SEARS ROEBUCK & CO
Form 10-Q/A
December 02, 2004

United States
Securities And Exchange Commission
Washington, D.C. 20549

FORM 10-Q/A
(Amendment No. 1)

x Quarterly Report Pursuant To Section 13 Or 15(D) Of The Securities Exchange Act Of 1934 For The Quarterly Period Ended July 3, 2004

Or

o Transition Report Pursuant To Section 13 Or 15(D) Of The Securities Exchange Act Of 1934

Commission file number 1-416

SEARS, ROEBUCK AND CO.

(Exact name of registrant as specified in its charter)

New York (State of Incorporation)	36-1750680 (I.R.S. Employer Identification No.)
3333 Beverly Road, Hoffman Estates, Illinois (Address of principal executive offices)	60179 (Zip Code)

Registrant s Telephone Number, Including Area Code: (847) 286-2500

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 and [2] has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

Yes x No o

As of July 31, 2004, the Registrant had 212,019,588 common shares, $.75 par value, outstanding.

SEARS, ROEBUCK AND CO.
INDEX TO QUARTERLY REPORT ON FORM 10-Q
13 Weeks and 26 Weeks Ended July 3, 2004

Explanatory Note

This Form 10-Q/A is being filed to correct a computational error in the pro forma disclosure of stock-based compensation contained in Note 10 of the Notes to the Condensed Consolidated Financial Statements. For ease of reference, this Form 10-Q/A restates the Form 10-Q for the fiscal quarter ended July 3, 2004 in its entirety. In order to preserve the nature and character of the disclosures set forth in such items as originally filed, no attempt has been made in this amendment to modify or update the disclosures in the original Quarterly Report on Form 10-Q except the restatement of Note 10. As a result, this Quarterly Report on Form 10-Q/A contains forward-looking information which has not been updated for events subsequent to the date of the original filing, and the Company directs you to its SEC filings made subsequent to that original filing date for additional information.

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SEARS, ROEBUCK AND CO.
Condensed Consolidated Statements of Operations
(Unaudited)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

millions, except per common share data	13 Weeks Ended		26 Weeks Ended	
	July 3, 2004	June 28, 2003	July 3, 2004	June 28, 2003
Merchandise sales and services	$ 8,700	$ 8,851	$ 16,403	$ 16,325
Credit and financial products revenues	81	1,345	172	2,751
Total revenues	8,781	10,196	16,575	19,076
COSTS AND EXPENSES				
Cost of sales, buying and occupancy	6,282	6,402	11,903	11,876
Selling and administrative	2,064	2,299	3,958	4,409
Provision for uncollectible accounts	11	461	27	944
Depreciation and amortization	262	230	490	455
Interest, net	68	287	144	566
Special charges	41	28	41	28
Total costs and expenses	8,728	9,707	16,563	18,278
Operating income	53	489	12	798
Other income, net	36	13	52	14
Income before income taxes, minority interest and cumulative effect of change in accounting principle	89	502	64	812
Income taxes	32	186	23	301
Minority interest	4	7	8	10
Income before cumulative effect of change in accounting principle	53	309	33	501
Cumulative effect of change in accounting principle	--	--	(839)	--
NET INCOME/(LOSS)	$ 53	$ 309	$ (806)	$ 501

EARNINGS/(LOSS) PER COMMON SHARE
BASIC

Earnings per share before cumulative effect of change in accounting principle	$	0.25	$	1.04	$	0.15	$	1.63
Cumulative effect of change in accounting principle		--		--		(3.86)		--
Earnings/(loss) per share	$	0.25	$	1.04	$	(3.71)	$	1.63
DILUTED								
Earnings per share before cumulative effect of change in accounting principle	$	0.24	$	1.04	$	0.15	$	1.63
Cumulative effect of change in accounting principle		--		--		(3.86)		--
Earnings/(loss) per share	$	0.24	$	1.04	$	(3.71)	$	1.63
Cash dividends declared per common share	$	0.23	$	0.23	$	0.46	$	0.46
Average common equivalent shares outstanding		216.5		298.0		217.1		307.9

See accompanying notes.

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SEARS, ROEBUCK AND CO.
Condensed Consolidated Balance Sheets

