CVS CORP
Form 10-Q
August 08, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

For the Quarterly Period Ended June 28, 2003

Commission File Number 001-01011

CVS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**05-0494040**
(State of Incorporation)	**(I.R.S. Employer Identification Number)**

One CVS Drive, Woonsocket, Rhode Island 02895

(Address of principal executive offices)

Telephone: (401) 765-1500

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes x No ¨

Common Stock, $0.01 par value, issued and outstanding at August 7, 2003: 394,712,000 shares

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Part I **Item 1**

CVS Corporation

Consolidated Condensed Statements of Operations

(Unaudited)

	13 Weeks Ended		26 Weeks Ended	
	June 28,	June 29,	**June 28,**	June 29,
In millions, except per share amounts	**2003**	2002	**2003**	2002
Net sales	**$ 6,444.9**	$ 5,989.5	**$ 12,757.7**	$ 11,960.2
Cost of goods sold, buying and warehousing costs	**4,811.1**	4,508.4	**9,518.4**	8,985.4
Gross margin	**1,633.8**	1,481.1	**3,239.3**	2,974.8
Selling, general and administrative expenses	**1,211.4**	1,104.0	**2,403.0**	2,226.2
Depreciation and amortization	**85.4**	78.8	**168.0**	153.8
Total operating expenses	**1,296.8**	1,182.8	**2,571.0**	2,380.0
Operating profit	**337.0**	298.3	**668.3**	594.8
Interest expense, net	**12.7**	13.8	**25.3**	26.9
Earnings before income tax provision	**324.3**	284.5	**643.0**	567.9
Income tax provision	**124.5**	108.1	**246.9**	215.8
Net earnings	**199.8**	176.4	**396.1**	352.1
Preference dividends, net of income tax benefit	**3.7**	3.7	**7.3**	7.4
Net earnings available to common shareholders	**$ 196.1**	$ 172.7	**$ 388.8**	$ 344.7
Basic earnings per common share:				
Net earnings	**$ 0.50**	$ 0.44	**$ 0.99**	$ 0.88
Weighted average basic common shares outstanding	**394.0**	392.0	**393.7**	391.8
Diluted earnings per common share:				
Net earnings	**$ 0.49**	$ 0.43	**$ 0.97**	$ 0.86
Weighted average diluted common shares outstanding	**406.6**	406.1	**406.2**	405.3
Dividends declared per common share	**$ 0.0575**	$ 0.0575	**$ 0.1150**	$ 0.1150

See accompanying notes to consolidated condensed financial statements.

Part I **Item 1**

CVS Corporation

Consolidated Condensed Balance Sheets

(Unaudited)

In millions, except share and per share amounts	**June 28, 2003**	December 28, 2002
Assets:		
Cash and cash equivalents	**$ 566.8**	$ 700.4
Accounts receivable, net	**1,088.6**	1,019.3
Inventories	**3,800.7**	4,013.9
Deferred income taxes	**208.8**	216.4
Other current assets	**31.2**	32.1
Total current assets	**5,696.1**	5,982.1
Property and equipment, net	**2,448.1**	2,215.8
Goodwill	**889.0**	878.9
Intangible assets, net	**365.0**	351.4
Deferred income taxes	**6.6**	6.6
Other assets	**215.9**	210.5
Total assets	**$ 9,620.7**	$ 9,645.3
Liabilities:		
Accounts payable	**$ 1,463.6**	$ 1,707.9
Accrued expenses	**1,226.9**	1,361.2
Short-term borrowings		4.8
Current portion of long-term debt	**332.1**	32.0
Total current liabilities	**3,022.6**	3,105.9
Long-term debt	**775.9**	1,076.3
Other long-term liabilities	**258.2**	266.1
Shareholders equity:		
Preference stock, series one ESOP convertible, par value $1.00: authorized 50,000,000 shares; issued and outstanding 4,587,000 shares at June 28, 2003 and 4,685,000 shares at December 28, 2002	**245.2**	250.4
Common stock, par value $0.01: authorized 1,000,000,000 shares; issued 409,591,000 shares at June 28, 2003 and 409,286,000 shares at December 28, 2002	**4.1**	4.1
Treasury stock, at cost: 15,440,000 shares at June 28, 2003 and 16,215,000 shares at December 28, 2002	**(447.1)**	(469.5)
Guaranteed ESOP obligation	**(194.4)**	(194.4)
Capital surplus	**1,545.6**	1,546.6
Retained earnings	**4,455.2**	4,104.4
Accumulated other comprehensive loss	**(44.6)**	(44.6)
Total shareholders equity	**5,564.0**	5,197.0

Total liabilities and shareholders equity	**$ 9,620.7**	$ 9,645.3

See accompanying notes to consolidated condensed financial statements.

