

Consolidated Statements of Income

millions, except per common share data	1995	1994	1993
REVENUES			
Merchandise sales and services	\$31,035	\$29,451	\$27,171
Credit revenues	3,890	3,574	3,273
Total revenues	34,925	33,025	30,444
COSTS AND EXPENSES			
Cost of sales, buying and occupancy	22,866	21,568	19,918
Selling and administrative	7,577	7,498	7,039
Depreciation and amortization	578	528	504
Provision for uncollectible accounts	826	698	821
Interest	1,373	1,279	1,318
Total costs and expenses	33,220	31,571	29,600
Operating income	1,705	1,454	844
Other income	23	17	110
Income before income taxes	1,728	1,471	954
Income taxes	703	614	329
INCOME FROM CONTINUING OPERATIONS	1,025	857	625
Discontinued operations	776	402	1,960
Income before extraordinary gain (loss)	1,801	1,259	2,585
Extraordinary gain (loss) related to early extinguishment of debt	—	195	(211)
NET INCOME	\$ 1,801	\$ 1,454	\$ 2,374
EARNINGS PER COMMON SHARE , after allowing for dividends on preferred shares			
Income from continuing operations	\$ 2.53	\$ 2.13	\$ 1.56
Discontinued operations	1.97	1.03	5.12
Income before extraordinary gain (loss)	4.50	3.16	6.68
Extraordinary gain (loss)	—	0.50	(0.55)
Net income	\$ 4.50	\$ 3.66	\$ 6.13
Average common and common equivalent shares outstanding	394.0	388.9	382.9

See accompanying notes.

Analysis of Consolidated Operations

Sears, Roebuck and Co. ("the Company") conducts merchandising and credit operations in the United States, Canada and Mexico. In 1995, the Company successfully completed the initiatives announced in November 1994 to transform the Company into a stand-alone, focused retailer for the first time since 1931.

- The Company's 80% ownership interest in The Allstate Corporation ("Allstate") was distributed to shareholders as a tax-free dividend in June 1995. The distribution of Allstate reduced consolidated shareholders' equity by \$8.98 billion.
- The divestiture of Homart Development Co. and affiliated entities ("Homart") was completed in December 1995.

In September 1992, the Company announced a strategic repositioning. The highlights of the repositioning, which was completed in 1993, were as follows:

- Dean Witter, Discover & Co. ("Dean Witter") was distributed to shareholders as a tax-free dividend in June 1993, following the primary initial public offering of 20% of its common stock in March 1993. The Dean Witter distribution reduced consolidated shareholders' equity by \$2.29 billion.
- Allstate completed a primary initial public offering of 20% of its common stock in June 1993, resulting in a gain of \$635 million.
- The sales of the Coldwell Banker residential services businesses, consisting of the residential brokerage and relocation businesses and mortgage banking operations, were completed in the fourth quarter of 1993.

The consolidated financial statements present the results of Allstate, Dean Witter, Coldwell Banker and Homart as discontinued operations as discussed in note 2 to the consolidated financial statements.

Operating results for the Company's merchandising and credit operations are reported for two business segments: domestic operations and international operations.

During late 1995, the Company announced organizational changes within domestic operations that further aligned its structure with its strategy to grow department, as well as off-the-mall, stores and services. The organizational changes included:

- The creation of separate organizations for department stores, which sell apparel, home fashions and hardlines merchandise; off-the-mall Home stores, comprised of Sears Hardware, Sears dealer and HomeLife stores; and Home Services, consisting of Product Services and other home improvement services.
- The separation of the Automotive business into two divisions: the Sears Tire Group, which sells and installs tires, batteries and related goods and services through the Sears Auto, Tire America and NTW stores; and the Parts Group, that includes the automotive parts stores of Western Auto and Parts America.

Domestic operations include the department stores, the off-the-mall stores (comprised of Home stores and Automotive stores), Home Services, Direct Response and Credit. Credit primarily relates to the Sears Card, the largest proprietary credit card in the United States. The domestic operations conduct business in the United States and Puerto Rico.

International operations includes similar merchandising and credit operations conducted in Canada through Sears Canada Inc. ("Sears Canada"), a 61.1% owned subsidiary, and in Mexico through Sears Roebuck de Mexico, S.A. de C.V. ("Sears Mexico"), a 75.4% owned subsidiary.

Consolidated revenues for 1995, 1994 and 1993 were as follows:

millions	1995	1994	1993
Domestic operations:			
Domestic merchandising	\$28,020	\$26,127	\$23,806
Domestic credit	3,538	3,249	2,970
Total domestic operations	31,558	29,376	26,776
International operations	3,367	3,649	3,668
Total revenues	\$34,925	\$33,025	\$30,444

Consolidated revenues in 1995 rose \$1.90 billion, or 5.8%. Domestic revenues increased \$2.18 billion, or 7.4%, primarily due to strong merchandise sales and solid credit revenue increases. International operations revenues declined \$282 million, or 7.7%, primarily due to adverse exchange rate changes and difficult economic conditions in both Canada and Mexico. In 1994, consolidated revenues increased \$2.58 billion, or 8.5%. Domestic revenues rose \$2.60 billion, or 9.7%, primarily due to hardlines and apparel sales increases during the year. International revenues declined \$19 million, or 0.5%, due to adverse exchange rate changes. In local currencies, international revenues increased 5.5% in 1994.

DOMESTIC OPERATIONS

Supplementary domestic merchandising information:

millions, except number of stores	1995	1994	1993
Department store revenues	\$20,133	\$18,910	\$17,344
Off-the-mall store revenues	5,354	4,866	4,210
Total retail store revenues	25,487	23,776	21,554
Service and other revenues	2,533	2,351	2,252
Domestic merchandising revenues	\$28,020	\$26,127	\$23,806
Number of department stores	806	800	799
Number of off-the-mall stores	1,500	1,140	1,018
Total retail stores	2,306	1,940	1,817
Retail store revenues per selling square foot	\$ 353	\$ 346	\$ 321
Comparable store sales increase	4.7%	8.3%	8.9%

One of the primary objectives of the Company's growth strategy has been to improve the sales productivity of its department stores. The success of this strategy can be measured by the comparable store sales increases which have remained strong over the past three years. The strength of the comparable store sales increases becomes even more evident considering the intense competition that the retail industry has experienced.

In addition to the strong comparable store sales increases, the increase in revenues per selling square foot also demonstrates the improvement in department store productivity.