millions	(Unaudited) July 3, 2004	June 28, 2003	January 3, 2004
ASSETS			
Current assets			
Cash and cash equivalents	$ 3,559	$ 2,921	$ 9,057
Domestic credit card receivables	--	29,465	--
Sears Canada credit card receivables	1,813	1,849	1,998
Less allowance for uncollectible accounts	31	1,953	42
Net credit card receivables	1,782	29,361	1,956
Other receivables	557	733	733
Merchandise inventories, net	5,543	5,447	5,335
Prepaid expenses, deferred charges and other current assets	891	620	407
Deferred income taxes	588	839	708
Total current assets	12,920	39,921	18,196
Property and equipment, net	6,565	6,909	6,788
Deferred income taxes	245	627	378
Goodwill	943	945	943
Tradenames and other intangible assets	709	703	710
Other assets	545	1,268	708
TOTAL ASSETS	$ 21,927	$ 50,373	$ 27,723
LIABILITIES			
Current liabilities			
Short-term borrowings, primarily 90 days or less	$ 770	$ 5,464	$ 1,033
Current portion of long-term debt and capitalized lease obligations	678	5,050	2,950
Merchandise payables	3,014	2,879	3,106
Income taxes payable	462	724	1,867
Other liabilities	2,408	3,156	2,950
Unearned revenues	1,256	1,256	1,244
Other taxes	496	496	609
Total current liabilities	9,084	19,025	13,759
Long-term debt and capitalized lease obligations	4,123	21,462	4,218
Pension and postretirement benefits	1,635	2,336	1,956
Minority interest and other liabilities	1,384	1,318	1,389
Total Liabilities	16,226	44,141	21,322

COMMITMENTS AND CONTINGENT LIABILITIES			
SHAREHOLDERS EQUITY			
Common shares	323	323	323
Capital in excess of par value	3,516	3,501	3,519
Retained earnings	10,731	8,861	11,636
Treasury stock at cost	(8,740)	(5,463)	(7,945)
Deferred ESOP expense	(12)	(34)	(26)
Accumulated other comprehensive loss	(117)	(956)	(1,106)
Total Shareholders Equity	5,701	6,232	6,401
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 21,927	$ 50,373	$ 27,723
Total common shares outstanding	213.1	282.6	230.4

See accompanying notes.

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SEARS, ROEBUCK AND CO.
Condensed Consolidated Statements of Cash Flows
(Unaudited)

millions	26 Weeks Ended July 3, 2004	26 Weeks Ended June 28, 2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Net (loss)/income	$ (806)	$ 501
Adjustments to reconcile net income/(loss) to net cash (used in) provided by operating activities		
Depreciation and amortization	490	455
Cumulative effect of change in accounting principle	839	--
Provision for uncollectible accounts	27	944
Gain on sales of property and investments	(37)	(4)
Income tax benefit on nonqualified stock options	5	1
Change in:		
Deferred income taxes	(325)	46
Credit card receivables	110	717
Merchandise inventories	(219)	(256)
Other operating assets	169	49
Other operating liabilities [1]	(1,726)	(1,039)
Net cash (used in) provided by operating activities	(1,473)	1,414
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of property and investments	73	19
Purchases of property and equipment	(306)	(319)
Purchases of investments	(321)	(22)
Net cash used in investing activities	(554)	(322)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from long-term debt	283	2,920
Repayments of long-term debt	(2,594)	(2,846)
(Decrease)/increase in short term borrowings, primarily 90 days or less	(256)	919
Common shares repurchased	(852)	(1,019)
Common shares issued for employee stock plans	50	25
Dividends paid to shareholders	(99)	(145)
Net cash used in financing activities	(3,468)	(146)
Effect of exchange rate changes on cash and cash equivalents	(3)	13
NET (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS	(5,498)	959

BALANCE AT BEGINNING OF YEAR		9,057		1,962
BALANCE AT END OF PERIOD	$	3,559	$	2,921

[(1)]For the 26 weeks ended July 3, 2004 and June 28, 2003, the Company paid income taxes of $1.3 billion and $0.3 billion, respectively.

See accompanying notes.

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Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Condensed Consolidated Balance Sheets as of July 3, 2004 and June 28, 2003, the related Condensed Consolidated Statements of Operations for the 13 and 26 weeks ended July 3, 2004 and June 28, 2003, and the Condensed Consolidated Statements of Cash Flows for the 26 weeks ended July 3, 2004 and June 28, 2003, are unaudited. The interim financial statements reflect all adjustments (consisting only of normal recurring accruals) which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Sears, Roebuck and Co. (Sears , and together with its consolidated subsidiaries, the Company) 2003 Annual Report on Form 10-K. The results of operations for the interim periods should not be considered indicative of results to be expected for the full year. The Company typically earns a disproportionate share of its operating income in the fourth quarter due to seasonal customer buying patterns.

Certain reclassifications have been made to the 2003 financial statements to conform with the current year presentation.