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Part I **Item 1**

CVS Corporation

Consolidated Condensed Statements of Cash Flows

(Unaudited)

In millions	*26 Weeks Ended* **June 28, 2003**	June 29, 2002
Cash flows from operating activities:		
Net earnings	**$ 396.1**	$ 352.1
Adjustments required to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	**168.0**	153.8
Deferred income taxes and other noncash items	**9.9**	49.8
Change in operating assets and liabilities, providing/(requiring) cash, net of effects from acquisitions:		
Accounts receivable, net	**(50.1)**	(37.9)
Inventories	**217.8**	42.6
Other current assets	**8.1**	4.3
Other assets	**(1.9)**	(8.7)
Accounts payable	**(244.2)**	(200.6)
Accrued expenses	**(154.3)**	(4.1)
Other long-term liabilities	**(4.4)**	(3.0)
Net cash provided by operating activities	**345.0**	348.3
Cash flows from investing activities:		
Additions to property and equipment	**(406.7)**	(590.3)
Proceeds from sale-leaseback transactions	**28.1**	135.5
Acquisitions (net of cash)	**(68.0)**	(32.5)
Proceeds from sale or disposal of assets	**3.8**	13.4
Net cash used in investing activities	**(442.8)**	(473.9)
Cash flow from financing activities:		
(Reductions in) additions to short-term borrowings	**(4.8)**	252.6
Proceeds from exercise of stock options	**14.6**	17.7
Reductions in long-term debt	**(0.3)**	(2.7)
Dividends paid	**(45.3)**	(45.0)
Net cash (used in) provided by financing activities	**(35.8)**	222.6
Net (decrease) increase in cash and cash equivalents	**(133.6)**	97.0
Cash and cash equivalents at beginning of period	**700.4**	236.3
Cash and cash equivalents at end of period	**$ 566.8**	$ 333.3

See accompanying notes to consolidated condensed financial statements.

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Part I **Item 1**

CVS Corporation

Notes to Consolidated Condensed Financial Statements

(Unaudited)

Note 1

The accompanying consolidated condensed financial statements of CVS Corporation and its wholly-owned subsidiaries (CVS or the Company) have been prepared without audit, in accordance with the rules and regulations of the Securities and Exchange Commission. In accordance with such rules and regulations, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted, although the Company believes that the disclosures included herein are adequate to make the information presented not misleading. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 28, 2002.

In the opinion of management, the accompanying consolidated condensed financial statements include all adjustments (consisting only of normal recurring adjustments) which are necessary to present a fair statement of the Company s results for the interim periods presented. Because of the influence of various factors on the Company s operations, including certain holidays and other seasonal influences, net earnings for any interim period may not be comparable to the same interim period in previous years or necessarily indicative of earnings for the full fiscal year.

Note 2

The Company accounts for its stock-based compensation plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. As such, no stock-based employee compensation cost is reflected in net earnings for options granted under those plans since they had an exercise price equal to the market value of the underlying common stock and the number of shares were fixed on the date of grant. The following table summarizes the effect on net earnings and earnings per common share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation for the respective periods:

	13 weeks ended		*26 weeks ended*	
In millions, except per share amount	**June 28, 2003**	June 29, 2002	**June 28, 2003**	June 29, 2002
Net earnings, as reported	**$ 199.8**	$ 176.4	**$ 396.1**	$ 352.1
Add: Stock-based employee compensation expense included in reported net earnings, net of related tax effects [(1)]	**0.6**	0.5	**1.1**	1.3
Deduct: Total stock-based employee compensation determined under fair value based method for all awards, net of related tax effect	**12.3**	13.5	**26.0**	29.3

Pro forma net earnings	**$ 188.1**	$ 163.4	**$ 371.2**	$ 324.1
Basic EPS: As reported	**$ 0.50**	$ 0.44	**$ 0.99**	$ 0.88
Pro forma	**0.47**	0.41	**0.92**	0.81
Diluted EPS: As reported	**$ 0.49**	$ 0.43	**$ 0.97**	$ 0.86
Pro forma	**0.46**	0.40	**0.92**	0.80

(1) Amounts represent the after-tax compensation costs for restricted stock grants.

Part I **Item 1**

CVS Corporation

Notes to Consolidated Condensed Financial Statements

(Unaudited)

Note 3

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

As of June 28, 2003, the Retail Pharmacy segment included 4,066 retail drugstores and the Company s online retail website, CVS.com®. The retail drugstores, which operate under the CVS® or CVS/pharmacy® name, are located in 27 states and the District of Columbia. The Retail Pharmacy segment is the Company s only reportable segment.

The PBM segment, which operates under the PharmaCare Management Services name, 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 PBM segment also includes the Company s specialty pharmacy business, which focuses on supporting individuals that require complex and expensive drug therapies. The PBM segment operates 47 retail and specialty pharmacies, located in 19 states and the District of Columbia.

Following is a reconciliation of the Company s business segments to the consolidated condensed financial statements as of and for the respective periods:

In millions	Retail Pharmacy Segment	PBM Segment	Consolidated Totals
13 weeks ended:			
June 28, 2003:			
Net sales	**$ 6,129.3**	**$ 315.6**	**$ 6,444.9**
Operating profit	**313.2**	**23.8**	**337.0**
June 29, 2002:			
Net sales	$ 5,715.1	$ 274.4	$ 5,989.5
Operating profit	280.1	18.2	298.3
26 weeks ended:			
June 28, 2003:			
Net sales	**$ 12,106.7**	**$ 651.0**	**$ 12,757.7**

Operating profit	**619.9**	**48.4**	**668.3**
June 29, 2002:			
Net sales	$ 11,408.0	$ 552.2	$ 11,960.2
Operating profit	563.2	31.6	594.8
Total assets:			
June 28, 2003	**$ 9,084.5**	**$ 536.2**	**$ 9,620.7**
December 28, 2002	9,132.1	513.2	9,645.3

Note 4

Accumulated other comprehensive loss consists of a $44.6 million minimum pension liability, net of a $27.3 million income tax benefit, as of June 28, 2003. There was no accumulated other comprehensive income or loss as of June 29, 2002.