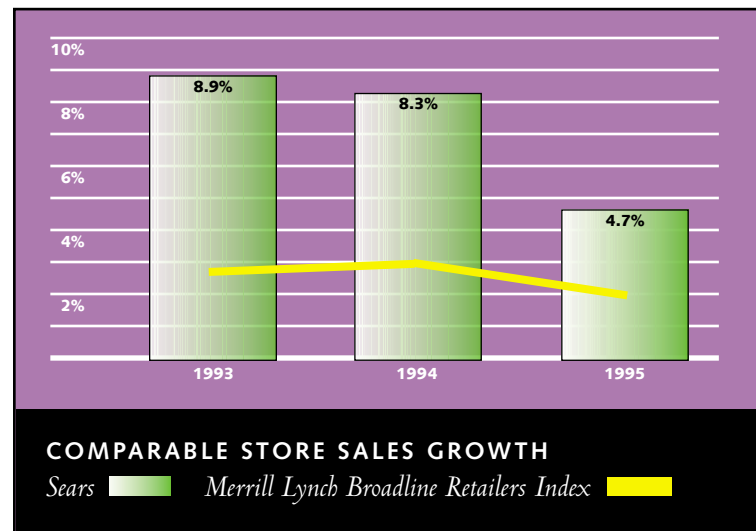
Analysis of Consolidated Operations (CONTINUED)

Department store revenues increased 6.5% in 1995, which built on a 9.0% increase in 1994. Department store revenues have increased substantially since the Company's restructuring announced in 1993 and have benefited from the remodeling and modernization of 353 mall stores, the conversion of 3.8 million square feet of non-selling space and 2.5 million square feet of selling space formerly occupied by furniture departments to apparel selling space, and a more targeted customer-focused merchandise selection.

Apparel sales posted significant gains in 1995, overcoming weak industry conditions. Sales increases were strongest in women's dresses, juniors, cosmetics, jewelry and men's fashions. The Company has undertaken several initiatives to grow the apparel business. They include remodeling the mall stores, offering more varied national brand-name merchandise and developing private brand fashion merchandise for select lines.

Hardlines merchandise had solid revenue growth in 1995 but did not achieve the same robust growth rates that were experienced in 1994. Brand Central contributed the largest portion of the increase on strong sales in home electronics, appliances and home office merchandise. Home Improvement sales also contributed to the hardlines sales increase and were generated by solid sales growth in hardware and exercise equipment.

In 1994, the increase in department store revenues was paced by excellent hardline sales as appliances and home electronics merchandise benefited from strong home-related consumer demand. Softline fashion sales also increased significantly in 1994 as women's fashions, fine jewelry, cosmetics, men's apparel and footwear sold particularly well.



With the department stores making considerable progress since the restructuring, the Company has planned for future growth opportunities by aggressively expanding its various off-the-mall store concepts.

Off-the-mall store revenues in 1995 increased 10.0% over 1994. The Home stores contributed the largest portion of the revenue growth in 1995. The increase was attributable to the expansion of the dealer store network, as the Company opened 98 stores in 1995, and growth in the Sears Hardware and HomeLife stores where 45 and 26 new stores were opened, respectively.

The automotive business also generated revenue growth in 1995. The Company has aggressively expanded this business by opening 49 and acquiring 166 automotive parts stores. As the acquisitions of the 166 stores were not completed until the fourth quarter, they did not have a significant impact on 1995 revenues. The Sears Tire Group experienced significant revenue growth with the opening of 15 NTW and 6 Tire America Stores in 1995.

In 1994, off-the-mall store revenues increased 15.6% over 1993. The increase was attributable to the growth of the Sears dealer, Sears Hardware and HomeLife stores networks. Revenues at the Automotive stores increased slightly in 1994, as strong sales increases in the Parts Group were partially offset by sales declines in the Sears Tire Group, reflecting the discontinuation of unprofitable product lines and services at the Sears Auto Centers.

Service and other revenues, which are generated by the home services and direct response businesses, increased 7.8% in 1995 and 4.4% in 1994. Increases in product services maintenance agreement sales, which benefited from strong Brand Central sales, accounted for the 1995 and 1994 growth.

Supplementary domestic credit revenue information:

millions	1995	1994	1993
Gross revenues	\$ 3,863	3,600	3,486
Funding cost on securitized receivables	\$ (325)	(351)	(516)
Net revenues	\$ 3,538	3,249	2,970
Sears Card sales as a % of sales (1)	59.7%	58.3	58.0
Gross customer receivables	\$23,760	21,325	20,351
Receivable balances sold at year end	\$ 4,549	3,946	5,174
Owned customer receivables at year end	\$19,211	17,379	15,177
Average gross receivables	\$21,685	20,094	19,649
Average owned receivables	\$17,381	15,718	13,471
Average account balance (dollars)	\$ 912	842	795

(1) For department and HomeLife stores only.

In 1995, gross credit revenues increased 7.3% reflecting higher gross receivable balances driven by strong merchandise sales and a reduction in the minimum required monthly payment rate. The percentage of merchandise sales and services transacted with the Sears Card in 1995 increased due to continuing efforts to integrate the Sears Card with the promotional plans of the department and off-the-mall stores. In 1994, gross credit revenues increased 3.3% against 1993, reflecting strong merchandise sales.

Analysis of Consolidated Operations (CONTINUED)

Key operating measures for domestic operations:

millions	1995	1994	1993
Gross margin	\$7,465	7,093	6,548
Percent of merchandise sales and services	26.6%	27.1	27.5
Selling and administrative expense	\$6,813	6,710	6,238
Percent of total revenues	21.6%	22.8	23.3
Interest expense	\$1,183	1,120	1,159
Funding cost on securitized receivables	\$ 325	351	516
Total funding costs	\$1,508	1,471	1,675
Provision for uncollectible accounts	\$ 764	650	795
Operating income	\$1,729	1,400	880
Percent of total revenues	5.5%	4.8	3.3
Net credit charge-offs to average gross customer receivables	3.52%	3.32	3.45
Gross credit customer receivables delinquent sixty days or more	4.19%	3.86	3.55
Allowance for uncollectible accounts as a percentage of gross credit customer receivables at year end	3.87%	4.31	4.72

Note: Corporate operating results are insignificant and have been included in Domestic Operations for 1995. Domestic Operations results for 1994 and 1993 have been restated to include Corporate.

Gross margin as a percentage of merchandise sales and services declined from 27.1% in 1994 to 26.6% in 1995. Gross margins were pressured by intense competition in the retail marketplace throughout the year, but fourth quarter gross margin rates increased relative to 1994 in the important holiday selling season on improved markdown trends. The year-to-year difference in the LIFO adjustment lowered 1995 gross margins by 20 basis points as compared to 1994.