NOTE 2 DISPOSITIONS

On November 3, 2003, the Company completed the sale of its domestic Credit and Financial Products business, including its clubs and services business (Credit), to Citigroup. On November 29, 2003, the Company sold National Tire & Battery (NTB) to TBC Corporation. The following table illustrates the impact the estimated results of the divested businesses had on the reported results for the 13- and 26-week periods ended June 28, 2003:

millions, except per share data	13 Weeks Ended June 28, 2003			26 Weeks Ended June 28, 2003		
	As Reported	Divested Businesses	Pro forma	As Reported	Divested Businesses	Pro forma
Revenues	$ 10,196	$ 1,380	$ 8,816	$ 19,076	$ 2,819	$ 16,257
Net income	309	168	141	501	369	132
Diluted earnings per share	1.04	0.56	0.48	1.63	1.20	0.43

NOTE 3 SECURITIZED ASSETS

A summary of the Company s securitized assets at July 3, 2004, June 28, 2003 and January 3, 2004 is as follows:

millions	July 3, 2004	June 28, 2003	January 3, 2004
Credit card receivables			
Domestic	$ --	$ 23,545	$ --
Sears Canada	997	976	1,093

Total credit card receivables	997	24,521	1,093
Property and equipment, net	496	--	500
Total securitized assets	$ 1,493	$ 24,521	$ 1,593

The Company securitizes certain of its credit card receivables through master trusts (trusts). Under the Sears Canada securitization program, trusts purchase undivided interests in the receivable balances, funded by issuing short-term and long-term debt, primarily commercial paper and senior and subordinated receivables-backed notes. The trusts related to the domestic receivables securitized the receivable balances by issuing certificates representing undivided interests in the trusts receivables both to outside investors and to the Company. These certificates entitled the holder to a series of scheduled cash flows under preset terms and conditions, the receipt of

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which was dependent upon cash flows generated by the related trusts assets. The Company accounts for credit card securitizations as secured borrowings.

Certain real estate assets were transferred to a wholly-owned consolidated subsidiary of Sears and segregated into a trust owned by the consolidated subsidiary. These assets are related to an inter-company loan agreement.

NOTE 4 INVESTMENTS

millions	July 3, 2004	
	Cost	Fair Value
Available-for-sale securities:		
State and political subdivisions obligations	$ 298	$ 298
U.S. treasury and federal agencies obligations	20	20
Corporate debt securities	2	2
Total available-for-sale securities	$ 320	$ 320

The fair value of the available-for-sale securities as of July 3, 2004 included unrealized losses of approximately $0.2 million.

The maturity distribution of available-for-sale securities outstanding is summarized in the following table. Actual maturities may differ from those scheduled as a result of prepayments by issuers.

millions	July 3, 2004	
	Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$ 300	$ 300
Due after one year through five years	20	20
Total available-for-sale securities	$ 320	$ 320

The available-for-sale securities due in one year or less are reported within prepaid expenses, deferred charges and other current assets on the balance sheet. The available-for-sale securities due after one year are reported within other assets on the balance sheet.

The Company did not have available-for-sale securities with maturities greater than 90 days during any period in 2003.

NOTE 5 BORROWINGS

Total borrowings outstanding at July 3, 2004, June 28, 2003 and January 3, 2004 were $5.5 billion, $31.3 billion and $8.1 billion, respectively. Total borrowings are presented on the balance sheet as follows:

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Notes to Condensed Consolidated Financial Statements
(Unaudited)

millions	July 3, 2004	June 28, 2003	January 3, 2004
Short-term borrowings:			
Unsecured commercial paper	$ 770	$ 3,259	$ 1,033
Asset-backed commercial paper	--	750	--
Asset-backed facility	--	1,400	--
Bank loans	--	55	--
Total short-term borrowings	770	5,464	1,033
Long-term debt[1]:			
Notes and debentures outstanding	3,371	14,410	5,825
Securitizations	880	10,892	756
Capital lease obligations	481	525	497
Total borrowings	$ 5,502	$ 31,291	$ 8,111
SFAS No. 133 Hedge Accounting Adjustment	69	685	90
Total debt	$ 5,571	$ 31,976	$ 8,201
Memo: Sears Canada debt	*$ 1,594*	*$ 1,621*	*$ 1,701*

(1) Includes capitalized lease obligations and current portion of long-term debt.

The Company maintains committed credit facilities to support its unsecured commercial paper borrowings. On May 17, 2004, the Company s domestic wholly-owned financing subsidiary, Sears Roebuck Acceptance Corp. (SRAC), through a syndicate of banks, obtained an unsecured, three-year revolving credit facility in the amount of $2.0 billion. The new facility replaced a 364-day facility, which expired in May 2004. The facility and related Sears guarantee require SRAC and the Company to maintain certain fixed charge ratios and a specified level of tangible net worth for the Company s domestic segment. SRAC and the Company were in compliance with these covenants at July 3, 2004.

During the 13- and 26-week periods ended July 3, 2004, the Company retired approximately $0.6 billion and $2.4 billion of domestic term debt, respectively.

NOTE 6 SPECIAL CHARGES AND IMPAIRMENTS

Following is a summary of the activity in the 2004 reserve established for employee termination and exit costs:

millions	Balance, Beginning	2004	Cash	Balance,

	of Year	Charge	Payments	July 3, 2004
2004 Employee termination costs	$ --	$ 41	$ --	$ 41

During the second quarter of 2004, the Company recorded a pretax charge of $41 million for the estimated costs of severance associated with the termination of approximately 3,300 associates related to the streamlining of the Company s headquarters organization as well as other productivity initiatives identified in its field operations. The identified associates will be terminated by the end of 2004 and the related severance paid out by the end of 2005.

