SEARS HOLDINGS CORP
Form 10-K
March 15, 2006

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United States
Securities And Exchange Commission

Washington, D.C. 20549

FORM 10-K

For Annual and Transition Reports pursuant to
Section 13 or 15(d) of the Securities Exchange Act of 1934

ý **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the Fiscal Year Ended January 28, 2006

Or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
Commission file number 000-51217

SEARS HOLDINGS CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**20-1920798**
(State of Incorporation)	(I.R.S. Employer Identification No.)
3333 Beverly Road, Hoffman Estates, Illinois	**60179**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(847) 286-2500**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of Each Exchange on Which Registered
None	

Securities registered pursuant to Section 12(g) of the Act:
Common Shares, par value $0.01 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

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. o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer ý Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

On February 25, 2006, the Registrant had 158,997,881 common shares outstanding. The aggregate market value (based on the closing price of the Registrant's common shares as reported in a summary of composite transactions in *The Wall Street Journal* for stocks quoted on the NASDAQ National Market) of the Registrant's common shares owned by non-affiliates (which are assumed, solely for the purpose of this calculation, to be stockholders other than (i) directors and executive officers of the Registrant and (ii) any person known by the Registrant to beneficially own five percent or more of the Registrant's common shares), as of July 30, 2005 was approximately $15 billion.

Documents Incorporated By Reference

Part III of this Form 10-K incorporates by reference certain information from the Registrant's proxy statement relating to its Annual Meeting of Stockholders to be held on April 12, 2006 (the "2006 Proxy Statement"), which will be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Form 10-K relates.

PART I

Item 1. Business

General

Sears Holdings Corporation ("Holdings" or the "Company") is the parent company of Kmart Holding Corporation ("Kmart") and Sears, Roebuck and Co. ("Sears"). Holdings was formed as a Delaware corporation in 2004 in connection with the merger of Kmart and Sears (the "Merger"). The Merger, completed on March 24, 2005, combined two of America's oldest existing retail entities, both with origins dating to the late 1800s. The Company is a broadline retailer with approximately 2,300 full-line and 1,100 specialty retail stores in the United States operating through Kmart and Sears and approximately 370 full-line and specialty retail stores in Canada operating through Sears Canada Inc. ("Sears Canada"), a 54%-owned subsidiary.

The Merger

The Merger has provided Holdings with an opportunity to significantly improve the earnings and cash flow performance of both Kmart and Sears given the scale of the combined entity. The Merger has also provided a means for leveraging the historical strengths of Kmart and Sears with the goal of making the Company's products, brands and service offerings more responsive to the needs of customers, thereby building long-term, value-added customer relationships.

Sears has a long-standing reputation for offering customers a wide variety of merchandise and related services, with a particular emphasis on a number of strong proprietary brands such as Kenmore, Craftsman, Diehard and Lands' End. Historically, Sears conducted its business primarily using a mall-based format. At the time of the Merger, Sears operated 874 domestic full-line stores mainly located in such on-mall locations. In response to off-mall competitor growth, Sears commenced a strategy prior to the Merger to increase the number of its off-mall stores in order to expand distribution points for its brands, merchandise and services. Kmart, on the other hand, historically used large format, off-mall locations in selling a selection of general merchandise goods. At the time of the Merger, Kmart operated approximately 1,400 off-mall stores and sought to further improve its operational performance by pursuing opportunities to offer customers a differentiated high-quality product selection to distinguish itself from competitors.

With Kmart's approximately 1,400 off-mall locations, Holdings is in a position to offer a greater number of customers an opportunity to purchase Sears products and services outside of Sears' traditional mall-based stores. This increase in distribution points brought about by the Merger provides a more rapid and lower-cost store base growth than Sears would have been able to accomplish on its own. At the same time, the addition of Sears-owned brands and services, including Sears' credit products, to Kmart stores enhances the selection and value proposition offered to Kmart customers and helps to differentiate Kmart from its general merchandise competitors. Furthermore, its combined store base of approximately 2,300 full-line stores places Holdings in a position to compete on a scale larger than that of many of its national competitors.

The scale of the combined enterprise has also generated significant opportunities for realizing cost synergies across a number of areas, including merchandise and non-merchandise purchasing, delivery and distribution and within other selling, general and administrative expense areas. While the Company will continue to operate both the Sears and Kmart store formats in the foreseeable future, many of the functions supporting these formats have been integrated. This integration will continue.

From an accounting perspective, the Merger has been treated as a purchase business combination, with Kmart acquiring Sears. In identifying Kmart as the acquiring entity, the companies took into account the relative share ownership of the Company after the Merger, the composition of the governing body of the combined entity and the designation of certain senior management positions.

Accordingly, the historical financial statements of Kmart serve as the historical financial statements of Holdings, the registrant.

In connection with the Merger, Kmart shareholders received one share of Holdings common stock for each Kmart share owned. In all, approximately 94.9 million shares of Holdings common stock were issued in exchange for all outstanding common stock of Kmart. Sears shareholders were issued an aggregate of 62.2 million shares of Holdings common stock at a total value of approximately $6.5 billion (based on the average closing price of $104.33 of Kmart's common stock during the period from November 15, 2004 through November 19, 2004, two business days before and after the date the Merger was announced). In addition, approximately $5.4 billion in cash was paid in consideration for (i) all outstanding shares of common stock of Sears, based upon the proration provisions of the agreement pursuant to which the Merger was effected, and (ii) all outstanding stock options of Sears. Including transaction costs of approximately $18 million, the total consideration paid was approximately $11.9 billion.

Additional information concerning the Merger is contained in Note 2 of Notes to Consolidated Financial Statements.