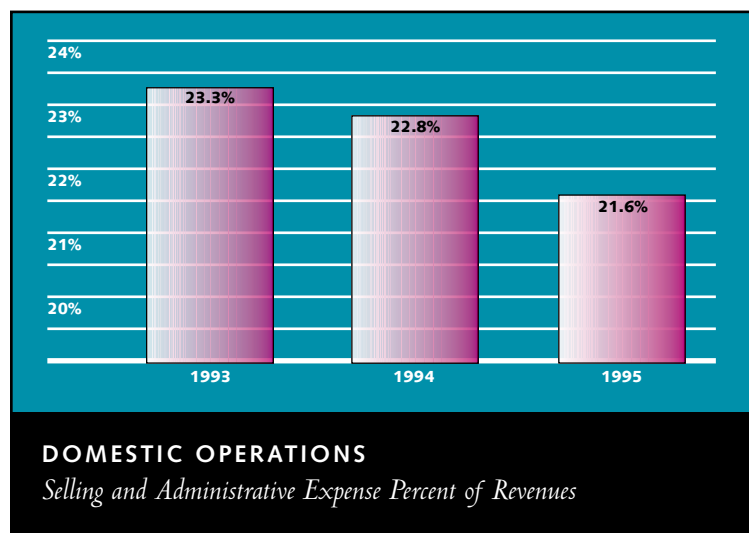
In 1994, gross margin as a percentage of merchandise sales and services decreased to 27.1% from 27.5% due largely to the strong sales performance in the Brand Central and home improvement departments, which provide lower gross margin rates than domestic merchandising operations as a whole.

Domestic operations selling and administrative expense as a percent of revenues in 1995 improved 120 basis points to 21.6% from 22.8% in 1994. The improvement in the selling and administrative expense ratio reflects the Company's continued emphasis on controlling expenses and leveraging its fixed cost base with strong revenue growth. Payroll, store operating and general overhead costs continued to decline as a percentage of revenues in 1995.

Included in domestic operations selling and administrative expense in 1995 was a \$51 million pretax restructuring charge related to the Company's realignment initiative. This initiative better aligns the Company's structure with its growth strategy, particularly the creation of separate tire and auto parts units and the consolidation of certain distribution facilities. Beginning in 1997, resulting after-tax savings from the restructuring will be approximately \$30 to \$35 million annually.

In 1995, the Company also reversed \$62 million of pretax reserves previously established as part of its \$2.65 billion restructuring announced in 1993, which are no longer needed based on the settlement of obligations and the adjustment of the carrying values of certain properties to be disposed of in connection with that restructuring. This reserve adjustment was also included in domestic operations selling and administrative expense in 1995.

In 1994, selling and administrative expense as a percent of revenues declined 50 basis points to 22.8% from 23.3% in 1993. The improvement was primarily attributable to a reduction in payroll and store operating costs as a percent of revenues.



Total domestic funding costs, comprised of interest expense and the cost associated with receivable securitizations, increased 2.6% as compared to 1994 reflecting the growth in gross credit receivables partially offset by a lower effective funding rate resulting from the favorable interest rate environment in 1995.

In 1994, total domestic funding costs decreased 12.2% reflecting lower funding needs stemming from the strategic repositioning partially offset by higher retail customer receivables.

The provision for uncollectible accounts increased 17.5% from 1994. The increase is attributable to a number of factors, primarily the 7.9% growth of the average gross receivable balance from 1994 levels, the rise in the delinquency rate and the increase in the net charge-off rate due to the industry-wide unfavorable trend in customer bankruptcies. The Company has responded to the rise in bankruptcies and delinquency trends by stepping up collection efforts and implementing additional collection strategies.

In 1994, the provision for uncollectible accounts was 18.2% lower than 1993 reflecting favorable customer write-off trends.

The key measure of the improved profit performance of domestic operations is the growth in operating income from 1993 through 1995. The improved performance is attributable to the strong merchandising revenue growth, the reduction in selling and administrative expense as a percent of revenues and the strong credit performance, partially offset by a decline in gross margin rates.

Consolidated Balance Sheets

millions	1995	1994
ASSETS		
Current Assets		
Cash and invested cash	\$ 606	\$ 548
Retail customer receivables	20,949	19,033
Less: Allowance for uncollectible accounts and unearned finance charges	843	832
	20,106	18,201
Other receivables	444	321
Merchandise inventories	4,033	4,044
Prepaid expenses and deferred charges	360	303
Deferred income taxes	892	712
Total current assets	26,441	24,129
Property and equipment		
Land	387	371
Buildings and improvements	4,382	4,041
Furniture, fixtures and equipment	3,775	3,777
Capitalized leases	313	229
	8,857	8,418
Less accumulated depreciation	3,780	4,165
Total property and equipment, net	5,077	4,253
Deferred income taxes	879	893
Other assets	733	806
Net assets of discontinued operations	—	7,231
TOTAL ASSETS	\$33,130	\$37,312
LIABILITIES		
Current Liabilities		
Short-term borrowings	\$ 5,349	\$ 6,190
Current portion of long-term debt and capitalized lease obligations	1,730	1,141
Accounts payable and other liabilities	6,133	5,307
Unearned revenues	887	795
Other taxes	508	480
Total current liabilities	14,607	13,913
Long-term debt and capitalized lease obligations	10,044	8,844
Postretirement benefits	2,825	2,810
Minority interest and other liabilities	1,269	944
TOTAL LIABILITIES	28,745	26,511
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY		
Preferred shares (\$1 par value, 50 shares authorized)		
8.88% Preferred Shares, First Series (3.25 shares issued and outstanding)	325	325
Series A Mandatorily Exchangeable Preferred Shares (7.1875 shares issued and outstanding as of Dec. 31, 1994)	—	1,236
Common shares (\$.75 par value, 1,000 shares authorized, 390.5 and 351.7 shares outstanding)	322	294
Capital in excess of par value	3,634	2,385
Retained income	2,444	8,918
Treasury stock—at cost	(1,634)	(1,690)
Minimum pension liability	(285)	—
Deferred ESOP expense	(253)	(558)
Unrealized net capital gains	—	32
Cumulative translation adjustments	(168)	(141)
TOTAL SHAREHOLDERS' EQUITY	4,385	10,801
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$33,130	\$37,312

See accompanying notes.