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Part I **Item 1**

CVS Corporation

Notes to Consolidated Condensed Financial Statements

(Unaudited)

Note 5

Following are the components of net interest expense:

	13 weeks ended		26 weeks ended	
In millions	**June 28, 2003**	June 29, 2002	**June 28, 2003**	June 29, 2002
Interest expense	**$ 13.8**	$ 14.7	**$ 27.8**	$ 29.2
Interest income	**(1.1)**	(0.9)	**(2.5)**	(2.3)
Interest expense, net	**$ 12.7**	$ 13.8	**$ 25.3**	$ 26.9

Note 6

The Company accounts for goodwill and intangibles under SFAS No. 142, Goodwill and Other Intangible Assets. As such goodwill and other indefinite-lived intangible assets are not amortized, but are subject to annual impairment reviews, or more frequent reviews if events or circumstances indicate there may be an impairment. During the third quarter of 2002, the Company performed its required annual goodwill impairment test. That annual review concluded there was no impairment of goodwill.

The carrying amount of goodwill as of June 28, 2003 was $889.0 million. For the twenty-six weeks ended June 28, 2003, goodwill increased $10.1 million due to acquisitions by the Company s PBM segment. There has been no impairment of goodwill during the twenty-six weeks ended June 28, 2003.

Intangible assets other than goodwill are required to be separated into two categories: finite-lived and indefinite-lived. Intangible assets with finite useful lives are amortized over their estimated useful life, while intangible assets with indefinite useful lives are not amortized. The Company currently has no intangible assets with indefinite lives.

Following is a summary of the Company s amortizable intangible assets as of the respective balance sheet dates:

	As of June 28, 2003		*As of December 28, 2002*	
In millions	**Gross Carrying Amount**	**Accumulated Amortization**	Gross Carrying Amount	Accumulated Amortization
Customer lists and Covenants not to compete	**$ 508.3**	**$ (220.2)**	$ 464.5	$ (194.1)
Favorable leases and Other	**150.6**	**(73.7)**	153.1	(72.1)
	$ 658.9	**$ (293.9)**	$ 617.6	$ (266.2)

The increase in the gross carrying amount of customer lists and covenants not to compete during the twenty-six weeks ended June 28, 2003 was primarily due to the acquisition of customer lists. The decrease in the gross carrying amount of favorable leases and other intangibles during the twenty-six weeks ended June 28, 2003 resulted from the write-off of fully amortized favorable leases. The amortization expense for these intangible assets for the thirteen and twenty-six week periods ended June 28, 2003 was $15.2 million and $29.9 million, respectively. The anticipated annual amortization expense for these intangible assets is $63.1 million, $56.1 million, $49.5 million, $45.8 million, $42.3 million and $37.7 million in 2003, 2004, 2005, 2006, 2007 and 2008, respectively.

CVS Corporation

Notes to Consolidated Condensed Financial Statements

(Unaudited)

Note 7

The Company adopted Emerging Issues Task Force release Issue No. 02-16, Accounting by a Reseller for Cash Consideration Received from a Vendor on a prospective basis effective December 29, 2002. This pronouncement requires vendor allowances be treated as a reduction in inventory costs unless specifically identified as a reimbursement for other services. In addition, any vendor allowances received in excess of the cost incurred for such services should also be treated as a reduction of inventory costs. The adoption of this pronouncement resulted in a $4.4 million and $9.2 million reduction in net earnings for the thirteen and twenty-six week periods ended June 28, 2003, respectively.

Note 8

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 period (the Basic Shares).

When computing diluted earnings per common share, the Company assumes that the ESOP preference stock is converted into common stock and all dilutive stock options are exercised. After the assumed ESOP preference stock conversion, the ESOP Trust would hold common stock rather than ESOP preference stock and would receive common stock dividends (currently $0.23 annually per share) rather than ESOP preference stock dividends (currently $3.90 annually per share). Since the ESOP Trust uses the dividends it receives to service its debt, the Company would have to increase its contribution to the ESOP Trust to compensate it for the lower dividends. This additional contribution would reduce the Company s net earnings, which in turn, would reduce the amounts that would have to be accrued under the Company s incentive compensation plans. Diluted earnings per common share is computed by dividing: (i) net earnings, after accounting for the difference between the dividends on the ESOP preference stock and common stock and after making adjustments for the incentive compensation plans 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. Options to purchase 19.6 million and 13.2 million shares of common stock were outstanding as of June 28, 2003 and June 29, 2002, respectively, but were not included in the calculation of diluted earnings per share because the options exercise prices were greater than the average market price of the common shares and, therefore, the effect would be antidilutive.