During the second quarter of 2003, the Company recorded a pretax charge of $28 million for the estimated cost of severance for approximately 650 associates. As of January 3, 2004, the remaining reserve was $9 million. As of July 3, 2004, all such severance had been paid out.

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During the third quarter of 2003, the Company announced a refinement of the business strategy for The Great Indoors (TGI) which included its decision to close three TGI stores and cease development of four future locations. Included within the total pretax charge of $141 million was $2 million related to employee termination costs and $11 million related to other contractual obligations for items such as reimbursement to licensed businesses for facility closures, lease termination costs and other exit costs. As of January 3, 2004, the three stores were closed, all related employees terminated, and the remaining severance reserves were $2 million. As of July 3, 2004, the remaining employee severance reserves were paid out. The remaining contractual obligation and other costs will be paid out over the remaining contractual terms.

NOTE 7 SHAREHOLDERS EQUITY

Dividend Payments

Under an agreement pursuant to which the Company has provided a credit facility in support of certain tax increment revenue bonds issued by the Village of Hoffman Estates, Illinois, in connection with the construction of its headquarters facility, the Company cannot take specified actions, including the declaration of cash dividends, that would cause its unencumbered assets, as defined, to fall below 150% of its liabilities, as defined. At July 3, 2004, approximately $5.0 billion could be paid in dividends to shareholders under this covenant.

Share Repurchase Program

The Company repurchased 18.6 million common shares, at a cost of $852 million, during the 26 weeks ended July 3, 2004 under a common share repurchase program approved by the Board of Directors. The Company did not repurchase any common shares during the 13 weeks ended July 3, 2004. As of July 3, 2004, the Company had remaining authorization under the existing share repurchase program to repurchase up to $726 million of shares by December 31, 2006.

Comprehensive Income and Accumulated Other Comprehensive Income

The following table shows the computation of comprehensive income:

millions	13 Weeks Ended July 3, 2004	13 Weeks Ended June 28, 2003	26 Weeks Ended July 3, 2004	26 Weeks Ended June 28, 2003
Net income/(loss)	$ 53	$ 309	(806)	501
Other comprehensive income/(loss):				
Minimum pension liability [1]	--	--	999	--
Amounts amortized into interest expense from OCI	2	4	6	8
Change in fair value of cash flow hedges	--	--	--	1
Foreign currency translation adjustments	(6)	50	(16)	91

Total other comprehensive income/(loss)	(4)	54	989	100
Total comprehensive income	$ 49	$ 363	183	601

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(Unaudited)

The following table displays the components of accumulated other comprehensive loss:

millions	July 3, 2004	June 28, 2003	January 3, 2004
Accumulated derivative loss	$ (3)	$ (192)	$ (9)
Currency translation adjustments	(35)	(53)	(19)
Minimum pension liability, net of tax[(1)]	(79)	(711)	(1,078)
Accumulated other comprehensive loss	$ (117)	$ (956)	$ (1,106)

(1) Minimum pension liability at July 3, 2004 reflects the effect of the change in accounting for domestic retirement benefits discussed in Note 9.

NOTE 8 EARNINGS/(LOSS) PER SHARE

The following table sets forth the computations of basic and diluted earnings/(loss) per share:

millions, except per share data	13 Weeks Ended		26 Weeks Ended	
	July 3, 2004	June 28, 2003	July 3, 2004	June 28, 2003
Net income/(loss)[(1)]	$ 53	$ 309	$ (806)	$ 501
Average common shares outstanding	213.9	296.4	217.1	307.1
Dilutive effect of stock options	2.6	1.6	--	0.8
Average common equivalent shares outstanding	216.5	298.0	217.1	307.9
Earnings/(loss) per share				
Basic	$ 0.25	$ 1.04	$ (3.71)	$ 1.63
Diluted	$ 0.24	$ 1.04	$ (3.71)	$ 1.63

(1) Net income/(loss) is the same for purposes of calculating basic and diluted earnings/(loss) per share.

In each period, certain options were excluded from the computation of diluted earnings per share because they would have been anti-dilutive. At July 3, 2004, options to purchase 14.5 million common shares at prices ranging from $40 to $64 per share were excluded from the 13-week 2004 calculation. Due to the net loss recognized for the 26-week period ended July 3, 2004, all options to purchase 33.1 million common shares were excluded from the 26-week 2004 calculation. At June 28, 2003, options to purchase 23.3 million common shares at prices ranging from $30 to $64 per share, and 23.5 million common shares at prices ranging from $27 to $64 per share, were excluded from the 13- and 26-week 2003 calculations, respectively.