Bankruptcy of Kmart Corporation

Kmart Corporation (the "Predecessor Company") is a predecessor operating company of Kmart (the "Successor Company"). In January 2002, the Predecessor Company and 37 of its U.S. subsidiaries (collectively, the "Debtors") filed voluntary petitions for reorganization under Chapter 11 of the federal bankruptcy laws ("Chapter 11"). The Debtors decided to seek bankruptcy reorganization based upon a rapid decline in their liquidity resulting from below-plan sales and earnings performance in the fourth quarter of fiscal 2001, the evaporation of the surety bond market, an erosion of supplier confidence, intense competition and unsuccessful sales and marketing initiatives, as well as the continued recession and capital market volatility in existence at that time. The Predecessor Company utilized Chapter 11 to strengthen its balance sheet and reduce debt, focus its store portfolio on the most productive locations and terminate leases for closed stores, develop a more efficient organization and lower overall operating costs.

On May 6, 2003 (the "Effective Date"), the Predecessor Company emerged from reorganization proceedings under Chapter 11 pursuant to the terms of an Amended Joint Plan of Reorganization (the "Plan of Reorganization") and related amended Disclosure Statement. This Plan received formal endorsement of the statutory creditors' committee and, as modified, was confirmed by the U.S. Bankruptcy Court in April 2003. The Predecessor Company is presently an indirect wholly-owned subsidiary of Holdings.

Sale of Sears Canada's Credit and Financial Services Business

On November 15, 2005, Sears Canada completed the sale of substantially all of the assets and liabilities of its Credit and Financial Services operations to JPMorgan Chase & Co. ("JPMorgan Chase") for approximately $2.0 billion in cash proceeds net of securitized receivables and other related costs and taxes. In addition, Sears Canada and JPMorgan Chase concurrently entered into a long-term marketing and servicing alliance with an initial term of ten years. Sears Canada used a substantial portion of the proceeds generated from this sale to fund an extraordinary cash dividend and a tax-free return of stated capital to shareholders of record on December 16, 2005. Holdings, as beneficial owner of approximately 54% of the outstanding common stock of Sears Canada, received $877 million in after-tax proceeds from this distribution. Additional information concerning the sale is contained in Note 4 of Notes to Consolidated Financial Statements.

Sears Canada Take-Over Bid

In December 2005, Holdings announced its intention to acquire the remaining 46% interest in Sears Canada that it does not already own. The Company commenced a take-over bid for the remaining interest in Sears Canada on February 9, 2006. The Company has offered C$16.86 (Canadian dollars) per share, or approximately C$835 million ($720 million U.S. dollars), for the minority interest. The take-over bid is open for acceptance until March 17, 2006. The Company believes that 100% ownership of Sears Canada would allow Sears Canada to be able to compete with the other Canadian retailers and the Canadian operations of major U.S. retailers.

In December 2005, the Company entered into a lock-up agreement with Natcan Investment Management, Inc. ("Natcan"), pursuant to which Natcan agreed to tender all Sears Canada common shares (representing approximately 9% of the outstanding common shares of Sears Canada) that it owns or controls in response to the Company's take-over bid, at a price of C$16.86 per share. This agreement obligates the Company to spend approximately $141 million to purchase the Natcan shares.

Real Estate Transactions

In the normal course of business, the Company considers opportunities to purchase leased operating properties, as well as offers to sell owned, or assign leased, operating and non-operating properties. These transactions may, individually or in the aggregate, result in material proceeds or outlays of cash. In addition, the Company reviews leases that will expire in the short term in order to determine the appropriate action to take with respect to them.

Further information concerning the Company's real estate transactions is contained in Note 16 of Notes to Consolidated Financial Statements.

Business Segments

Holdings has integrated many Kmart and Sears store-support functions to more efficiently serve both formats; however, for purposes of reviewing operating performance and making asset-allocation decisions, senior management has continued to utilize principally the reporting structures that existed independently for Kmart and Sears prior to the Merger. As a result, the following discussion of the Company's business segments is organized into three segments: Kmart, Sears Domestic and Sears Canada.

Financial information, including revenues, operating income and total assets for each of these business segments is contained in Note 21 of Notes to Consolidated Financial Statements. Information regarding the components of revenue for Holdings is included in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Kmart

As of January 28, 2006, Holdings operated a total of 1,416 Kmart stores across 49 states, Guam, Puerto Rico, and the U.S. Virgin Islands. This store count included 1,361 discount stores, averaging 92,000 square feet, and 55 Super Centers, averaging 165,000 square feet. Most Kmart stores are one-floor, free-standing units that carry a wide assortment of general merchandise, including products sold under such well-known labels as Jaclyn Smith, Joe Boxer, and Martha Stewart Everyday. Subsequent to the Merger, the Company began selling certain Sears brand products and services within certain Kmart stores. As of January 28, 2006, approximately 100 Kmart stores were selling an assortment of Sears brand products, mainly within home appliances and tools. Approximately 1,100 Kmart stores also contain in-store pharmacies. The Super Centers generally operate 24-hours a day and combine a full-service grocery along with the general merchandise selection of a discount store. Kmart also sells its products through its kmart.com website.

Sears Domestic

As of January 28, 2006, Sears Domestic operations consisted of the following:

Full-line Stores 866 Full-line stores located across all 50 states and Puerto Rico, primarily mall-based locations averaging 132,000 square feet. Full-line stores offer a wide array of products across many merchandise categories, including home appliances, consumer electronics, tools, fitness and lawn and garden equipment, certain automotive services and products such as tires and batteries, home fashion products, as well as apparel, footwear and accessories for the whole family, including Lands' End merchandise. Also, as of January 28, 2006, the Company operated a total of 58 Sears Essentials and Sears Grand stores located in 22 states, primarily free-standing units averaging 122,000 square feet and offering health and beauty, pantry, household products and toys in addition to the offerings of the typical mall-based store. In February 2006, management decided that, on a go-forward basis, Sears Essentials and Sears Grand stores will all be operated under the Sears Grand name. Management expects to begin the conversion to the Sears Grand nameplate in the first half of fiscal 2006. Sears also extends the availability of its product selection through the use of its sears.com website, which offers a more limited assortment of home, apparel and accessory merchandise and provides customers the option of buying through the internet and picking up their merchandise in Sears Full-line stores.