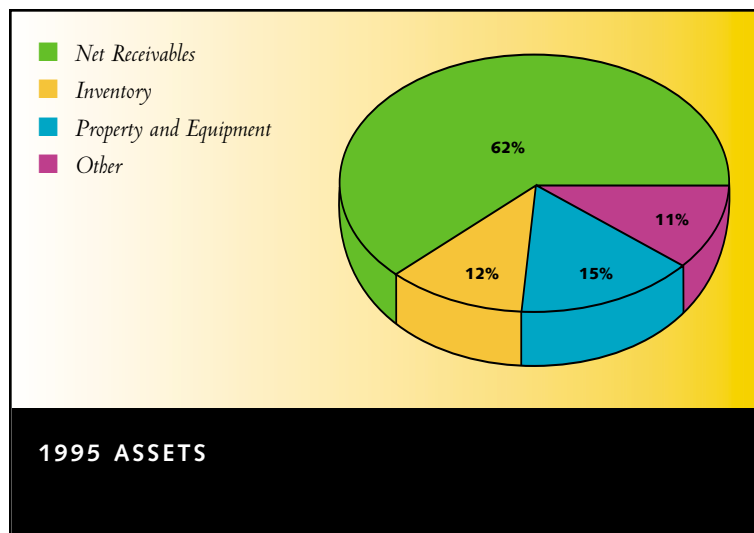
Analysis of Consolidated Financial Condition

ANALYSIS OF CONSOLIDATED FINANCIAL CONDITION

The Company's significant financial capacity and flexibility are exemplified by the quality and liquidity of its assets and by its ability to access multiple sources of capital.

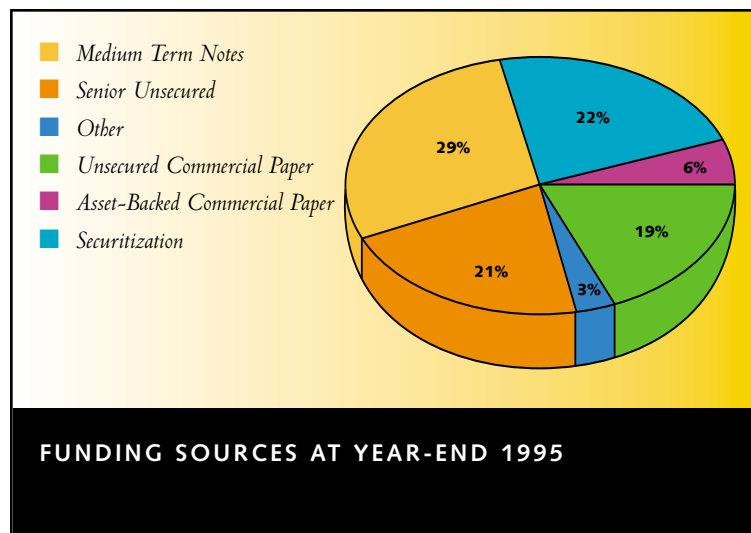
The retail customer receivables portfolio of \$20.11 billion of owned receivable balances excludes \$5.08 billion of receivables sold through securitizations. Domestic and international accounts represent \$18.92 billion and \$1.19 billion of the owned portfolio, respectively. The portfolio is geographically diversified in the U.S., Canada and Mexico. The Company extends and monitors retail consumer credit based on an extensive use of proprietary and commercially available credit histories and scoring models. The Company promptly recognizes uncollectible accounts and emphasizes the maintenance of an adequate loss allowance, which is assessed using multiple modeling approaches based on the portfolio risk characteristics. Domestic accounts are written off at 210 days delinquent or within 60 days of receipt of a bankruptcy notice.

Merchandising inventories are primarily valued on the last-in, first-out or LIFO method. Inventories would have been \$711 million higher if valued on the first-in, first-out or FIFO method at Dec. 30, 1995. Inventories on a FIFO basis totaled \$4.74 billion at Dec. 30, 1995 and Dec. 31, 1994.



CAPITAL RESOURCES

Total net funding for the Company at Dec. 30, 1995 was \$22.06 billion compared with \$20.53 billion at Dec. 31, 1994, and was used primarily to fund retail customer receivables. Net funding includes debt reflected on the balance sheet and investor certificates related to retail customer receivables sold through securitizations. Funding related to customer receivables grew during the year, as gross customer receivables increased, reflecting the continuing strength of the Sears Card business. The Company's debt-to-equity ratio was 3.9 at Dec. 30, 1995.



During 1994, the Company eliminated debt of \$845 million through the transfer of Sears Tower and all related assets and liabilities to a third party as trustee of a trust. Debt was reduced by \$2.41 billion as a result of the classification of Allstate and Homart as discontinued operations.

The Company accesses a variety of capital markets to preserve flexibility and diversify its funding sources. The broad access to capital markets also allows the Company to effectively manage liquidity and repricing risk. Liquidity risk is the measure of the Company's ability to fund maturities and provide for the operating needs of its businesses. Repricing risk is the impact on net income due to changes in interest rates. The Company's cost of funds is affected by a variety of general economic conditions, including the level and volatility of interest rates. To aid in the management of repricing risk, the Company uses off-balance sheet instruments, such as interest rate swaps and caps. The Company has policies that centrally govern the use of off-balance sheet instruments.

Consolidated Statements of Cash Flows

millions	1995	1994	1993
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$1,801	\$ 1,454	\$ 2,374
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation, amortization and other noncash items	631	601	645
Extraordinary (gain) loss related to early extinguishment of debt	—	(319)	107
Provision for uncollectible accounts	826	698	821
Gain on sales of property and investments	(35)	(22)	(73)
Change in:			
Deferred income taxes	37	359	341
Retail customer receivables	(2,807)	(3,199)	(2,868)
Merchandise inventories	(7)	(594)	514
Other operating assets	(145)	638	(111)
Other operating liabilities	837	(148)	(865)
Discontinued operations	(776)	(402)	(1,960)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	362	(934)	(1,075)
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from sales of investments	—	—	364
Proceeds from sales of property and equipment	41	26	10
Purchases of property and equipment	(1,183)	(954)	(562)
Discontinued operations—net	483	233	1,289
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	(659)	(695)	1,101
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term debt	2,588	2,798	707
Repayments of long-term debt	(1,124)	(2,717)	(1,537)
Increase (decrease) in short-term borrowings, primarily 90 days or less	(637)	1,617	980
Repayments of ESOP note receivable	44	69	15
Common shares issued for employee stock plans	97	45	193
Dividends paid to shareholders	(607)	(698)	(727)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	361	1,114	(369)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND INVESTED CASH	(6)	(3)	(1)
NET INCREASE (DECREASE) IN CASH AND INVESTED CASH	58	(518)	(344)
CASH AND INVESTED CASH AT BEGINNING OF YEAR	548	1,066	1,410
CASH AND INVESTED CASH AT END OF YEAR	\$ 606	\$ 548	\$ 1,066

See accompanying notes.