The following table sets forth the computations of basic and diluted earnings per share before the cumulative effect of the change in accounting principle:

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millions, except per share data	26 Weeks Ended July 3, 2004	26 Weeks Ended June 28, 2003
Income before cumulative effect of change in accounting principle[1]	$ 33	$ 501
Average common shares outstanding	217.1	307.1
Dilutive effect of stock options	3.4	0.8
Average common and common equivalent shares outstanding	220.5	307.9
Earnings per share		
Basic	$ 0.15	$ 1.63
Diluted	$ 0.15	$ 1.63

[1] Income before cumulative effect of change in accounting principle is the same for purposes of calculating basic and diluted earnings per share.

NOTE 9 RETIREMENT BENEFIT PLANS

Certain domestic full-time and part-time employees are eligible to participate in noncontributory defined benefit plans after meeting age and service requirements. Substantially all full-time Canadian employees as well as some part-time 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.

In addition to providing pension benefits, the Company provides domestic and Canadian employees certain medical and life insurance benefits for retired employees. Employees may become eligible for medical benefits if they retire in accordance with the Company s established retirement policy and are continuously insured under the Company s group medical plans or other approved plans for 10 or more years immediately prior to retirement. The Company shares the cost of the retiree medical benefits with retirees based on years of service. Generally, the Company s share of these benefit costs will be capped at the Company contribution calculated during the year of retirement. The Company s postretirement benefit plans are not funded. The Company has the right to modify or terminate these plans. The Company does not expect to contribute to the domestic pension plan in 2004.

The components of net periodic benefit cost/(benefit) are as follows:

	13 Weeks Ended				26 Weeks Ended			
	Pension Benefits		Postretirement Benefits		Pension Benefits		Postretirement Benefits	
millions	July 3, 2004	June 28, 2003	July 3, 2004	June 28, 2003	July 3, 2004	June 28, 2003	July 3, 2004	June 28, 2003

Components of net periodic benefit cost/(benefit):								
Benefits earned during the period	$ 26	$ 23	$ 1	$ 1	$ 52	$ 46	$ 2	$ 2
Interest cost	59	49	13	12	118	98	26	23
Expected return on plan assets	(63)	(53)	(1)		(126)	(106)	(2)	
Amortization of unrecognized net prior service benefit	(2)	(1)	(19)	(24)	(4)	(2)	(38)	(48)
Recognized net (gain)/loss	(1)	21	1	(5)	(2)	42	2	(10)
Other	1	(2)			(1)	(4)	(30)[1]	
Net periodic benefit cost/(benefit)	$ 20	$ 37	$ (5)	$ (16)	$ 37	$ 74	$ (40)	$ (33)

[1] Represents $30 million curtailment gain related to a change in retiree medical benefits.

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Notes to Condensed Consolidated Financial Statements
(Unaudited)

Accounting Change

Subsequent to the sale of Credit, the Company initiated a project to review its domestic employee retirement benefits cost structure and programs. The Company assessed its retirement benefits programs in the context of comparable programs in the retail industry. As a result of this review, in January 2004, the Company announced a series of benefit plan changes which included the enhancement of the Company s 401(k) defined contribution plan and the phasing out of participation in its domestic pension plan. Associates hired in 2004 and those under the age of 40 as of December 31, 2004, will receive an increased Company-matching contribution to the 401(k) plan of 110%, but will no longer earn additional pension benefits effective January 1, 2005. Pension benefits continue to accrue for associates age 40 and older as of December 31, 2004, unless they elect to participate in the enhanced 401(k) defined contribution plan.

In addition, the Company eliminated its domestic retiree medical insurance contribution for associates hired in 2004 and those under the age of 40 as of December 31, 2004, and capped the contribution at the 2004 level for associates age 40 and older. A curtailment gain of $30 million is included within selling and administrative costs for the 26-week period ended July 3, 2004 as a result of the change in the domestic retiree medical benefit.

In connection with the domestic pension and postretirement plan changes discussed above, the Company believed it was preferable to change its accounting methods, which under SFAS Nos. 87 and 106 delay recognition of past events. Therefore, in the first quarter of 2004, the Company changed its method for determining the market-related value of plan assets used in determining the expected return-on-assets component of annual net pension costs and its method for recognizing gains and losses for both its domestic pension and postretirement benefit plans. Under the previous accounting method, the market-related value of the domestic pension plan assets was determined by averaging the value of equity assets over a five-year period. The new method recognizes equity assets at fair value. Further, under its previous accounting method, all unrecognized gains and losses in excess of the 10% corridor were amortized over the expected working lifetime of active employees (approximately 10 years). Under the new methodology, the portion of the total gain or loss outside the 10% corridor will be immediately recognized. As a result of this accounting change, the Company recorded an after-tax charge of $839 million in the first quarter of 2004 for the cumulative effect of the change in accounting principle. The charge represents the recognition of unamortized experience losses at the beginning of 2004 in accordance with the new methods.