Specialty Stores 1,128 specialty stores located across all 50 states and Puerto Rico, located primarily in free-standing, off-mall locations or high-traffic neighborhood shopping centers, and including the operations of:

809 Dealer Stores Primarily independently-owned stores, predominantly located in smaller communities and averaging 8,900 square feet offering appliances, consumer electronics, lawn and garden equipment, hardware and automotive batteries. Dealer stores carry proprietary Sears brands, such as Craftsman, Kenmore and DieHard, as well as a wide assortment of national brands.

147 Sears Hardware Stores and 84 Orchard Supply Hardware Stores Neighborhood hardware stores averaging 37,000 square feet that carry Craftsman tools and lawn and garden equipment, a wide assortment of national brands and other home improvement products. Approximately 120 locations also offer a limited selection of home appliances.

16 The Great Indoors Stores Home decorating and remodeling superstores, averaging 143,000 square feet, dedicated to the four main rooms of the house: kitchen, bedroom, bathroom and great room.

50 Outlet Stores Locations offering overstock and/or distressed appliances, consumer electronics and lawn and garden equipment at a discount.

Commercial Sales This business primarily targets home builders, remodelers and property managers for appliance purchases.

Direct to Customer The Direct to Customer business includes the direct merchant business of Lands' End, Inc. ("Lands' End"). Lands' End is a leading direct merchant of traditionally-styled casual clothing, accessories and footwear for men, women and children, as well as home products and soft luggage. These products are offered through multiple selling channels including Landsend.com, one of the leading apparel websites, as well as catalog mailings, international businesses and 17 Lands' End retail stores. These retail stores, averaging 7,700 square feet, offer Lands' End merchandise primarily from catalog and internet channel overstocks. Direct to Customer also includes direct marketing of Sears goods through specialty catalogs.

Home Services Product Repair Services, the nation's largest product repair service provider, is a key element in the Company's active relationship with more than 46 million households. With over 10,000 service technicians making over 13 million service calls annually, this business delivers a broad range of retail-related residential and commercial services across all 50 states and Puerto Rico under the Sears Parts & Repair Services and A&E Factory Service brand names. Commercial and residential customers can obtain parts and repair services for all major brands of products within the home appliances, lawn and garden equipment, consumer electronics, floorcare products, and heating and cooling systems categories. Smaller items for repair can be brought into Sears Parts & Repair Centers located throughout the United States or to any Sears Full-line store. This business also offers protection agreements, product installation services and Kenmore and Carrier residential heating and cooling systems. Home Services also includes home improvement services (primarily siding, windows, cabinet refacing, kitchen remodeling, HVAC and carpet cleaning) provided through Sears Home Improvement Services.

Sears Canada

Sears Canada, a consolidated, 54%-owned subsidiary of Sears, conducts retail operations in Canada similar to those conducted by Sears Domestic, with a greater emphasis on apparel and other softlines than in the U.S. stores. In addition, Sears Canada conducted credit operations prior to the November 15, 2005 sale of its Credit and Financial Services operations to JPMorgan Chase.

As of January 28, 2006, Sears Canada operated a total of 123 full-line stores, 252 specialty stores (49 furniture and appliance stores, 159 dealer stores operated under independent local ownership, five appliances and mattresses stores, 28 Corbeil stores and 11 outlet stores), 50 floor covering stores, approximately 2,116 catalog pick-up locations and 112 travel offices. Sears Canada also conducts business over the internet through its website, sears.ca.

Trademarks, Trade Names and Licenses

The "KMART®" and "SEARS®" trade names, service marks and trademarks, used by the Company both in the United States and internationally, are material to the Company's retail and other related businesses.

The Company sells proprietary branded merchandise under a number of brand names that are important to its operations. The Company's KENMORE®, CRAFTSMAN®, DIEHARD® and LANDS' END® brands are among the most recognized proprietary brands in retailing. These marks are the subject of numerous United States and foreign trademark registrations. Other well-recognized Company trademarks and service marks include THE GREAT INDOORS®, OSH®, CANYON RIVER BLUES®, COVINGTON®, and ATHLETECH®. The Company also has the right to sell an exclusive line of Martha Stewart Everyday® products in its Kmart locations over the next four years, as well as within Sears Canada stores through August 2008.

Seasonality

The retail business is seasonal in nature, and the Company generates a high proportion of its revenues and operating cash flows during the fourth quarter of its fiscal year, which includes the holiday season. As a result, the Company's overall profitability is heavily impacted by its fourth quarter operating results. Additionally, in preparation for the fourth quarter holiday season, the Company significantly increases its merchandise inventory levels, which have traditionally been financed from operating cash flows and credit terms received from vendors. Fourth quarter reported revenues accounted for 33% of total reported revenues in fiscal 2005.

Competition

The Company's business is subject to highly competitive conditions. The Company competes with a wide variety of retailers, including other department stores, discounters, home improvement stores, consumer electronics dealers, auto parts and auto service providers, specialty retailers, wholesale clubs and many other competitors operating on a national, regional or local level along with internet and catalog businesses, which handle similar lines of merchandise. Wal-Mart, Target, Kohl's, JC Penney, Home Depot, Lowe's and Best Buy are some of the major competitors with which the Company competes. Home Depot, Lowe's and Best Buy are major competitors in relation to the Company's home appliance business, which accounted for approximately 15% of the Company's fiscal 2005 reported revenues. Sears Canada competes in Canada with Hudson's Bay Company and U.S.-based competitors, including those mentioned above, that are expanding into Canada. Success in this competitive marketplace is based on factors such as price, convenience, product assortment and quality, and service, including availability of retail-related services such as access to credit, product delivery, repair and installation.