Analysis of Consolidated Financial Condition (CONTINUED)

The current debt ratings of the Company appear in the table below. The Company believes that its debt ratings continue to afford cost-effective access to the capital markets.

	Moody's Investors Services, Inc.	Standard & Poor's	Duff & Phelps Credit Rating Co.	Fitch Investors Service Inc.
Unsecured long-term debt	A2	BBB	A	A
Unsecured commercial paper	P-1	A-2	D-1	F-1
Term securitization	Aaa	AAA	AAA	AAA
Asset-backed commercial paper	P-1	A-1+	NR	NR

NR—Not rated.

On January 5, 1996, Standard & Poor's placed the unsecured long-term debt rating of the Company under review with positive implications.

The Company utilizes Sears Roebuck Acceptance Corp. ("SRAC"), a wholly-owned subsidiary, to issue long-term underwritten debt, to maintain a continuously offered medium-term note program, to issue intermediate-term notes and to issue commercial paper. SRAC issued term debt securities totaling \$1.93 billion in 1995. SRAC commercial paper outstandings were \$4.45 billion and \$4.91 billion at Dec. 30, 1995 and Dec. 31, 1994, respectively. SRAC commercial paper is supported by a \$4.68 billion syndicated credit facility which expires in 2000 and by a \$1.0 billion, 364-day, syndicated credit facility.

The Company also issues commercial paper secured by retail customer receivables through the Sears Credit Corp. ("SCC") entities. The commercial paper issued by SCC is collateralized by Sears Card receivables and allows for the cost-effective management of the Company's term securitization issues. SCC commercial paper outstandings were \$1.00 billion and \$1.75 billion at Dec. 30, 1995 and Dec. 31, 1994, respectively. SCC commercial paper is supported by syndicated credit facilities of \$1.04 billion.

In 1995, the Company and SRAC issued medium-term notes in an on-going program to average interest rates on a portion of its term senior unsecured financings. Variable-rate notes totaling \$292 million were issued in 1995 at an average maturity of 2.3 years. Fixed-rate issuances in 1995 totaled \$1.64 billion with a weighted average coupon of 6.5% and an average term of 3.9 years. During 1995, SRAC issued \$500 million of discrete senior debt with a weighted average coupon of 6.63% and an average term of 7.5 years.

The Company securitizes credit card receivables to access intermediate-term investors in a cost-effective manner. These securities are rated in the highest category by the national rating agencies. The Company issued \$2.39 billion of domestic, fixed-rate term securitizations in 1995 at an average coupon of 7.03%. As of Dec. 30, 1995, there were \$6.91 billion of domestic investor certificates outstanding, which were backed by \$4.55 billion of sold domestic retail customer receivables and \$2.36 billion of other investments.

On Mar. 20, 1995, the Company exchanged all of its 28.8 million Series A Mandatorily Exchangeable Preferred Shares ("PERCS") for 35.7 million common shares of the Company. The exchange did not dilute earnings per share as the PERCS were reflected in the Company's earnings per share calculation in prior years.

CAPITAL SPENDING

The Company is currently in the middle of a five-year, \$4 billion capital expenditure program which is focused on renovating and updating the department stores. In addition, the Company plans to grow its off-the-mall businesses. The capital expended for property and equipment during the past three years has been used as follows:

millions	1995	1994	1993
Department stores, primarily remodel and expansion efforts	\$ 868	\$673	\$306
Off-the-mall stores	111	106	82
Other - distribution centers/support functions	204	175	174
Total capital expenditures	\$1,183	\$954	\$562

The Company plans capital expenditures of \$1.40 billion for 1996, which includes remodeling and expansion of approximately 100 existing stores, and opening of 10 to 20 new department stores, 65 to 75 Sears Hardware stores, 10 to 15 HomeLife stores and 100 to 115 automotive stores. The Company may also pursue selective strategic acquisitions as a means of growth.

OPERATING, INVESTING AND FINANCING ACTIVITIES

Cash flows from operating activities consist primarily of net income adjusted for certain noncash expense items including depreciation, the provision for uncollectible accounts, changes in receivables, inventories and deferred taxes.

Cash provided by operating activities in 1995 improved \$1.30 billion as compared with 1994. The change was due to higher income from continuing operations, lower levels of inventory growth, lower increases in owned domestic customer receivables and a larger increase in other operating liabilities as compared to 1994. These changes were partially offset by an increase in other operating assets as compared to 1994. The lower levels of inventory growth in 1995 reflect the Company's continued emphasis on inventory management and control. The lower increase in owned customer receivables reflects higher levels of securitized receivables partially offset by higher levels of gross domestic customer receivables. The cash generated by other operating liabilities is due primarily to lower levels of restructuring payments and a general increase in other operating liabilities in 1995 as compared to 1994. The increase in other operating assets reflects a change in other receivables related to the Company's securitization program which occurred in 1994.