The new method of determining market-related value of plan assets and recognizing gains and losses is preferable because it produces results that more closely match the current economic position of the Company s domestic retirement benefit plans by not delaying the recognition of past events.

The cumulative effect of the accounting changes related to fiscal 2004 is presented in the following table:

	2004	
millions	Pretax	After-tax
Domestic Pension	$ 1,574	$ 999
Domestic Postretirement	(253)	(160)
Total	$ 1,321	$ 839

Loss per share	$ (3.86)

Presented below is pro forma net income and earnings per share for the quarters ended March 29, 2003, June 28, 2003, September 27, 2003 and January 3, 2004 and for the full-year ended January 3, 2004 showing the estimated effects as if the accounting change were applied retroactively:

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	2003				
millions, except per share data	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Net income as reported	$ 192	$ 309	$ 147	$ 2,749	$ 3,397
Impact of change in accounting for domestic retirement plans	10	11	11	(373)	(341)
Net income pro forma	$ 202	$ 320	$ 158	$ 2,376	$ 3,056
Earnings per share basic:					
As reported	$ 0.60	$ 1.04	$ 0.53	$ 11.06	$ 11.95
Pro forma	$ 0.63	$ 1.08	$ 0.57	$ 9.56	$ 10.75
Earnings per share diluted:					
As reported	$ 0.60	$ 1.04	$ 0.52	$ 10.84	$ 11.86
Pro forma	$ 0.63	$ 1.08	$ 0.56	$ 9.37	$ 10.67

The Company uses October 31 as the measurement date for determining retirement plan assets, obligations and experience gains or losses. Under the new accounting method for domestic plans, the Company will recognize the portion of experience gain or loss in excess of the 10% corridor at the measurement date, which falls in the fourth quarter of the fiscal year. Had the Company used this accounting method in 2003, an experience loss would have been recognized in the fourth quarter of 2003 which would have reduced net income by $373 million.

NOTE 10 - STOCK-BASED COMPENSATION

The Company has various stock-based employee compensation plans which are described more fully in Note 10 of the Notes to Consolidated Financial Statements in the Company s 2003 Annual Report on Form 10-K. The Company accounts for those plans in accordance with Accounting Principles Board Opinion No. 25, Accounting For Stock Issued to Employees , and related Interpretations. No stock-based employee compensation cost is reflected in net income/(loss), as no options granted under those plans had an exercise price less than the market value of the underlying common stock on the date of grant.

Subsequent to the issuance of its condensed consolidated financial statements for the 13 weeks and 26 weeks ended July 3, 2004, the Company determined it had used an incorrect vesting period for certain stock options granted in 2004 in the calculation of its pro forma stock-based employee compensation expense determined under the fair value based method. As a result, the following pro forma information has been restated to increase the pro forma stock-based employee compensation expense determined under the fair value method and reduce pro forma net income by $22 million ($0.10 per share basic and diluted) and increase pro forma net loss by $34 million ($0.15 per share basic and diluted) for the 13 and 26 weeks ended July 3, 2004, respectively, from the amounts previously reported.

	13 Weeks Ended		26 Weeks Ended	
millions, except per share data	July 3, 2004	June 28, 2003	July 3, 2004	June 28, 2003

Net income/(loss) as reported	$ 53	$ 309	$ (806)	$ 501
Less: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related taxes	36	13	63	25
Net income/(loss) pro forma	$ 17	$ 296	$ (869)	$ 476
Earnings/(loss) per share basic				
As reported	$ 0.25	$ 1.04	$ (3.71)	$ 1.63
Pro forma	0.08	1.00	(4.00)	1.55
Earnings/(loss) per share diluted				
As reported	$ 0.24	$ 1.04	$ (3.71)	$ 1.63
Pro forma	0.08	0.99	(4.00)	1.54

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NOTE 11 LEGAL PROCEEDINGS

Pending against the Company and certain of its officers and directors are a number of lawsuits, described below, that relate to the credit card business and public statements about it. The Company believes that all of these claims lack merit and is defending against them vigorously.

§ On and after October 18, 2002, several actions were filed in the United States District Court for the Northern District of Illinois against the Company and certain current and former officers alleging that certain public announcements by the Company concerning its credit card business violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The Court has consolidated the actions and certified the consolidated action as a class action. Discovery is underway. Trial is scheduled to begin on August 8, 2005.

§ On and after November 15, 2002, several actions were filed in the United States District Court for the Northern District of Illinois against the Company, certain officers and directors, and alleged fiduciaries of Sears 401(k) Savings Plan (the Plan), seeking damages and equitable relief under the Employee Retirement Income Security Act of 1974 (ERISA). The plaintiffs purport to represent participants in the Plan, and allege breaches of fiduciary duties under ERISA in connection with the Plan s investment in the Company s common shares and alleged communications made to Plan participants regarding the Company s financial condition. These actions have been consolidated into a single action. Discovery is underway. No trial date has been set.