Employees

As of January 28, 2006, the Company had approximately 317,000 employees in the United States and U.S. territories, and approximately 38,000 employees in Canada through Sears Canada including, in each case, part-time employees.

Our Website; Availability of SEC Reports and Other Information

The Company's corporate website is located at *www.searsholdings.com*. The Company's Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to these reports are available, free of charge, through the SEC filings portion of the Investor Information section of the Company's website as soon as reasonably practicable after they are electronically filed with or furnished to the Securities and Exchange Commission.

The Corporate Governance Guidelines of the Company's Board of Directors, the charters of the Audit, Compensation, Finance and Nominating and Governance Committees of the Board of Directors, the Company's Code of Conduct and the Board of Directors Code of Conduct are available on the Corporate Governance section of *www.searsholdings.com*. References to the Company's website address do not constitute incorporation by reference of the information contained on the website, and the information contained on the website is not part of this document.

Item 1A. Risk Factors

References to "us", "we" and "our" refer to the Company. The following risk factors could adversely affect our business, results of operations and financial condition. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us may also negatively impact us.

If we fail to offer merchandise and services that our customers want, our sales may be limited, which would reduce our revenues and profits.

In order for our business to be successful, we must identify, obtain supplies of, and offer to our customers attractive, innovative and high-quality merchandise on a continuous basis. Our products and services must satisfy the desires of our customers, whose preferences may change in the future. If we misjudge either the demand for products and services we sell or our customers' purchasing habits and tastes, we may be faced with excess inventories of some products and missed opportunities for products and services we chose not to offer. In addition, our sales may decline or we may be required to sell the merchandise we have obtained at lower prices. This would have a negative effect on our business and results of operations.

If we do not successfully manage our inventory levels, our operating results will be adversely affected.

We must maintain sufficient inventory levels to operate our business successfully. However, we also must guard against accumulating excess inventory as we seek to minimize out-of-stock levels across all product categories and to maintain in-stock levels. We obtain a significant portion of our inventory from vendors located outside the United States. These vendors often require lengthy advance notice of our requirements in order to be able to supply products in the quantities we request. This usually requires us to order merchandise, and enter into purchase order contracts for the purchase and manufacture of such merchandise, well in advance of the time these products will be offered for sale. As a result, we may experience difficulty in responding to a changing retail environment, which makes us vulnerable to changes in price. If we do not accurately anticipate the future demand for a particular product or the time it will take to obtain new inventory, our inventory levels will not be appropriate and our results of operations may be negatively impacted.

If we are unable to compete effectively in the highly competitive retail industry, our business and results of operations could be materially adversely affected.

The retail industry is highly competitive with few barriers to entry. We compete with a wide variety of retailers including other department stores, discounters, home improvement stores, consumer electronics dealers, auto parts and auto service providers, specialty retailers, wholesale clubs and many other competitors operating on a national, regional or local level. Internet and catalog businesses which handle similar lines of merchandise also compete with us. In this competitive marketplace, success is based on factors such as price, product assortment and quality, service, and convenience.

Our success depends on our ability to differentiate ourselves from our competitors with respect to shopping convenience, a quality assortment of available merchandise and superior customer service. We must also successfully respond to our customers' changing tastes. The performance of our competitors, as well as changes in their pricing policies, marketing activities, new store openings and other business strategies, could have a material adverse effect on our business, financial condition and results of operations.

Our failure to successfully integrate Kmart and Sears may cause us to fail to realize cost savings and other benefits, which could adversely affect our future results.

We may fail to successfully complete the integration of Kmart and Sears and, as a result, may fail to realize synergies, cost savings and other benefits expected from the Merger. The eventual success of the Merger depends, in part, on our ability to realize the anticipated growth opportunities and cost savings from combining the businesses of Kmart and Sears. In particular, expanding the offering and distribution of proprietary brands may impact the value of those brands and lead to cannibalization of sales from either Sears or Kmart. In addition, we may be unable to successfully differentiate product offerings at our various locations. If we do not achieve these benefits, our results of operations could be materially adversely affected.

Also, we may fail to achieve sufficient cost savings through the integration of purchasing functions, supply chain, administrative and other operational activities. Furthermore, we must achieve these savings without adversely affecting our revenues. If we are not able to successfully achieve these objectives, the anticipated benefits of the Merger may not be realized fully or at all, or it may take longer to realize them than expected, and our results of operations could be materially adversely affected.

Due to the seasonality of our business, our annual operating results would be adversely affected if our fourth quarter results fail to meet our expectations.

Our business is seasonal, with a high proportion of revenues and operating cash flows being generated during the fourth quarter of our fiscal year, which includes the holiday season. As a result, our fourth quarter operating results significantly impact our annual operating results. Our fourth quarter operating results may fluctuate significantly, based on many factors, including holiday spending patterns and weather conditions.

Our comparable store sales may fluctuate for a variety of reasons, which could adversely affect our results of operations.

Our business is sensitive to customers' spending patterns, which in turn are subject to prevailing economic conditions. Our comparable store sales and results of operations have fluctuated in the past, and we expect them to continue to fluctuate in the future. A variety of other factors affect our comparable store sales and financial performance, including:

- actions by our competitors, including opening of new stores in our existing markets,
- seasonal fluctuations due to weather conditions,
- changes in our merchandise strategy and mix,
- changes in population and other demographics, and
- timing of our promotional events.

Accordingly, our results for any one fiscal quarter are not necessarily indicative of the results to be expected for any other quarter, and comparable store sales for any particular future period may decrease. For more information on our results of operations, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of this Form 10-K.

We rely on foreign sources for significant amounts of our merchandise, and our business may therefore be negatively affected by the risks associated with international trade.

We depend on a large number of products produced in foreign markets. We face risks associated with the delivery of merchandise originating outside the United States, including:

- potential economic and political instability in countries where our suppliers are located,
- increases in shipping costs,
- transportation delays and interruptions,
- adverse fluctuations in currency exchange rates, and
- changes in U.S. and foreign laws affecting the importation and taxation of goods, including duties, tariffs and quotas, or changes in the enforcement of those laws.