Consolidated Statements of Shareholders' Equity

	1995	1994	1993	1995	1994	1993
	dollars in millions			shares in thousands		
8.88% PREFERRED SHARES, FIRST SERIES						
Balance, beginning of year	\$ 325	\$ 325	\$ 325	3,250	3,250	3,250
Issued during year	—	—	—	—	—	—
Balance, end of year	\$ 325	\$ 325	\$ 325	3,250	3,250	3,250
SERIES A MANDATORILY EXCHANGEABLE PREFERRED SHARES (PERCS)						
Balance, beginning of year	\$ 1,236	\$ 1,236	\$ 1,236	7,188	7,188	7,188
Issued during year	—	—	—	—	—	—
Exchanged to common shares during year	(1,236)	—	—	(7,188)	—	—
Balance, end of year	\$ —	\$ 1,236	\$ 1,236	—	7,188	7,188
COMMON SHARES						
Balance, beginning of year	\$ 294	\$ 294	\$ 291	392,310	391,752	387,514
Conversion of PERCS	27	—	—	35,673	—	—
Stock options exercised and other changes	1	—	3	1,700	558	4,238
Balance, end of year	\$ 322	\$ 294	\$ 294	429,683	392,310	391,752
CAPITAL IN EXCESS OF PAR VALUE						
Balance, beginning of year	2,385	2,354	2,195			
Stock options exercised and other changes	40	31	159			
Conversion of PERCS	1,209	—	—			
Balance, end of year	3,634	2,385	2,354			
RETAINED INCOME						
Balance, beginning of year	8,918	8,163	8,772			
Net income	1,801	1,454	2,374			
Preferred share dividends	(53)	(137)	(137)			
Common share dividends (\$1.26, \$1.60 and \$1.60 per share)	(475)	(562)	(558)			
Distribution of The Allstate Corporation shares	(7,747)	—	—			
Distribution of Dean Witter, Discover & Co. shares	—	—	(2,288)			
Balance, end of year	2,444	8,918	8,163			
TREASURY STOCK—AT COST						
Balance, beginning of year	(1,690)	(1,704)	(1,734)	(40,570)	(40,904)	(41,670)
Reissued under compensation plans	56	14	30	1,375	334	766
Balance, end of year	(1,634)	(1,690)	(1,704)	(39,195)	(40,570)	(40,904)
MINIMUM PENSION LIABILITY						
Balance, beginning of year	—	—	—			
Minimum liability adjustment during year	(285)	—	—			
Balance, end of year	(285)	—	—			
DEFERRED ESOP EXPENSE						
Balance, beginning of year	(558)	(614)	(700)			
Reductions	305	56	86			
Balance, end of year	(253)	(558)	(614)			
UNREALIZED NET CAPITAL GAINS						
Balance, beginning of year	32	1,674	428			
Net increase (decrease)	1,176	(1,642)	1,246			
Distribution of The Allstate Corporation shares	(1,208)	—	—			
Balance, end of year	—	32	1,674			
CUMULATIVE TRANSLATION ADJUSTMENTS						
Balance, beginning of year	(141)	(64)	(40)			
Net unrealized loss during year	(7)	(77)	(24)			
Distribution of The Allstate Corporation shares	(20)	—	—			
Balance, end of year	(168)	(141)	(64)			
TOTAL COMMON SHAREHOLDERS' EQUITY AND SHARES OUTSTANDING						
	\$4,060	\$ 9,240	\$10,103	390,488	351,740	350,848
TOTAL SHAREHOLDERS' EQUITY						
	\$4,385	\$10,801	\$11,664			

See accompanying notes.

Analysis of Consolidated Financial Condition (CONTINUED)

Cash used in operations in 1994 decreased \$141 million compared with 1993. The change was due to higher income from continuing operations, a decrease in other operating assets and a smaller decrease in other operating liabilities compared to 1993. These changes were partially offset by an increase in merchandise inventories, a larger increase in owned retail customer receivables compared with 1993 and a lower provision for uncollectible accounts. The decrease in other operating assets was primarily due to changes in receivables related to the Company's securitization program. The increase in owned retail customer receivables was due to higher gross retail customer receivables partially offset by lower securitized receivables. Merchandise inventories increased as a result of expansion of selling space in the department stores and the growth of the off-the-mall stores.

Net cash used in investing activities decreased in 1995 due to higher cash realized from discontinued operations partially offset by increased levels of capital expenditures from the department store remodel program. The cash realized from discontinued operations in 1995 relates primarily to the proceeds from the sale of Homart. Net cash used in investing activities in 1994 increased over 1993, reflecting a lower level of cash provided by discontinued operations and higher store remodeling capital expenditures.

The decline in cash provided by financing activities in 1995 was primarily due to an increase in securitization levels to finance retail customer receivable growth over 1994 levels.

Net cash provided by financing activities in 1994 was primarily due to increases in short-term borrowings supporting higher owned retail customer receivable balances, resulting from the decrease in receivables sold through securitizations.

The Company paid cash dividends of \$1.43 per common share in 1995, the 60th consecutive year of payout. Since the Allstate spin-off, the Company's quarterly cash dividend has been \$0.23 per common share. The payment of future common dividends is dependent upon the Company's earnings and investment opportunities.

Notes to Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The consolidated financial statements include the accounts of Sears, Roebuck and Co. ("the Company") and all significant domestic and international companies in which the Company has more than a 50% equity ownership. Investments in companies in which the Company has a 20% to 50% ownership are accounted for using the equity method. The Allstate Corporation ("Allstate"), Homart Development Co. and affiliated entities ("Homart"), Dean Witter, Discover & Co. ("Dean Witter") and Coldwell Banker and affiliated entities ("Coldwell Banker") are presented as discontinued operations.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Although not a part of the financial statements, included with the consolidated statements is a five-year summary of consolidated financial data.

Certain reclassifications have been made in the 1994 and 1993 financial statements to conform to current accounting classifications.

FISCAL YEAR

In 1994, the Company changed its fiscal year to end on the last Saturday in December. Fiscal year 1995 ended on December 30, while fiscal years 1994 and 1993 ended on December 31.

MERCHANDISE SALES AND SERVICES

Revenues from merchandise sales and services are net of returns and allowances and exclude sales tax. Included in merchandise sales and services are gross revenues from licensed departments of \$1.10, \$1.07 and \$1.03 billion for 1995, 1994 and 1993, respectively.

MAINTENANCE AGREEMENTS

The Company sells extended service contracts with terms of coverage between 12 and 36 months. Revenue and incremental direct acquisition costs from the sale of these contracts are deferred and amortized on a straight-line basis over the lives of the contracts. Costs related to servicing the contracts are expensed as incurred.

STORE PRE-OPENING EXPENSES

Costs associated with the opening of new stores are expensed in the year incurred.

EARNINGS PER COMMON SHARE

Earnings per common share is computed based on the weighted average number of common and common equivalent shares (dilutive stock options) outstanding and after adjustment for dividends of \$29 million in 1995, 1994 and 1993 on the 8.88% Preferred Shares. The Series A Mandatorily Exchangeable Preferred Shares ("PERCS") were exchanged for common shares on Mar. 20, 1995.

CASH AND INVESTED CASH

Cash and invested cash includes all highly liquid investments with maturities of three months or less.

RETAIL CUSTOMER RECEIVABLES

Retail customer receivables at Dec. 30, 1995 include approximately \$9.9 billion of domestic accounts and \$406 million of Canadian accounts which will not become due within one year. These receivables are expected to earn finance charge revenue at annual percentage rates ranging from 10.3% to 21.0% for domestic accounts and 28.8% for Canadian accounts.

Retail customer receivables are shown net of an allowance for uncollectible accounts. When receivables are securitized and sold with recourse, the portion of the allowance for uncollectible accounts pertaining to such receivables is transferred to a recourse liability at the date of sale. Factors such as prior account loss experience, changes in the volume of the account portfolio and overall portfolio quality are considered in determining the allowance and the recourse liability.