CVS Corporation

Notes to Consolidated Condensed Financial Statements

(Unaudited)

Following is a reconciliation of basic and diluted earnings per common share for the respective periods:

In millions, except per share amounts	*13 weeks ended* **June 28, 2003**	*13 weeks ended* *June 29, 2002*	*26 weeks ended* **June 28, 2003**	*26 weeks ended* *June 29, 2002*
Numerator for earnings per common share calculation:				
Net earnings	**$ 199.8**	$ 176.4	**$ 396.1**	$ 352.1
Preference dividends, net of income tax benefit	**(3.7)**	(3.7)	**(7.3)**	(7.4)
Net earnings available to common shareholders, basic	**$ 196.1**	$ 172.7	**$ 388.8**	$ 344.7
Net earnings	**$ 199.8**	$ 176.4	**$ 396.1**	$ 352.1
Dilutive earnings adjustments	**(1.6)**	(1.7)	**(3.2)**	(3.4)
Net earnings available to common shareholders, diluted	**$ 198.2**	$ 174.7	**$ 392.9**	$ 348.7
Denominator for earnings per common share calculation:				
Weighted average common shares, basic	**394.0**	392.0	**393.7**	391.8
Effect of dilutive securities:				
ESOP preference stock	**10.7**	10.7	**10.7**	10.7
Stock options	**1.9**	3.4	**1.8**	2.8
Weighted average common shares, diluted	**406.6**	406.1	**406.2**	405.3
Basic earnings per common share	**$ 0.50**	$ 0.44	**$ 0.99**	$ 0.88
Diluted earnings per common share	**$ 0.49**	$ 0.43	**$ 0.97**	$ 0.86

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Part I **Independent Auditors Review Report**

The Board of Directors and Shareholders

CVS Corporation:

We have reviewed the consolidated condensed balance sheet of CVS Corporation and subsidiaries as of June 28, 2003, and the related consolidated condensed statements of operations and cash flows for the thirteen and twenty six-week periods ended June 28, 2003 and June 29, 2002. These consolidated condensed financial statements are the responsibility of the Company s management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of CVS Corporation and subsidiaries as of December 28, 2002 and the related consolidated statements of operations, shareholders equity, and cash flows for the fifty-two week period then ended (not presented herein); and in our report dated January 31, 2003 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated condensed balance sheet as of December 28, 2002, is fairly presented, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

KPMG LLP

Providence, Rhode Island

July 25, 2003

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

Introduction

The following discussion explains the material changes in our results of operations for the thirteen and twenty-six weeks ended June 28, 2003 and June 29, 2002 and the significant developments affecting our financial condition since December 28, 2002. We strongly recommend that you read our audited consolidated financial statements and footnotes and Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the fiscal year ended December 28, 2002.

Results of Operations

Thirteen and Twenty-Six Weeks Ended June 28, 2003 versus June 29, 2002

Net sales ~ The following table summarizes our sales performance for the respective quarters:

	13 weeks ended		*26 weeks ended*	
	June 28, 2003	June 29, 2002	**June 28, 2003**	June 29, 2002
Net sales *(in billions)*	**$ 6.4**	$ 6.0	**$ 12.8**	$ 12.0
Net sales increase:				
Total	**7.6%**	9.0%	**6.7%**	9.9%
Pharmacy	**9.2%**	12.0%	**9.0%**	11.8%
Front Store	**4.1%**	3.2%	**1.7%**	6.1%
Same store sales increase:				
Total	**5.5%**	8.6%	**4.7%**	9.4%
Pharmacy	**7.5%**	12.3%	**7.3%**	12.0%
Front Store	**1.4%**	1.7%	**(0.6)%**	4.4%
Pharmacy percentage of total sales	**68.9%**	67.9%	**69.1%**	67.7%
Third party percentage of pharmacy sales	**92.6%**	91.5%	**92.7%**	91.9%

As you review our sales performance, we believe you should consider the following important information:

Our pharmacy sales growth continued to benefit from our ability to attract and retain managed care customers and favorable industry trends. These trends include an aging American population; many baby boomers are now in their fifties and are consuming a greater number of prescription drugs. The increased use of pharmaceuticals as the first line of defense for healthcare also contributed to the growing demand for pharmacy services.

Pharmacy sales dollars were negatively impacted by increased generic drug sales, as generic drugs typically have a lower selling price than their brand name counterparts. Excluding the increased generic drug sales, we estimate that total same store sales growth for the second quarter of 2003 would have been approximately 120 basis points higher while pharmacy same store sales growth would have been approximately 200 basis points higher. For the first six months of 2003, we estimate total and pharmacy same store sales growth would have been approximately 130 basis points and 200 basis points higher, respectively.

Front store sales for the thirteen weeks ended June 28, 2003 were positively impacted by a late Easter (April 20^{th} this year versus March 31^{st} last year), which shifted the holiday sales into the second quarter. Excluding the impact of the Easter shift, we estimate total same store sales for the second quarter of 2003 would have been approximately 65 basis points lower, while front store same store sales would have decreased approximately 200 basis points. The Easter shift had no impact on the first six months of 2003.

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Part I **Item 2**

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

Total sales benefited from new store openings and our store relocation program, which seeks to move our existing shopping center stores to larger, more convenient, freestanding locations. Historically, we have achieved significant improvements in customer count and net sales when we do this. Although the number of annual relocations has decreased, our relocation strategy remains an important component of our overall growth strategy. As of June 28, 2003, approximately 48% of our existing stores were freestanding.

Gross margin, which includes net sales less the cost of merchandise sold during the reporting period and the related purchasing costs, warehousing costs, delivery costs and actual and estimated inventory losses, increased $152.7 million (or 10.3%) to $1,633.8 million, or 25.4% of net sales for the second quarter of 2003, compared to $1,481.1 million or 24.7% of net sales in the second quarter of 2002. Inventory losses for the second quarter of 2003 were 0.92% of net sales, compared to 1.35% of net sales in the second quarter of 2002 and 0.98% of net sales in the first six months of 2003, compared to 1.21% of net sales in the first six months of 2002. Gross margin for the first six months of 2003 increased $264.5 million (or 8.9%) to $3.2 billion, or 25.4% of net sales, compared to $3.0 billion, or 24.9% of net sales in the first six months of 2002.