A decline in general economic conditions, consumer spending levels and other conditions could lead to reduced consumer demand for our merchandise thereby reducing our revenues and gross margins.

Many economic and other factors outside our control, including consumer confidence, consumer spending levels, employment levels, prevailing interest rates, housing starts and remodels, and consumer debt levels, as well as fuel costs and the availability of consumer credit, affect consumer spending habits. In addition, disposable income levels may influence consumer purchasing patterns. A general slowdown in the United States economy or an uncertain economic outlook could adversely affect consumer spending habits and our operating results.

The domestic and international political situation also affects consumer confidence. The threat, outbreak or escalation of terrorism, military conflicts or other hostilities could lead to a decrease in consumer spending. Any of these events and factors could cause us to increase inventory markdowns and promotional expenses, thereby reducing our gross margins and operating results.

We rely extensively on computer systems to process transactions, summarize results and manage our business. Disruptions in these systems could harm our ability to run our business.

Given the number of individual transactions we have each year, it is critical that we maintain uninterrupted operation of our computer and communications hardware and software systems. Our primary computer systems and operations are located at our corporate headquarters in Hoffman Estates, Illinois and our facilities in Troy, Michigan. In addition, each of our stores is connected to our computerized inventory management and other systems. Our systems are subject to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches, catastrophic events such as fires, tornadoes and hurricanes, and usage errors by our employees. If our systems are damaged or cease to function properly, we may have to make a significant investment to fix or replace them, and we may suffer interruptions in our operations in the interim. Any material interruption in our computer operations may have a material adverse effect on our business or results of operations.

The loss of key personnel may disrupt our business and adversely affect our financial results.

We depend on the contributions of our senior management team, including Aylwin B. Lewis (Chief Executive Officer and President) and other key employees, for our future success. Although certain executives, including Mr. Lewis, have employment agreements with us, changes in our senior management and any future departures of key employees may disrupt our business and materially adversely affect our results of operations.

Affiliates of our Chairman, whose interests may be different than your interests, exert substantial influence over our company.

Affiliates of Edward S. Lampert, the Chairman of our Board of Directors, beneficially own approximately 41% of the outstanding shares of our common stock. These affiliates are controlled, directly or indirectly, by Mr. Lampert. Accordingly, these affiliates, and thus Mr. Lampert, have substantial influence over many if not all actions to be taken or approved by our stockholders, including the election of directors and any transactions involving a change of control.

The interests of these affiliates, which have investments in other companies, may from time to time diverge from the interests of our other stockholders, particularly with regard to new investment opportunities. This substantial influence may have the effect of discouraging offers to acquire our company because the consummation of any such acquisition would likely require the consent of these affiliates.

We may be subject to product liability claims if people or property are harmed by the products we sell.

Some of the products we sell may expose us to product liability claims relating to personal injury, death, or property damage caused by such products, and may require us to take actions such as product recalls. Although we maintain liability insurance, we cannot be certain that our coverage will be adequate for liabilities actually incurred or that insurance will continue to be available to us on economically reasonable terms, or at all.

We may be subject to periodic litigation and other regulatory proceedings. These proceedings may be affected by changes in laws and government regulations or changes in the enforcement thereof.

From time to time we may be involved in lawsuits and regulatory actions relating to our business. Due to the inherent uncertainties of litigation and regulatory proceedings, we cannot accurately predict the ultimate outcome of any such proceedings. An unfavorable outcome could have a material adverse impact on our business, financial condition and results of operations. In addition, regardless of the outcome of any litigation or regulatory proceedings, these proceedings could result in substantial costs and may require that we devote substantial resources to defend our company. Further, changes in governmental regulations both in the United States and in the other countries where we operate could have adverse effects on our business and subject us to additional regulatory actions. For a description of current legal proceedings, see Item 3, "Legal Proceedings" in this Form 10-K.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The following table summarizes the locations of the Company's Kmart and Sears Domestic stores as of January 28, 2006:

	Kmart		Sears Domestic		
State/Territory	Discount Stores	Super Centers	Full-line Mall Stores	Sears Grand/ Essentials	Specialty Stores
Alabama	26		13	3	32
Alaska			3		3
Arizona	18	2	14	1	12
Arkansas	6		7		30
California	107	1	81	10	131
Colorado	17	4	13	2	18
Connecticut	7		8	1	10
Delaware	6		4		4
District of Columbia					
Florida	98		56	10	25
Georgia	38	1	22		37
Hawaii	7		6		1
Idaho	8		6		7
Illinois	60	4	38	6	52
Indiana	38	5	21	2	34
Iowa	24		12		13
Kansas	13		10		21
Kentucky	30		11	1	24
Louisiana	11		13		19
Maine	6		6		10
Maryland	23		19	1	8
Massachusetts	19		21	1	8
Michigan	79	7	27	3	39
Minnesota	32		12		35
Mississippi	6		9		20
Missouri	28		14	1	42
Montana	10		3		7
Nebraska	8		5		10
Nevada	9	2	4	1	6
New Hampshire	6		6	3	8
New Jersey	37		20	5	20
New Mexico	15		7		11
New York	60	1	48		35
North Carolina	43	4	27		36
North Dakota	7		4		4
Ohio	75	11	42		52
Oklahoma	9		11		20
Oregon	14		9		19
Pennsylvania	100	2	45	2	38
Rhode Island	1		2		2
South Carolina	27	1	14	1	18
South Dakota	9		2		7
Tennessee	33	3	24	1	26
Texas	19	1	60	1	81
Utah	18		5	1	5
Vermont	3		2		6
Virginia	40	4	23	1	19
Washington	21		23		12
West Virginia	16	1	8		7
Wisconsin	38		15		32