MERCHANDISE INVENTORIES

Merchandise inventories of domestic operations are valued at the lower of cost (primarily using the last-in, first-out or LIFO method) or market using the retail method. To estimate the effects of inflation in inventories, the Company utilizes internally developed price indices.

The LIFO adjustment to cost of sales was a charge of \$19 million in 1995, compared with a credit of \$34 million in 1994 and a charge of \$5 million in 1993. Partial liquidation of merchandise inventories valued under the LIFO method in all three years resulted in credits of \$15, \$3 and \$74 million in 1995, 1994 and 1993, respectively. If the first-in, first-out (FIFO) method of inventory valuation had been used instead of the LIFO method, merchandise inventories would have been \$711 and \$692 million higher at Dec. 30, 1995 and Dec. 31, 1994, respectively.

Merchandise inventories of international operations, Western Auto and Puerto Rico, which represent approximately 18% of merchandise inventories, are recorded based on the FIFO method.

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost less accumulated depreciation. Depreciation is provided principally by the straight-line method over the estimated useful lives of the related assets, generally 5 to 10 years for equipment and 40 to 50 years for real property. Accumulated depreciation was \$3.78 and \$4.17 billion at Dec. 30, 1995 and Dec. 31, 1994, respectively.

INCOME TAXES

The consolidated federal income tax return of Sears, Roebuck and Co. includes results of the domestic operations of both the continuing businesses and discontinued operations. Tax liabilities and benefits are allocated as generated by the respective businesses, whether or not such benefits would be currently available on a separate return basis.

Notes to Consolidated Financial Statements (CONTINUED)

OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

The Company utilizes various off-balance sheet financial instruments to manage the interest rate and foreign currency risk associated with its borrowings. The counterparties to these instruments are major financial institutions with credit ratings primarily of AA.

Interest rate swap agreements modify the interest characteristics of a portion of the Company's debt. The differential to be paid or received is accrued as interest rates change and recognized as an adjustment to interest expense in the statement of income. The related accrued receivable or payable is included in other assets or liabilities. The fair values of the swap agreements are not recognized in the financial statements.

Interest rate caps are used to lock in a maximum rate if rates rise, but enable the Company to otherwise pay lower market rates. The cost of interest rate caps is amortized to interest expense over the life of the caps. Payments received due to the interest rate caps reduce interest expense. The unamortized cost of the interest rate caps is included in other assets.

2. DISCONTINUED OPERATIONS

Income from discontinued operations was as follows:

millions	1995	1994	1993
Operating income, net of income tax expense (benefit) of \$249, \$(256) and \$240	\$776	\$402	\$1,389
Gain from Allstate's initial public offering	—	—	635
Loss on disposal, including income tax expense of \$22	—	—	(64)
Total	\$776	\$402	\$1,960

On Nov. 10, 1994, the Company announced its intention to distribute in a tax-free dividend to the Company's common shareholders its 80% ownership interest in The Allstate Corporation. The distribution was approved by shareholders at a special meeting on March 31, 1995. On June 20, 1995, the Company's Board of Directors approved the distribution to Sears shareholders in a tax-free dividend. Sears shareholders of record on June 30, 1995 received, effective June 30, 1995, .93 shares of The Allstate Corporation for each Sears common share owned. This transaction resulted in a noncash dividend to Sears shareholders totaling \$8.98 billion.

In July 1995, the Company completed the sale of Homart's commercial office building portfolio to an operating partnership composed of the Morgan Stanley Real Estate Fund II, L.P. and Hines Interests Limited Partnership. In December 1995, the Company completed the sale of the retail shopping center and community development businesses of Homart to a wholly-owned subsidiary of General Growth Properties, Inc. No gain or loss to the Company resulted from these transactions.

In March 1993, Dean Witter completed an initial public offering of 20% of its common stock. The Company did not recognize a gain on this transaction. On June 18, 1993, the Company's Board of Directors approved a tax-free spin-off of Dean Witter to the Company's common shareholders. Sears common shareholders of record on June 28, 1993 received, effective June 30, 1993, .39 shares of Dean Witter for each Sears common share owned. This transaction resulted in a noncash dividend to Sears common shareholders totaling \$2.29 billion.

In May 1993, the Company entered into separate agreements to sell the Coldwell Banker residential business and the mortgage banking operations. A \$64 million after-tax loss was recorded in the second quarter of 1993 primarily due to adverse income tax effects related to the sale of Sears Savings Bank (an affiliate of Coldwell Banker). These sales were completed in the fourth quarter of 1993.

The operating results of the discontinued operations are summarized below:

millions	1995	1994	1993
Allstate			
Revenues	\$11,244	\$21,464	\$20,946
Income	776	388	1,160
Homart			
Revenues	\$ 256	\$ 266	\$ 234
Income (loss)	—	14	(11)
Dean Witter			
Revenues	\$ —	—	\$ 2,832
Income	—	—	248
Coldwell Banker			
Revenues	\$ —	—	\$ 1,204
Income (loss)	\$ —	—	(8)

3. RESTRUCTURING

Included in domestic operations selling and administrative expenses in 1995 was a \$51 million pretax restructuring charge associated with the Company's organizational realignment. This initiative better aligns the Company's structure with its growth strategy, particularly the creation of separate tire and auto parts units and the consolidation of certain distribution facilities. Beginning in 1997, resulting after-tax savings from the restructuring will be an estimated \$30 to \$35 million annually.

In 1995, the Company also reversed \$62 million of pretax reserves related to the \$2.65 billion domestic merchandising restructuring announced in 1993. The reserves which were released are no longer needed due to the settlement of obligations and the adjustment of the carrying values of certain properties to be disposed of in connection with that restructuring. The remaining reserve balance for that restructuring is not material.