§ On October 23, 2002, a purported derivative action was filed in the Supreme Court of the State of New York against the Company (as a nominal defendant) and certain current and former directors seeking damages on behalf of the Company. The complaint purports to allege a breach of fiduciary duty by the directors with respect to the Company s management of the credit card business. On June 21, 2004, the Court dismissed the complaint because the plaintiff had filed the suit without having demanded that the Board of Directors bring the suit. The plaintiff has filed a notice of appeal from that ruling. Two similar actions (the Cook County actions) were filed in the Circuit Court of Cook County, Illinois (the Illinois state court), and a third (the federal derivative action) was filed in the United States District Court for the Northern District of Illinois. All three actions were stayed pending the disposition of the action in New York. In light of the New York court s decision, the Illinois state court has lifted the stay of the Cook County actions and has reinstated motions to dismiss which defendants had filed prior to the stay. The Illinois state court has ordered the parties to file supplemental briefs concerning the effect of the New York court s decision on the motions to dismiss the Cook County actions. The plaintiffs in the federal derivative action appealed the stay order in that case to the United States Court of Appeals for the Seventh Circuit. On July 19, 2004, the Court of Appeals affirmed the stay of the federal derivative action, and that stay remains in effect.

§ On June 17, 2003, an action was filed in the Northern District of Illinois against the Company and certain officers, purportedly on behalf of a class of all persons who, between June 21, 2002 and October 17, 2002, purchased the 7% notes that SRAC issued on June 21, 2002. An amended complaint has been filed, naming as additional defendants certain former officers, SRAC and several investment banking firms who acted as underwriters for SRAC s March 18, May 21 and June 21, 2002 notes offerings. The amended complaint alleges that the defendants made misrepresentations or omissions concerning its credit business during the class period and in the registration statements and prospectuses relating to the offerings. The amended complaint alleges that these misrepresentations and omissions violated Sections 10(b) and 20(a) of the Securities Exchange Act and

Rule 10b-5 promulgated thereunder, and Sections 11, 12 and 15 of the Securities Act of 1933 and purports to be brought on behalf of a class of all persons who purchased any security of SRAC between October 24, 2001 and October 17, 2002, inclusive. Motions to dismiss the amended complaint are pending.

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The Company is subject to various other legal and governmental proceedings, many involving litigation incidental to its businesses. Some matters contain class action allegations, environmental and asbestos exposure allegations and other consumer-based claims that involve compensatory, punitive or treble damage claims in very large amounts as well as other types of relief. The consequences of these matters are not presently determinable but, in the opinion of management of the Company after consulting with legal counsel, and taking into account insurance and reserves, the ultimate liability is not expected to have a material adverse effect on annual results of operations, financial position, liquidity or capital resources of the Company.

NOTE 12 FINANCIAL GUARANTEES

The Company issues various types of guarantees in the normal course of business. As of July 3, 2004, the Company had the following guarantees outstanding:

millions	
Parent guarantee of SRAC debt	$ 3,544
Import letters of credit	268
Standby letters of credit	131
Secondary lease obligations	110
Performance guarantee	60

The debt obligations of SRAC are reflected in the Company s consolidated balance sheets. As a result of the Company s sale of Credit, Sears was required to issue a guarantee of SRAC s outstanding public debt in order to maintain SRAC s exemption from being deemed an investment company under the Investment Company Act of 1940, as amended. Sears also guarantees any outstanding borrowings under SRAC s three-year, unsecured credit facility. As of July 3, 2004, no borrowings were outstanding under this facility. These guarantees would require Sears to repay such debt should SRAC default in payment.

The secondary lease obligations relate to certain store leases of previously divested businesses. The Company remains secondarily liable if the primary obligor defaults. As of July 3, 2004, the Company had a $10 million liability recorded in other liabilities which represents the Company s current estimate of potential exposure related to these secondary lease obligations.

The performance guarantee relates to certain municipal bonds issued in connection with the Company s headquarters building. This guarantee expires in 2007.

NOTE 13 SIGNIFICANT EVENT

On June 30, 2004, the Company announced it had agreed to acquire an ownership or leasehold interest in up to 61 off-mall stores in key Sears markets from Kmart Holding Corporation and Wal-Mart Stores, Inc. The Company will pay a maximum purchase price of approximately $620 million in cash for up to 54 Kmart stores, plus the assumption of existing leases. Sears will make lease payments to Wal-Mart under subleases for up to seven Wal-mart stores. The acquisitions include real estate and Kmart store fixtures, but exclude inventory and liabilities not related to leases. Sears expects to take possession of four stores in 2004, up to 55 stores in 2005 and the remaining two stores in 2006. The acquisitions are subject to customary closing conditions.