	Kmart		Sears Domestic		
Wyoming	9		2		6
Puerto Rico	22	1	9		6
U.S. Virgin Islands	4				
Guam	1				
Totals	1,361	55	866	58	1,128

	Kmart		Sears Domestic			Sears Canada		
	Discount Stores	Super Centers	Full-line Mall Stores	Sears Grand/ Essentials	Specialty Stores	Full-line Stores	Specialty Stores	Total
Stores as of January 28, 2006								
Owned	134	34	516	15	44	17	2	762
Leased	1,227	21	350	43	275	106	91	2,113
Independently-owned and operated stores					809		159	968
Totals	1,361	55	866	58	1,128	123	252	3,843

In addition, as of January 28, 2006, the Company had 42 domestic supply chain distribution centers, of which 14 are owned and 28 are leased for terms ranging from one to 15 years. Of the total, 15 primarily support Kmart locations and the remaining 27 primarily support Sears stores. In addition, the Company had 651 domestic store warehouses, customer call centers and service facilities, most of which are leased for terms ranging from one to 10 years or are part of other facilities included in the above table.

The Company's principal executive offices are located on a 200-acre site owned by the Company at the Prairie Stone office park in Hoffman Estates, Illinois. The complex consists of six interconnected office buildings totaling approximately two million gross square feet of office space.

In December 2005, the Company sold the former Kmart headquarters building in Troy, Michigan. The Company still owns an 86,000 square foot office building in Troy, Michigan which houses the Company's data center.

As of January 28, 2006, Sears Canada operated a total of 123 full-line stores, 252 specialty stores (49 furniture and appliance stores, 159 dealer stores operated under independent local ownership, five appliances and mattresses stores, 28 Corbeil stores and 11 outlet stores), 50 floor covering stores, approximately 2,116 catalog pick-up locations and 112 travel offices.

A description of the Company's leasing arrangements appears in Note 17 of Notes to Consolidated Financial Statements.

Item 3. Legal Proceedings

See Part II, Item 8, "Financial Statements and Supplementary Data" "Notes to Consolidated Financial Statements", Note 11 "Emergence from Chapter 11 Bankruptcy Protection and Fresh-Start Accounting," and Note 22 "Legal Proceedings", for information regarding legal proceedings, which information is incorporated herein by this reference.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 4A. Executive Officers of the Registrant

The following table and information sets forth the names of the executive officers of the Company, their current positions and offices with the Company, the date they first became executive officers of the Company, their current ages, and their principal employment during the past five years.

Name	Position	Date First Became an Executive Officer	Age
Aylwin B. Lewis	Chief Executive Officer and President	2005*	51
Alan J. Lacy	Vice Chairman	2005*	52
Karen A. Austin	Executive Vice President, Chief Information Officer	2005*	44
Kristine K. Crow	Senior Vice President/General Manager, Financial Services	2005*	46
William C. Crowley	Executive Vice President, Chief Financial and Administrative Officer	2005*	48
Mark C. Good	Executive Vice President and General Manager, Home Services	2005*	49
William R. Harker	Vice President, Acting General Counsel and Corporate Secretary	2006	33
W. Bruce Johnson	Executive Vice President, Supply Chain and Operations	2005*	54
Daniel F. Laughlin	Senior Vice President, Merchandising	2005	55
Robert D. Luse	Senior Vice President, Human Resources	2005*	43
Maureen A. McGuire	Executive Vice President, Chief Marketing Officer	2005	54
William K. Phelan	Vice President, Controller and Chief Accounting Officer	2005*	43
Peter J. Whitsett	Senior Vice President, Merchandising	2005	40
Corwin M. Yulinsky	Executive Vice President, Strategy and Customer Insight	2005	51

* Became an executive officer of Holdings upon the completion of the Merger on March 24, 2005.

Mr. Lewis became Chief Executive Officer and President in October 2005, after serving as the Chief Executive Officer and President of Kmart and Sears Retail as well as President of Holdings from March 2005 until September 2005. He was previously a director and the Chief Executive Officer and President of Kmart from October 2004 to March 2005. Prior to joining Kmart in October 2004, Mr. Lewis was President, Chief Multi-Branding and Operating Officer of YUM! Brands, Inc. (franchisor and licensor of quick-service restaurants) from 2000 until October 2004.

Mr. Lacy was previously Chief Executive Officer and Vice Chairman of the Company from March 2005 to September 2005. He served as Chairman of the Board, Chief Executive Officer and President of Sears from December 2000 until March 2005.

Ms. Austin became Executive Vice President, Chief Information Officer in February 2006 and was Senior Vice President and Chief Information Officer prior thereto. She was Senior Vice President,

Chief Information Officer of Kmart from April 2002 to March 2005. She previously served as its Vice President, IT Applications from 2001 to 2002.

Ms. Crow became Senior Vice President, Financial Services of Sears in May 2004. From December 2000 to April 2004, she was Vice President, Customer Relationship Management for Sears.

Mr. Crowley was previously Senior Vice President, Finance of Kmart, and had served as an officer of Kmart since 2003. Mr. Crowley is also the President and Chief Operating Officer of ESL Investments, Inc., a private investment firm, and has served in that capacity since 1999.

Mr. Good was previously Executive Vice President and General Manager, Home Services (formerly Product Repair Services) of Sears from August 1999 to March 2005, when he assumed the same role with Sears Holdings.

Mr. Harker joined the Company as Vice President and Chief Counsel in September 2005. He became Acting General Counsel and Corporate Secretary in January 2006. Prior to joining Sears Holdings, he practiced corporate law with the law firm of Wachtell, Lipton, Rosen and Katz from September 2000 to August 2005.

Mr. Johnson was previously Kmart's Senior Vice President, Supply Chain and Operations. He joined Kmart in October 2003, after serving as Director, Organization and Systems for Carrefour S.A. from March 1998 to October 2003.