As you review our performance in this area, we believe you should consider the following important information:

Our gross margin rate increased during the second quarter and the first six months of 2003 as a result of decreased inventory losses. During 2002, we initiated a number of programs to address physical inventory losses. These programs began to reduce inventory losses during the second half of 2002 and continued to do so during the first half of 2003. We believe these programs should continue to yield benefits for the balance of 2003.

Our gross margin rate continues to benefit from the increase in generic drug sales (discussed above), which normally yield a higher gross margin rate than brand name drug sales.

Pharmacy sales are growing at a faster pace than front store sales. On average, our gross margin on pharmacy sales is lower than our gross margin on front store sales. Pharmacy sales as a percentage of total sales for the second quarter and first six months of 2003 were 68.9% and 69.1%, respectively, compared to 67.9% in the second quarter of 2002 and 67.7% in the first six months of 2002.

Sales to customers covered by third party insurance programs have continued to increase and, thus, have become a larger part of our total pharmacy business. On average, our gross margin on third party pharmacy sales is lower than our gross margin on cash pharmacy sales. Third party prescription sales for the second quarter and first six months of 2003 were 92.6% and 92.7%, respectively, of pharmacy sales, versus 91.5% in the second quarter of 2002 and 91.9% in the first six months of 2002.

In recent years, our third party gross margin rates have been adversely affected by the efforts of managed care organizations, pharmacy benefit managers, governmental, and other third party payers to reduce prescription drug costs. To address this trend, we have dropped and/or renegotiated a number of third party programs that fell below our minimum profitability standards. These efforts have helped to improve third party reimbursement rates. However, in recent months, as a result of increasing budget shortfalls, numerous state legislatures have proposed or are reported to be considering reductions in pharmacy reimbursement rates for Medicaid and other governmental programs as well as other measures designed to reduce prescription plan drug costs. In the event this trend continues and we elect to withdraw from third party programs and/or decide not to participate in future programs that fall below our minimum profitability standards, we may not be able to sustain our current rate of sales growth and gross margin dollars could be adversely impacted.

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

Total operating expenses, which include store and administrative payroll, employee benefits, store and administrative occupancy costs, selling expenses, advertising expenses, administrative expenses and depreciation and amortization expense, increased $114.0 million (or 9.6%) to $1,296.8 million, or 20.1% of net sales for the second quarter of 2003, compared to $1,182.8 million, or 19.8% of net sales in the second quarter of 2002. Total operating expenses for the first six months of 2003 increased $191.0 million (or 8.0%) to $2,571.0 million or 20.2% of net sales, compared to $2,380.0 million or 19.9% of net sales in the first six months of 2002. Total operating expenses as a percentage of net sales increased during the second quarter and first six months of 2003 primarily due to higher advertising expense, new store growth, investments in new service initiatives, and lower sales growth resulting from higher generic drug sales.

Operating profit for the second quarter of 2003 increased $38.7 million (or 13.0%) to $337.0 million, or 5.2% of net sales, compared to $298.3 million or 5.0% of net sales in the second quarter of 2002. For the first six months of 2003, operating profit increased $73.5 million (or 12.4%) to $668.3 million, or 5.2% of net sales, compared to $594.8 million, or 5.0% of net sales in the first six months of 2002.

Interest expense, net consisted of the following:

	13 weeks ended		*26 weeks ended*	
In millions	**June 28, 2003**	June 29, 2002	**June 28, 2003**	June 29, 2002
Interest expense	**$ 13.8**	$ 14.7	**$ 27.8**	$ 29.2
Interest income	**(1.1)**	(0.9)	**(2.5)**	(2.3)
Interest expense, net	**$ 12.7**	$ 13.8	**$ 25.3**	$ 26.9

The decrease in interest expense for the thirteen and twenty-six weeks ended June 28, 2003 was primarily due to lower average debt balances during 2003 compared to 2002.

Income tax provision ~ Our effective income tax rate was 38.4% for the second quarter and first six months of 2003, compared to 38.0% for the respective periods of 2002. The increase in our effective income tax rate was primarily due to higher state income taxes.

Net earnings for the second quarter of 2003 increased $23.4 million (or 13.3%) to $199.8 million, or $0.49 per diluted share, compared to $176.4 million, or $0.43 per diluted share, in the second quarter of 2002. Net earnings for the first six months of 2003 increased $44.0 million (or 12.5%) to $396.1 million, or $0.97 per diluted share, compared to $352.1 million, or $0.86 per diluted share, in the first six months of 2002.

Liquidity and Capital Resources

We anticipate that cash flows from operations, supplemented by commercial paper and long-term borrowings, will continue to fund the growth of our business.

Net cash provided by operating activities decreased $3.3 million to $345.0 million during the first six months of 2003. This compares to net cash provided by operations of $348.3 million during the first six months of 2002. Cash provided by operating activities will be negatively impacted by future lease payments associated with the stores closed as part of the 2001 strategic restructuring. The timing of future cash payments related to the 2001 strategic restructuring depends on when, and if, early lease terminations can be reached. We made cash payments totaling $5.7 and $11.3 million, in the second quarter and first six months of 2003, respectively, related to the 2001 strategic restructuring. As of June 28, 2003, we estimate the remaining payments associated with the 2001 strategic restructuring, which primarily consist of noncancelable lease obligations extending through 2024, to be $179.9 million.