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NOTE 14 SEGMENT DISCLOSURES

With the sale of Credit, the Company s financial reporting segments for fiscal 2004 have been changed to reflect two operating segments a Domestic segment and a Sears Canada segment.

The Domestic segment consists of merchandise sales and related services, including product protection agreements, delivery and product installation and repair services. It includes all Sears selling channels, Specialty and Full-line Stores as well as Direct to Customer operations encompassing online, catalogs, and the Lands End online and catalog business. The results of operations for the divested businesses, Credit and Financial Products and NTB, are included within the Domestic segment for the 13- and 26-week periods ended June 28, 2003.

The Sears Canada segment includes retail, credit and corporate operations conducted by Sears Canada, a 54.3% owned subsidiary.

Prior to the sale of Credit, the Company organized its business into three domestic segments: Retail and Related Services, Credit and Financial Products and Corporate and Other; and one international segment: Sears Canada.

§ The Retail and Related Services segment consisted of merchandise sales and related services, including product protection agreements, delivery and product installation and repair services. It included all Sears selling channels, including Specialty and Full-line Stores as well as Direct to Customer operations which includes online, catalogs, and Lands End online and catalog business. Beginning November 3, 2003, this segment also included the revenues earned under the long-term marketing and servicing alliance with Citigroup.

§ The Credit and Financial Products segment managed the Company s domestic portfolio of Sears Card and MasterCard receivables. This segment also included related financial products, such as credit protection and insurance products. The domestic Credit and Financial Products business was sold on November 3, 2003, and thus the segment results include its results of operations through November 2, 2003.

§ The Corporate and Other segment included activities that are of an overall holding company nature primarily consisting of administrative activities supporting the Domestic operations. This segment also included Home Improvement Services which installs siding and windows.

§ External revenues and expenses were allocated between the applicable segments. For zero-percent financing promotions in which customers received free financing, Retail and Related Services reimbursed Credit and Financial Products over the life of the financing period at a 10% annual rate. The cost was reported as selling expense by Retail and Related Services and an offsetting benefit was recognized by Credit and Financial Products. With the sale of the domestic Credit and Financial Products business, the allocation of these costs is included in the results of operations through November 2, 2003. Under the terms of the long-term marketing and servicing alliance with Citigroup, Citigroup will support the Company s historical level zero-percent receivable balances at no cost to the Company.

§ The domestic segments participated in a centralized funding program. Interest expense was allocated to the Credit and Financial Products segment based on its funding requirements. Funding included unsecured debt reflected on the balance sheet and investor certificates related to credit card receivables transferred to trusts through securitizations. The remainder of net domestic interest expense was reported in the Retail and Related Services segment through November 3, 2003. Subsequent to the sale of Credit, the allocation of interest expense was changed such that net interest expense associated with approximately $3.8 billion of outstanding domestic term debt remaining from the Credit and Financial Products segment, also referred to as credit legacy debt, was allocated to the Corporate and Other Segment. As of July 3, 2004, approximately $1.4

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billion of domestic term debt related to the former Credit and Financial Products segment remained outstanding. The 2003 segment information has been presented on the 2004 basis Domestic and Sears Canada. In addition, the Company has provided, for 2003, information on the operating segments comprising the Domestic segment in 2003.

For the 13 weeks ended July 3, 2004

millions	Domestic	Sears Canada	Consolidated
Merchandise sales and services	$ 7,673	$ 1,027	$ 8,700
Credit and financial products revenues	--	81	81
Total revenues	7,673	1,108	8,781
Costs and expenses			
Cost of sales, buying and occupancy	5,536	746	6,282
Selling and administrative	1,776	288	2,064
Provision for uncollectible accounts	--	11	11
Depreciation and amortization	237	25	262
Interest, net	41	27	68
Special change	41	--	41
Total costs and expenses	7,631	1,097	8,728
Operating income	$ 42	$ 11	$ 53
Total assets	$ 17,962	$ 3,965	$ 21,927

For the 13 weeks ended June 28, 2003

millions	Retail and Related Services	Domestic Credit and Financial Products	Corporate and Other	Total Domestic	Sears Canada	Consolidated
Merchandise sales and services	$ 7,771	$ --	$ 100	$ 7,871	$ 980	$ 8,851
Credit and financial products revenues	--	1,266	--	1,266	79	1,345

Total revenues	7,771	1,266	100	9,137	1,059	10,196
Costs and expenses						
Cost of sales, buying and occupancy	5,662	--	41	5,703	699	6,402
Selling and administrative	1,707	215	109	2,031	268	2,299
Provision for uncollectible accounts	--	446	--	446	15	461
Depreciation and amortization	187	5	10	202	28	230
Interest, net	16	245	--	261	26	287
Special charge	16	--	12	28	--	28
Total costs and expenses	7,588	911	172	8,671	1,036	9,707
Operating income/(loss)	$ 183	$ 355	$ (72)	$ 466	$ 23	$ 489