Mr. Laughlin was elected Senior Vice President, Merchandising in December 2005. Previously, he served as Sears' Senior Vice President/General Merchandise Manager, Sears Home, from October 2003 to December 2005, Senior Vice President/General Manager, Home Stores from May 2003 to September 2003, and Vice President/General Merchandise Manager, Tools and Paint prior thereto.

Mr. Luse joined Sears as Vice President, HR Retail and Related Services in 2001.

Ms. McGuire joined the Company as Executive Vice President and Chief Marketing Officer in October 2005. Prior to joining Sears Holdings, she spent over 30 years at International Business Machines Corporation, most recently as Vice President, Worldwide Strategy and Marketing, IBM Systems and Technology Group from January 2005 to September 2005. Previously she served as IBM's Vice President, Worldwide Marketing and Strategy, IBM Global Services from August 2003 to January 2005 and Vice President, Worldwide Market Management and Integrated Marketing Communications from 1995 to August 2003.

Mr. Phelan was elected Vice President and Controller of Sears Holdings effective March 2005. From December 2000 to March 2005 he served as Assistant Controller of Sears.

Mr. Whitsett was elected Senior Vice President, Kmart Merchandising Officer in July 2005. He joined Kmart in 1999 as Director, Merchandise Planning & Replenishment and has served in a variety of positions, including Divisional Vice President, Merchandise Planning from 2000 to 2003, Divisional Vice President, Merchandising Consumables in 2003, Vice President/General Merchandise Manager, Drug Store and Food from 2003 to 2004, and Vice President/General Merchandise Manager from 2004 to 2005.

Mr. Yulinsky joined the Company as Executive Vice President, Strategy and Customer Insight in October 2005. Previously, he was a leader of the Financial Institutions and Marketing/CRM practice at McKinsey and Co., a consulting firm, from August 1999 to October 2005.

The Company's Code of Conduct applies to all employees, including the Company's principal executive officer, principal financial officer and principal accounting officer. The Code of Conduct is available on the "Corporate Governance" portion of the Company's corporate website at searsholdings.com. The Company intends to disclose on this website any amendment to, or waiver of, a provision of its Code of Conduct that applies to any of those three officers of the Company.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Holdings common stock is quoted on The NASDAQ Stock Market under the ticker symbol SHLD. There were approximately 25,000 registered stockholders of Holdings common stock as of January 28, 2006.

The common stock of Holdings began trading on March 28, 2005, the first trading day after the consummation of the Merger. Prior to that date, Kmart's common stock was quoted on The NASDAQ Stock Market, under the ticker symbol KMRT. The quarterly high and low sales prices for Holdings' common stock (for the 2005 fiscal year) and for Kmart's common stock (for the 2004 fiscal year) are set forth below.

	2005			
	Sears Holdings			
	First Quarter(1)	Second Quarter	Third Quarter	Fourth Quarter
Common stock price				
High	$ 149.50	$ 163.50	$ 155.90	$ 127.66
Low	125.90	133.24	113.30	111.64

	2004			
	Kmart			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Common stock price				
High	$ 48.50	$ 84.50	$ 93.18	$ 119.69
Low	26.10	40.66	61.76	84.51

(1) During the first quarter of 2005, Kmart's common stock traded from January 27, 2005 until March 23, 2005, during which its high price was $133.85 and its low price was $89.37.

Neither Holdings nor Kmart paid dividends on common stock in the last two fiscal years.

Equity Compensation Plan Information

The following table reflects information about securities authorized for issuance under the Company's equity compensation plans as of January 28, 2006.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders(1)	350,000	$ 112.90	
Equity compensation plans not approved by security holders			
Total	350,000	$ 112.90	

(1) Includes a grant to Aylwin B. Lewis of options to purchase 150,000 shares of Holdings' common stock and a grant to Alan J. Lacy of options to purchase 200,000 shares of Holdings' common stock. On October 18, 2004, Kmart granted Mr. Lewis options to purchase 150,000 shares of Kmart's common stock, subject to approval by Kmart's stockholders. Kmart's stockholders approved the option grant on March 24, 2005, and these options were converted into options to purchase an equal number of shares of Holdings' common stock upon effectiveness of the Merger. The grant to Mr. Lacy was approved by Kmart, the sole stockholder of Holdings on November 16, 2004 in connection with the approval of Mr. Lacy's employment agreement pursuant to which the options were granted.

Purchase of Equity Securities

The following table provides information about shares of common stock the Company acquired during the fourth quarter of fiscal 2005, including shares assigned to the Company as part of settlement agreements resolving claims arising from the Chapter 11 reorganization of the Predecessor Company. During the 13 weeks ended January 28, 2006, the Company repurchased 1.3 million of its common shares at a total cost of $155 million under a common share repurchase program. This program, approved by the Board of Directors during the third quarter of fiscal 2005, authorized the repurchase of up to an aggregate of $1.0 billion of the Company's common shares. As of January 28, 2006, the Company had approximately $0.4 billion of remaining authorization under this program.

	Total Number of Shares Purchased(1)	Average Price Paid per Share(2)	Total Number of Shares Purchased as Part of Publicly Announced Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program
October 30, 2005 to November 26, 2005	334,074	$ 114.15	333,842	
November 27, 2005 to December 31, 2005	529,967	116.80	492,517	
January 1, 2006 to January 28, 2006	645,180	115.11	495,675	
Total	1,509,221	$ 115.49	1,322,034	$ 410,000,000

(1) Includes the following numbers of shares acquired as payment of withholding taxes in connection with the vesting of restricted stock and as Bankruptcy-related settlements:

October 30, 2005 to November 26, 2005	232
November 27, 2005 to December 31, 2005	37,450
January 1, 2006 to January 28, 2006	149,505

(2) Excluding shares acquired pursuant to Bankruptcy-related settlements, the average price paid per share was $117.63.

