as follows: $17.3 million in 2000, $21.6 million in 2001, $26.5 million in 2002, $32.3 million in 2003, $323.5 million in 2004, $154.6 million in 2005 and thereafter.

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Leases

The Company and its subsidiaries lease retail stores, warehouse facilities, office facilities and equipment under noncancelable operating leases typically over periods ranging from 5 to 20 years, along with options to renew over periods ranging from 5 to 15 years.

Following is a summary of the Company's net rental expense for operating leases for the respective fiscal years:

		Fiscal Year	
In millions	**1999**	1998	1997
Minimum rentals	**$ 572.4**	$ 459.1	$ 409.6
Contingent rentals	**64.8**	60.3	60.2
	637.2	519.4	469.8
Less: sublease income	**(13.2)**	(14.0)	(9.5)
	$ 624.0	$ 505.4	$ 460.3

Following is a summary of the future minimum lease payments under capital and operating leases as of January 1, 2000:

In millions	*Capital Leases*	*Operating Leases*
2000	$ 0.4	$ 474.1
2001	0.4	441.8
2002	0.4	406.0
2003	0.4	377.4
2004	0.4	347.5
Thereafter	1.6	3,159.1
	3.6	$ 5,205.9
Less: imputed interest	(2.1)	
Present value of capital lease obligations	$ 1.5	

During fiscal 1999, the Company entered into sale-leaseback transactions totaling $229 million as a means of financing a portion of its store development program. The properties were sold at net book value and were typically leased back over periods of 20 years. The resulting leases are being accounted for as operating leases and are included in the above tables.

Stock Incentive Plans

As of January 1, 2000, the Company had the following stock incentive plans, which include the pre-merger plans of Arbor and Revco. Effective with the mergers, all 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") superceded 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 January 1, 2000, the 1997 ICP provided for the granting of up to 23,382,245 shares of common stock in the form of stock options, stock appreciation rights, 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 January 1, 2000, there were 17,915,519 shares available for future grants under the 1997 ICP.

Restricted shares issued under the 1997 ICP may not exceed 3.6 million shares. In fiscal 1999, 1998 and 1997, 14,402, 155,400 and 44,610 shares of restricted stock were granted at a weighted average grant date fair value of $50.88, $37.80 and $23.02, respectively. Participants are entitled to vote and receive dividends on their restricted shares, although they are subject to certain transfer restrictions. Compensation costs, which are recognized over the restricted period, totaled $2.3 million in 1999, $3.1 million in 1998 and $3.5 million in 1997.

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 nonemployee 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 January 1, 2000, there were 247,071 shares available for future grant under the 1996 DSP.

Following is a summary of the fixed stock option activity for the respective fiscal years:

	1999		1998		1997	
	Shares	***Weighted Average Exercise Price***	*Shares*	*Weighted Average Exercise Price*	*Shares*	*Weighted Average Exercise Price*
Outstanding at beginning of year	**11,982,122**	**$ 23.31**	16,070,146	$ 16.95	23,569,930	$ 13.96
Granted	**2,175,342**	**48.02**	3,119,410	37.16	3,695,530	23.62
Exercised	**(927,080)**	**18.87**	(7,137,027)	15.01	(10,756,726)	12.99
Canceled	**(265,784)**	**37.65**	(70,407)	26.48	(438,588)	14.48
Outstanding at end of year	**12,964,600**	**27.38**	11,982,122	23.31	16,070,146	16.95
Exercisable at end of year	**6,065,351**	**$ 17.92**	6,127,402	$ 17.16	11,729,688	$ 16.11

Following is a summary of the fixed stock options outstanding and exercisable as of January 1, 2000:

	Options Outstanding			*Options Exercisable*	
Range of Exercise Prices	*Number Outstanding*	*Weighted Average Remaining Life*	*Weighted Average Exercise Price*	*Number Exercisable*	*Weighted Average Exercise Price*
Under $15	516,927	5.3	$ 11.43	496,038	$ 11.83
$15.01 to $20.00	4,934,909	4.9	16.72	4,607,689	16.72
20.01 to 25.00	2,357,420	6.4	22.81	652,241	22.27
25.01 to 40.00	3,110,464	8.0	36.71	297,019	36.24
40.01 to 51.38	2,044,880	9.3	48.19	12,364	42.65
Total	12,964,600	6.6	$ 27.38	6,065,351	$ 17.92

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:

In millions, except per share amounts	Fiscal Year 1999	1998	1997
Net earnings:			
As reported	**$ 635.1**	$ 384.5	$ 88.8
Pro forma	**614.7**	359.0	70.6
Basic EPS:			
As reported	**$ 1.59**	$ 0.96	$ 0.20
Pro forma	**1.53**	0.89	0.15
Diluted EPS:			
As reported	**$ 1.55**	$ 0.95	$ 0.19
Pro forma	**1.50**	0.88	0.15