Notes to Consolidated Financial Statements (CONTINUED)

4. INCOME TAXES

Income before income taxes was as follows:

millions	1995	1994	1993
Domestic	\$1,727	\$1,411	\$ 905
Foreign	1	60	49
Total	\$1,728	\$1,471	\$ 954

Federal, state and foreign taxes were as follows:

millions	1995	1994	1993
Federal income tax			
Current	\$ 571	\$ 324	\$ (35)
Deferred	31	171	295
State income tax			
Current	93	45	(5)
Deferred	10	38	57
Foreign income tax			
Current	23	51	8
Deferred	(25)	(15)	9
Income tax provision	\$ 703	\$ 614	\$ 329

A reconciliation of the statutory federal income tax rate to the effective rate was as follows:

	1995	1994	1993
Statutory federal income tax rate	35.0%	35.0%	35.0%
State income taxes, net of federal income taxes	3.9	3.8	3.6
Deferred income taxes adjustment for rate change	—	—	(6.0)
Other	1.8	2.9	1.9
Effective income tax rate	40.7%	41.7%	34.5%

Deferred taxes based upon differences between the financial statement and tax bases of assets and liabilities and available tax carryforwards consisted of:

Assets/(Liabilities) in millions	1995	1994
Unearned maintenance income	\$ 430	\$ 294
Allowance for uncollectible accounts	377	362
Alternative minimum tax credit	—	57
Workers' compensation reserve	71	62
Public liability claims reserve	79	60
Postretirement benefit liability	1,161	1,146
Minimum pension liability	183	—
Other deferred tax assets	680	662
Property and equipment	(548)	(402)
Prepaid pension	(187)	(159)
LIFO	(125)	(169)
Other deferred tax liabilities	(350)	(308)
Total	\$1,771	\$1,605

U.S. income and foreign withholding taxes were not provided on certain unremitted earnings of international affiliates which the Company considers to be permanent investments. The cumulative amount of unremitted income for which income taxes have not been provided totaled \$241 million at Dec. 30, 1995. If these earnings were to be remitted, taxes of \$64 million would be due.

Income taxes of \$616, \$470 and \$(171) million were paid (refunded) in 1995, 1994 and 1993, respectively.

5. BENEFIT PLANS

Expenses for retirement and savings-related benefit plans were as follows:

millions	1995	1994	1993
Savings and Profit Sharing Fund of Sears Employees			
Defined contribution	\$ 61	\$ 61	\$ 64
Additional ESOP benefit	(19)	(4)	(23)
Pension plans	38	(61)	(45)
Retiree insurance benefits	185	232	249
Other plans	10	8	18
Total	\$275	\$236	\$263

PROFIT SHARING FUND

Most domestic employees are eligible to become members of The Savings and Profit Sharing Fund of Sears Employees ("the Fund"). The Company contribution is based on 6% of consolidated income, as defined, for the participating companies. Company contributions are limited to 70% of eligible employee contributions.

The Fund includes an Employee Stock Ownership Plan ("the ESOP") to prefund a portion of the Company's anticipated contribution through 2004. The Company loaned the ESOP \$800 million which it used to purchase 25.9 million of Sears common shares. The loan is repaid with dividends on ESOP shares and Company contributions.

Notes to Consolidated Financial Statements (CONTINUED)

In conjunction with the Allstate spin-off, The Savings and Profit Sharing Fund of Sears Employees, which includes the ESOP, was split into two separate plans, a plan for employees of the Company and its affiliates other than Allstate and a plan for Allstate employees. The ESOP was split with 50% of the unallocated shares in the ESOP and 50% of the ESOP debt transferred to the Allstate plan. In connection with this transfer, Allstate purchased from the Company 50% of the Company's remaining loan to the ESOP at a purchase price of \$327 million.

The additional ESOP benefit included in the benefit plan expense table was computed as follows:

millions	1995	1994	1993
Interest expense recognized by ESOP	\$ 45	\$ 64	\$ 71
Less dividends accrued on ESOP shares	(31)	(43)	(40)
Cost of shares allocated to employees and plan expenses	28	56	71
	42	77	102
ESOP expense attributable to discontinued operations	—	(24)	(63)
Reduction of defined contribution due to ESOP	(61)	(57)	(62)
Additional ESOP benefit	\$(19)	\$ (4)	\$(23)

The Company contributed \$62, \$91 and \$45 million to the ESOP in 1995, 1994 and 1993, respectively. At Dec. 30, 1995, total committed to be released, allocated and unallocated ESOP shares were 1.7, 7.6 and 16.6 million, respectively.

PENSION PLANS

Substantially all domestic full-time and certain part-time employees are eligible to participate in noncontributory defined benefit plans after meeting age and service requirements. Substantially all Canadian employees are eligible to participate in contributory defined benefit plans. Pension benefits are based on length of service, compensation, and in certain plans, Social Security or other benefits. Funding for the various plans is determined using various actuarial cost methods, and amounted to \$76, \$81 and \$12 million for 1995, 1994 and 1993, respectively.

Pension expense (benefit) was comprised of the following:

millions	1995	1994	1993
Benefits earned during the period	\$ 68	\$ 81	\$ 74
Interest on projected benefit obligation	181	196	225
Actual return on plan assets	(383)	12	(514)
Net amortization and deferral	172	(350)	170
Pension expense (benefit)	\$ 38	\$ (61)	\$(45)

The Company uses October 31 as the measurement date for purposes of determining pension plan assets and obligations. The weighted average discount rate and rate of increase in compensation used in determining the actuarial present value of the projected benefit obligations were 7.75% and 3.75% in 1995, 9.0% and 4.0% in 1994 and 7.5% and 3.75% in 1993. The expected long-term rate of return on plan assets used in determining net periodic pension cost was 9.5% in 1995, 1994 and 1993.

The plans' funded status was as follows:

	1995		1994	
millions	Assets exceed accumulated benefits	Accumulated benefits exceed assets	Assets exceed accumulated benefits	Accumulated benefits exceed assets
Actuarial present value of benefit obligations				
Vested benefit obligation	\$419	\$1,743	\$1,718	\$ 71
Accumulated benefit obligation	\$420	\$1,975	\$1,842	\$ 72
Projected benefit obligation (PBO)	\$469	\$2,241	\$2,027	\$ 77
Plan assets at fair value, primarily publicly traded stocks and bonds	635	1,626	2,070	6
PBO less than (in excess of) plan assets	166	(615)	43	(71)
Unrecognized net loss	30	734	329	12
Unrecognized prior service cost	—	54	58	—
Unrecognized transitional asset	(25)	—	(64)	—
Adjustment required to recognize minimum liability	—	(522)	—	(13)
Prepaid (accrued) pension cost in the Balance Sheet at year end	\$171	\$(349)	\$ 366	\$(72)

The provisions of Statement of Financial Accounting Standards ("SFAS") No. 87 "Employers' Accounting For Pensions" require the recognition of an additional minimum liability for each defined benefit plan for which the accumulated benefit obligation exceeds plan assets. In 1995, the Company recorded a \$522 million minimum liability adjustment. The Company also recognized an intangible asset of \$54 million, which is an amount equal to the unrecognized prior service cost. The minimum liability in excess of prior service cost was recorded, net of tax, as a \$285 million reduction to shareholders' equity.