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

Net cash used in investing activities decreased to $442.8 million during the first six months of 2003. This compares to $473.9 million used during the first six months of 2002. The decrease in net cash used in investing activities was primarily due to lower additions to property and equipment. Additions to property and equipment totaled $406.7 million in the first six months of 2003, compared to $590.3 million in the first six months of 2002. The majority of the spending in both periods supported our real estate development program. During the first six months of 2003, we opened 63 new stores, relocated 48 stores and closed 37 stores. For the remainder of 2003, we plan to open 140-160 new or relocated stores. For the year, approximately 80 to 100 of our new stores are expected to be in new markets. We finance a portion of our new store development program through sale-leaseback transactions. Proceeds from sale-leaseback transactions totaled $28.1 million for the first six months of 2003, compared to $135.5 million during the first six months of 2002. The properties were sold at net book value and the resulting leases qualify and are accounted for as operating leases. As of June 28, 2003, we operated 4,113 retail and specialty pharmacy stores in 32 states and the District of Columbia.

Net cash used in financing activities increased to $35.8 million during the first six months of 2003. This compares to $222.6 million net cash provided by financing activities during the first six months of 2002. The increase in net cash used in financing activities was primarily due to changes in commercial paper borrowings. Commercial paper was reduced by $4.8 million during the first six months of 2003, compared to commercial paper borrowings of $252.6 million during the first six months of 2002.

We had no commercial paper outstanding as of June 28, 2003. In connection with our commercial paper program, we maintain a $650 million, five-year unsecured back-up credit facility, which expires on May 21, 2006 and a $600 million, 364-day unsecured back-up credit facility, which expires on May 17, 2004. The credit facilities allow for borrowings at various rates depending on our public debt rating. As of June 28, 2003, we had not borrowed against the credit facilities.

Our credit facilities and unsecured senior notes contain customary restrictive financial and operating covenants. These covenants do not include a requirement for the acceleration of our debt maturities in the event of a downgrade in our credit rating. We do not believe that the restrictions contained in these covenants materially affect our financial or operating flexibility.

We believe that our cash on hand and cash provided by operations, together with our ability to obtain additional short-term and long-term financing, will be sufficient to cover our working capital needs, capital expenditures and debt service requirements for at least the next twelve months and the foreseeable future.

Off-Balance Sheet Arrangements

Other than in connection with executing operating leases, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, including variable interest entities, nor do we have or guarantee any off-balance sheet debt. We finance a portion of our new store development through sale-leaseback transactions, which involve selling stores to unrelated parties at net book value and then leasing the stores back under leases that qualify and are accounted for as operating leases. We do not have any retained or contingent interests in the stores nor do we provide any guarantees, other than a corporate level guarantee of the lease payments, in connection with the sale-leaseback transactions. In accordance with generally accepted accounting principles, our operating leases are not reflected in our consolidated balance sheet.

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

In connection with certain business dispositions completed between 1991 and 1997, we continue to guarantee lease obligations for approximately 875 former stores. The respective purchasers indemnify the Company for these obligations. If any of the purchasers were to become insolvent, we could be required to assume the lease obligation. We refer you to the Notes to Consolidated Financial Statements on page 35 of our Annual Report on Form 10-K for the fiscal year ended December 28, 2002 for a detailed discussion of these guarantees.

Critical Accounting Policies

We prepare our consolidated financial statements in conformity with generally accepted accounting principles, which requires management to make certain estimates and apply judgment. We base our estimates and judgments on historical experience, current trends and other factors that management believes to be important at the time the consolidated financial statements are prepared. On a regular basis, management reviews our accounting policies and how they are applied and disclosed in our consolidated financial statements. While management believes that the historical experience, current trends and other factors considered support the preparation of our consolidated financial statements in conformity with generally accepted accounting principles, actual results could differ from our estimates, and such differences could be material. We refer you to the Notes to Consolidated Financial Statements on pages 26 through 29 of our Annual Report on Form 10-K for the fiscal year ended December 28, 2002 for a discussion of our significant accounting policies. Management believes that the following accounting policies include a higher degree of judgment and/or complexity and, thus, are considered to be critical accounting policies. The critical accounting policies discussed below are applicable to both of our business segments. Management has discussed the development and selection of our critical accounting policies with the Audit Committee of our Board of Directors and the Audit Committee has reviewed the Company s disclosures relating to them.

Impairment of Long-Lived Assets

We evaluate the recoverability of long-lived assets, including intangible assets with finite lives, but excluding goodwill, which is tested for impairment using a separate test, annually or whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. We group and evaluate long-lived assets for impairment at the individual store level, which is the lowest level at which individual cash flows can be identified. When evaluating long-lived assets for potential impairment, we first compare the carrying amount of the asset to the individual store s estimated future cash flows (undiscounted and without interest charges). If the estimated future cash flows are less than the carrying amount of the asset, an impairment loss calculation is prepared. The impairment loss calculation compares the carrying amount of the asset to the individual store s estimated future cash flows (discounted and with interest charges). If required, an impairment loss is recorded for the portion of the asset s carrying value that exceeds the asset s estimated future cash flow (discounted and with interest charges).