The fair value of each stock option grant was estimated using the Black-Scholes Option Pricing Model with the following assumptions:

	Fiscal Year 1999	1998	1997
Dividend yield	**0.58%**	0.40%	0.70%
Expected volatility	**25.86%**	22.49%	22.77%
Risk-free interest rate	**6.50%**	5.75%	5.50%
Expected life	**6.0**	7.0	5.5

1999 Employee Stock Purchase Plan

The 1999 Employee Stock Purchase Plan provides for the granting of up to 7,400,000 shares of common stock. The plan, which covers substantially all employees, gives employees the option to purchase common stock at the end of each six-month offering period, at a purchase price equal to 85% of the lower of the fair market value on the first day or the last day of the offering period.

Employees pay for the shares ratably over each offering period through payroll deductions. During 1999, options for 210,833 shares were exercised at an average price of $33.42.

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Pension Plans and Other Postretirement Benefits

The Company sponsors a noncontributory 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. The plan is funded based on actuarial calculations and applicable federal regulations.

Pursuant to various labor agreements, the Company is also required to make contributions to certain union-administered pension and health and welfare plans that totaled $8.4 million, $7.5 million and $7.6 million in fiscal 1999, 1998 and 1997, respectively. The Company may be liable for its share of the plans' unfunded liabilities if the plans are terminated. The Company also has nonqualified supplemental executive retirement plans 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 voluntary 401(k) Savings Plan that covers substantially all employees who meet plan eligibility requirements. The Company makes matching contributions consistent with the provisions of the plan. The Company also maintains a non-qualified, unfunded Deferred Compensation Plan for certain key employees. This plan provides participants the opportunity to defer portions of their compensation and receive matching contributions that they would have otherwise received under the 401(k) Savings Plan if not for certain restrictions and limitations under the Internal Revenue Code. The Company's contributions under the above defined contribution plans totaled $17.0 million, $26.4 million and $24.1 million in fiscal 1999, 1998 and 1997, respectively. 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 as of the respective balance sheet dates:

	Defined Benefit Plans Fiscal Year		*Other Postretirement Benefits Fiscal Year*	
In millions	**1999**	1998	**1999**	1998
Change in benefit obligation:				
Benefit obligation at beginning of year	**$ 297.6**	$ 253.3	**$ 14.0**	$ 14.4
Service cost	**0.7**	0.5	**—**	—
Interest cost	**19.8**	19.5	**0.9**	1.0
Actuarial (gain) loss	**(40.3)**	49.3	**1.1**	0.5
Benefits paid	**(23.0)**	(25.0)	**(2.0)**	(1.9)
Benefit obligation at end of year	**$ 254.8**	$ 297.6	**$ 14.0**	$ 14.0
Change in plan assets:				
Fair value at beginning of year	**$ 223.1**	$ 201.5	**$ —**	$ —
Actual return on plan assets	**37.3**	28.4	**—**	—
Company contributions	**11.4**	18.2	**2.0**	1.9
Benefits paid	**(23.0)**	(25.0)	**(2.0)**	(1.9)
Fair value at end of year[1]	**$ 248.8**	$ 223.1	**$ —**	$ —
Funded status:				
Funded status	**$ (6.0)**	$ (74.5)	**$ (14.0)**	$ (14.0)
Unrecognized prior service cost	**1.1**	1.3	**(0.9)**	(1.0)
Unrecognized net (gain) loss	**(60.6)**	1.6	**0.8**	(0.3)
Accrued pension costs	**$ (65.5)**	$ (71.6)	**$ (14.1)**	$ (15.3)

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

Following is a summary of the net periodic pension cost for the defined benefit and other postretirement benefit plans for the respective fiscal years:

	Defined Benefit Plans			*Other Postretirement Benefits*		
In millions	**1999**	1998	1997	**1999**	1998	1997
Service cost[1]	**$ 0.7**	$ 0.5	$ 7.6	**$ —**	$ —	$ —
Interest cost on benefit obligation	**19.8**	19.5	19.2	**0.9**	1.0	1.0
Expected return on plan assets	**(16.6)**	(16.4)	(14.9)	**—**	—	—
Amortization of net loss (gain)	**1.3**	1.2	0.3	**—**	(0.2)	—
Amortization of prior service cost	**0.1**	0.1	0.3	**(0.1)**	(0.1)	(0.3)
Curtailment gain	**—**	—	(6.0)	**—**	—	—
Net periodic pension cost	**$ 5.3**	$ 4.9	$ 6.5	**$ 0.8**	$ 0.7	$ 0.7
Weighted average assumptions:						
Discount rate	**8.00%**	6.75%	7.25%	**7.75%**	6.75%	7.25%
Expected return on plan assets	**9.00%**	9.00%	9.00%	**—**	—	—
Rate of compensation increase	**4.00%**	4.50%	4.50%	**—**	—	—

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

For measurement purposes, future healthcare costs are assumed to increase at an annual rate of 9.0%, decreasing to an annual growth rate of 5.0% in 2004 and thereafter. A one percent change in the assumed healthcare cost trend rate would change the accumulated postretirement benefit obligation by $0.9 million and the total service and interest costs by $0.1 million.

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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 January 1, 2000, 5.2 million shares of ESOP Preference Stock were outstanding, of which 1.9 million shares were allocated to participants and the remaining 3.3 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 activity as of the respective fiscal years:

		Fiscal Year	
In millions	**1999**	1998	1997
ESOP expense recognized	**$ 16.6**	$ 25.8	$ 13.8
Dividends paid	**20.1**	20.5	20.8
Cash contributions	**16.6**	25.8	22.9
Interest payments	**23.1**	24.9	26.4
ESOP shares allocated	**0.3**	0.4	0.4

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Income Taxes

The provision for income taxes consisted of the following for the respective fiscal years:

		Fiscal Year	
In millions	**1999**	1998	1997
Current: Federal	**$ 289.6**	$ 197.3	$ 182.5
State	**68.4**	41.4	68.5
	358.0	238.7	251.0
Deferred: Federal	**72.6**	44.1	(75.0)
State	**10.7**	23.7	(26.8)
	83.3	67.8	(101.8)
Total	**$ 441.3**	$ 306.5	$ 149.2

Following is a reconciliation of the statutory income tax rate to the Company's effective tax rate for the respective fiscal years:

		Fiscal Year	
	1999	1998	1997
Statutory income tax rate	**35.0%**	35.0%	35.0%
State income taxes, net of federal tax benefit	**4.8**	5.8	6.6
Goodwill and other	**1.2**	1.2	1.4
Effective tax rate before merger-related costs	**41.0**	42.0	43.0
Merger-related costs(1)	**—**	2.4	19.8
Effective tax rate	**41.0%**	44.4%	62.8%

(1) Includes state tax effect.

Following is a summary of the significant components of the Company's deferred tax assets and liabilities as of the respective balance sheet dates:

In millions	**January 1, 2000**	December 26, 1998
Deferred tax assets:		
Employee benefits	**$ 56.7**	$ 84.5
Other	**135.1**	185.5
Total deferred tax assets	**191.8**	270.0
Deferred tax liabilities:		
Accelerated depreciation	**(68.9)**	(44.0)
Inventory	**(10.7)**	(1.6)
Total deferred tax liabilities	**(79.6)**	(45.6)
Net deferred tax assets	**$ 112.2**	$ 224.4

Income taxes paid were $354.5 million, $102.6 million and $258.9 million for fiscal 1999, 1998 and 1997, respectively.

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

Supplemental Information

Following are the components of property and equipment included in the consolidated balance sheets as of the respective balance sheet dates:

In millions	**January 1, 2000**	December 26, 1998
Land	**$ 89.6**	$ 91.0
Buildings and improvements	**467.8**	296.8
Fixtures and equipment	**1,326.5**	1,171.8
Leasehold improvements	**518.5**	477.4
Capital leases	**2.2**	2.8
	2,404.6	2,039.8
Accumulated depreciation and amortization	**(803.6)**	(688.6)
	$ 1,601.0	$ 1,351.2

Following is a summary of the Company's noncash financing activities for the respective fiscal years:

In millions	**1999**	1998	1997
Fair value of assets acquired	**$ —**	$ 62.2	$ —
Cash paid	**—**	62.2	—
Liabilities assumed	**$ —**	$ —	$ —
Equity securities or notes received from sale of business	**$ —**	$ —	$ 52.0

Interest expense was $66.1 million, $69.7 million and $59.1 million and interest income was $7.0 million, $8.8 million and $15.0 million in fiscal 1999, 1998 and 1997, respectively. Interest paid totaled $69.0 million, $70.7 million and $58.4 million in fiscal 1999, 1998 and 1997, respectively.

Commitments & Contingencies

In connection with certain business dispositions completed between 1991 and 1997, the Company continues to guarantee lease obligations for approximately 1,400 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 $1.0 billion as of January 1, 2000.

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.

As of January 1, 2000, the Company had outstanding commitments to purchase $283.8 million of merchandise inventory for use in the normal course of business. The Company currently expects to satisfy these purchase commitments by 2002.

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.