Our impairment loss calculation contains uncertainty since management must use judgment to estimate each store s future sales, profitability and cash flows. When preparing these estimates, management considers each store s historical results and current operating trends and our consolidated sales, profitability and cash flow results and forecasts. These estimates can be affected by a number of factors including, but not limited to, general economic conditions, the cost of real estate, the continued efforts of third party organizations to reduce prescription drug costs, the continued efforts of competitors to gain market share and consumer spending patterns. We have not made any material changes to our impairment loss assessment methodology during the past three years.

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

Closed Store Lease Liability

We account for closed store lease termination costs in accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. As such, when a leased store is closed, we record a liability for the estimated present value of the remaining obligation under the non-cancelable lease, which includes future real estate taxes, common area maintenance and other charges, if applicable. The liability is reduced by estimated future sublease income.

The calculation of our closed store lease liability contains uncertainty since management must use judgment to estimate the timing and duration of future vacancy periods, the amount and timing of future lump sum settlement payments and the amount and timing of potential future sublease income. When estimating these potential termination costs and their related timing, we consider a number of factors, which include, but are not limited to, historical settlement experience, the owner of the property, the location and condition of the property, the terms of the underlying lease, the specific marketplace demand and general economic conditions. We have not made any material changes in the reserve methodology used to record closed store lease reserves during the past three years.

Self-Insurance Liabilities

We are self insured for certain losses related to general liability, worker s compensation and auto liability although we maintain stop loss coverage with third party insurers to limit our total liability exposure.

The estimate of our self-insurance liability contains uncertainty since management must use judgment to estimate the ultimate cost that will be incurred to settle reported claims and unreported claims for incidents incurred but not reported as of the balance sheet date. When estimating our self-insurance liability, we consider a number of factors, which include, but are not limited to, historical claim experience, demographic factors, severity factors and valuations provided by independent third-party actuaries. On a quarterly basis, management reviews its assumptions with its independent third party actuaries to determine that our self-insurance liability is adequate. We have not made any material changes in the accounting methodology used to establish our self-insurance liability during the past three years.

Inventory

Our inventory is valued at the lower of cost or market on a first-in, first-out basis using the retail method for inventory in our stores and the cost method for inventory in our distribution centers. Under the retail method, inventory is stated at cost, which is determined by applying a cost-to-retail ratio to the ending retail value of our inventory. Since the retail value of our inventory is adjusted on a regular basis to reflect current market conditions, our carrying value should approximate the lower of cost or market. In addition, we reduce the value of our ending inventory for estimated inventory losses that have occurred during the interim period between physical inventory counts. Physical inventory counts are taken on a regular basis in each location to ensure that the amounts reflected in the consolidated financial statements are properly stated.

The accounting for inventory contains uncertainty since management must use judgment to estimate the inventory losses that have occurred during the interim period between physical inventory counts. When estimating these losses, we consider a number of factors, which include but are not limited to, historical physical inventory results on a location-by-location basis and current inventory loss trends. We have not made any material changes in the accounting methodology used to establish our inventory loss reserves during the past three years.

Although management believes that the estimates discussed above are reasonable and the related calculations conform to generally accepted accounting principles, actual results could differ from our estimates, and such differences could be material.

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Part I **Item 2**

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

Recent Accounting Pronouncements

We adopted Emerging Issues Task Force release Issue No. 02-16, Accounting by a Reseller for Cash Consideration Received from a Vendor on a prospective basis effective December 29, 2002. This pronouncement requires vendor allowances be treated as a reduction in inventory costs unless specifically identified as a reimbursement for other services. In addition, any vendor allowances received in excess of the cost incurred for such services should also be treated as a reduction of inventory costs. The adoption of this pronouncement resulted in a $4.4 million and $9.2 million reduction in net earnings for the thirteen and twenty-six week periods ended June 28, 2003, respectively.

In May 2003, the Financial Accounting Standards Board issued Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. This Statement requires that certain instruments that were previously classified as equity on a company s statement of financial position now be classified as liabilities. The Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We do not expect that the adoption of this Statement will have a material impact on our consolidated results of operations or financial position.

Cautionary Statement Concerning Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 (the Reform Act) provides a safe harbor for forward-looking statements made by or on behalf of CVS Corporation. The Company and its representatives may, from time to time, make written or verbal forward-looking statements, including statements contained in the Company s filings with the Securities and Exchange Commission and in its reports to stockholders. Generally, the inclusion of the words believe, expect, intend, estimate, project, anticipate, will, and similar expressions identify statem constitute forward-looking statements. All statements addressing operating performance of CVS Corporation or any subsidiary, events, or developments that the Company expects or anticipates will occur in the future, including statements relating to sales growth, earnings or earnings per common share growth, free cash flow, debt rating, inventory levels, inventory turn and loss rates, store development, relocations and new market entries, as well as statements expressing optimism or pessimism about future operating results or events, are forward-looking statements within the meaning of the Reform Act. The forward-looking statements are and will be based upon management s then-current views and assumptions regarding future events and operating performance, and are applicable only as of the dates of such statements. The Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise. By their nature, all forward-looking statements involve risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements for a number of reasons, including but not limited to:

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

- The continued efforts of health maintenance organizations, managed care organizations, pharmacy benefit management companies, governmental entities and other third party payers to reduce prescription drug costs and pharmacy reimbursement rates;
- Increased competition from other drugstore chains, from alternative distribution channels such as pharmacy benefit management companies and other mail order companies, supermarkets, membership clubs, discount retailers and internet companies (e-commerce) as well as changes in consumer preferences or loyalties;
- The frequency and rate of introduction of successful new prescription drugs;
- Our ability to generate sufficient cash flows to support capital expansion and general operating activities;
- Interest rate fluctuations and changes in capital market conditions or other events affecting our ability to obtain necessary financing on favorable terms;
- Our ability to establish effective advertising, marketing and promotional programs (including pricing strategies and price reduction programs implemented in response to competitive pressures and/or to drive demand);
- Our ability to continue to secure suitable new store locations under acceptable lease terms;
- Our ability to enter new markets successfully;
- Our ability to attract, hire and retain suitable pharmacists and management personnel;
- Our ability to achieve cost efficiencies and other benefits from various operational initiatives and technological enhancements;
- Litigation risks as well as changes in laws and regulations, including changes in accounting standards and taxation requirements (including tax rate changes, new tax laws and revised tax law interpretations);
- The creditworthiness of the purchasers of businesses formerly owned by CVS and whose leases are guaranteed by CVS;
- Fluctuations in inventory cost, availability and loss levels and our ability to maintain relationships with suppliers on favorable terms;
- Our ability to implement successfully and to manage new computer systems and technologies;
- The strength of the economy in general or in the markets served by CVS, including changes in consumer purchasing power and/or spending patterns; and
- Other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission.

The foregoing list is not exhaustive. There can be no assurance that the Company has correctly identified and appropriately assessed all factors affecting its business. Additional risks and uncertainties not presently known to the Company or that it currently believes to be immaterial also may adversely impact the Company. Should any risks and uncertainties develop into actual events, these developments could have material adverse effects on the Company s business, financial condition, and results of operations. For these reasons, you are cautioned not to place undue reliance on the Company s forward-looking statements.

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Part I **Item 3**

Quantitative and Qualitative Disclosures About Market Risk

The Company has not entered into any transactions using derivative financial instruments or derivative commodity instruments and believes that its exposure to market risk associated with other financial instruments, principally interest rate risk inherent in its debt portfolio, is not material.

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Part I **Item 4**

Controls and Procedures

(a) Evaluation of disclosure controls and procedures: The Company s Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Exchange Act Rules 13a-14(c) and 15d-14(c)) as of June 28, 2003, have concluded that as of such date the Company s disclosure controls and procedures were adequate and effective and designed to ensure that material information relating to the Company and its subsidiaries would be made known to such officers on a timely basis.

(b) Changes in internal controls: There have been no changes in our internal controls over financial reporting that occurred during the fiscal quarter covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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Part II **Item 4**

Submission of Matters to a Vote of Security Holders

The following matters were submitted to a vote of security holders at our Annual Meeting of Stockholders, which was held on Wednesday, April 23, 2003 in Woonsocket, Rhode Island:

		For	*Against*	*Abstained*	*Broker Non-Votes*
1.	The election, for one-year terms, of all persons nominated for directors, as set forth in the Company s proxy statement dated March 12, 2003, was approved by the following votes:				
	W. Don Cornwell	297,107,152	45,675,043		
	Thomas P. Gerrity	335,573,937	7,208,258		
	Stanley P. Goldstein	338,084,180	4,698,015		
	Marian L. Heard	335,599,439	7,182,756		
	William H. Joyce	335,627,076	7,155,119		
	Terry R. Lautenbach	316,979,396	25,802,799		
	Terrence Murray	335,240,829	7,541,366		
	Sheli Z. Rosenberg	316,775,536	26,006,659		
	Thomas M. Ryan	335,237,091	7,545,104		
2.	Ratification of the appointment of KPMG LLP as the Company s independent auditors for the fiscal year ending January 3, 2004 was approved by the following vote:	331,269,940	9,196,006	2,316,248	

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Part II **Item 6**

Exhibits and Reports on Form 8-K

Exhibits:

3.1	Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to CVS Corporation s Annual Report on Form 10-K for the fiscal year ended December 31, 1996).
3.1A	Certificate of Amendment to the Amended and Restated Certificate of Incorporation, effective May 13, 1998 (incorporated by reference to Exhibit 4.1A to Registrant s Registration Statement No. 333-52055 on Form S-3/A dated May 18, 1998).
3.2	By-laws of the Registrant, as amended and restated (incorporated by reference to Exhibit 3.2 to CVS Corporation s Annual Report on Form 10-K for the fiscal year ended December 31, 1998).
10.1	Amendment No. 2 to the 364-day Credit Agreement dated as of May 19, 2003 by and among the Registrant, the lenders party hereto, Credit Suisse First Boston and Wachovia Bank, National Association, as Co-Documentation Agents, the Bank of New York as Syndication Agent, and Fleet National Bank, as Administrative Agent.
10.2	Separation agreement, dated as of April 10, 2003, between CVS Corporation and Deborah Ellinger.
15.1	Letter re: Unaudited Interim Financial Information.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Reports on Form 8-K:

On July 30, 2003, we filed a Current Report on Form 8-K in connection with a press release issued announcing our earnings for the second quarter ended June 28, 2003.

Signatures:

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned thereunto duly authorized.

CVS Corporation

(Registrant)

/s/ David B. Rickard

David B. Rickard

Executive Vice President,

Chief Financial Officer and

Chief Administrative Officer

August 8, 2003