Item 6. Selected Financial Data

The table below summarizes the Company's recent financial information. The data set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 and the Company's consolidated financial statements and notes thereto in Item 8.

				Predecessor Company		
	Fiscal				Fiscal	
dollars in millions, except per share data	**2005[1]**	**2004**	**39 Weeks Ended January 28, 2004**	**13 Weeks Ended April 30, 2003**	**2002**	**2001**
Summary of Operations						
Total revenues[2]	$ 49,124	$ 19,843	$ 17,190	$ 6,181	$ 29,352	$ 34,180
Comparable sales %	(5.3)%	(11.0)%	(9.5)%	(3.2)%	(10.1)%	(0.1)%
Income (loss) from continuing operations[3]	948	1,106	234	(852)	(2,771)	(2,377)
Cumulative effect of a change in accounting principle, net of tax[3]	(90)					
Discontinued operations				(10)	(448)	(69)
Net income (loss)[3]	858	1,106	234	(862)	(3,219)	(2,446)
Per Common Share						
Basic:						
Continuing income (loss)	$ 6.22	$ 12.39	$ 2.61	$ (1.63)	$ (5.47)	$ (4.81)
Cumulative effect of change in accounting principle	(0.59)					
Discontinued operations	$	$	$	$ (0.02)	$ (0.89)	$ (0.14)
Net income (loss)	$ 5.63	$ 12.39	$ 2.61	$ (1.65)	$ (6.36)	$ (4.95)
Diluted:						
Continuing income (loss)	$ 6.17	$ 11.00	$ 2.51	$ (1.63)	$ (5.47)	$ (4.81)
Cumulative effect of change in accounting principle	(0.58)					
Discontinued operations	$	$	$	$ (0.02)	$ (0.89)	$ (0.14)
Net income (loss)	$ 5.59	$ 11.00	$ 2.51	$ (1.65)	$ (6.36)	$ (4.95)
					Predecessor Company	
Book value per common share	$ 72.67	$ 50.39	$ 24.64	$ 19.45	$ (0.58)	$ 6.42
Financial Data						
Total assets	$ 30,573	$ 8,651	$ 6,074	$ 6,660	$ 11,238	$ 14,183
Long-term debt[4]	2,482	91	76	59		330
Long-term capital lease obligations	786	275	374	415	623	857
Trust convertible preferred securities					646	889
Capital expenditures (Predecessor Company for the 13 weeks ended April 30, 2003)	546	230	108	4	252	1,385
Number of Stores	3,843	1,480	1,511	1,513	1,829	2,114

(1) Fiscal 2005 includes the results of Sears subsequent to the Merger date. As a result, fiscal 2005 results include approximately 44 weeks of Sears' results and 52 weeks of Kmart's results.

(2) Fiscal 2005 ended on the last Saturday in January 2006. Fiscal 2001, fiscal 2002, the 39 weeks ended January 28, 2004, and fiscal 2004 ended on the last Wednesday in January. The reported results for fiscal 2003 have been divided into two parts as a result of Kmart's emergence from Chapter 11 bankruptcy in fiscal 2003. As further discussed in Note 11 of Notes to Consolidated Financial Statements, due to the application of Fresh-Start Accounting (defined below) upon emergence from Chapter 11 bankruptcy, the reported historical financial statements of the Predecessor Company for the periods prior to May 1, 2003 generally are not

comparable to those of the Successor Company. Thus, the results of operations of the Successor Company were not combined with those of the Predecessor Company.

(3) Results include the following items of the type that periodically affect results, but the amounts of which may vary significantly from period to period and have a disproportionate effect on the periods presented: in fiscal 2005, a $90 million charge, net of taxes, due to the cumulative effect of a change in accounting principle pertaining to a change in accounting for certain indirect buying, warehousing and distribution costs, a $39 million gain on the sale of assets, a $111 million charge for restructuring costs; in fiscal 2004, a $946 million net gain on sales of assets; in the 39 weeks ended January 28, 2004, an $89 million net gain on sales of assets; in the 13 weeks ended April 30, 2003, a $47 million charge for accelerated depreciation on unimpaired assets to be disposed of following store closings, and a $10 million credit as a result of a change in the estimated expenses for 2002 cost reduction initiatives; in fiscal 2002, $1,019 million for inventory write-downs in conjunction with accelerated mark-downs due to store closings, $533 million for asset impairments, $50 million for cost reduction initiatives, and $33 million for other items; in fiscal 2001, $827 million for asset impairments, $163 million for supply chain restructuring, $97 million for the restructuring/impairment of BlueLight.com, and $23 million for a voluntary early retirement program/severance.

(4) For fiscal years 2002 and 2001, long-term debt does not include liabilities classified as subject to compromise.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

In order to facilitate an understanding of Holdings, the reporting periods presented, and the basis for this presentation, the Company has divided its "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") into the following seven sections:

- Overview of Holdings
- Merger and Change in Fiscal Year
- Fiscal 2005 Initiatives and Accomplishments
- Results of Operations:
  Fiscal 2005 Summary
  Holdings Results:
    - Fiscal 2005 Compared to Fiscal 2004 (as reported and pro forma)
    - Fiscal 2004 Compared to Fiscal 2003 (as reported)
      - 39-Week Period Ended January 26, 2005 Compared to the 39 Week Period Ended January 28, 2004
      - 13-Week Period Ended April 28, 2004 Compared to the 13 Week Period Ended April 30, 2003 (Predecessor Company)

  Business Segment Results:
    - Kmart Fiscal 2005 (as reported) Compared to Fiscal 2004 (as reported)
    - Sears Domestic Fiscal 2005 (pro forma) Compared to Fiscal 2004 (pro forma)
    - Sears Canada Fiscal 2005 (pro forma) Compared to Fiscal 2004 (pro forma)

  Pro Forma Reconciliation
- Analysis of Consolidated Financial Condition
- Contractual Obligations and Off-Balance-Sheet Arrangements
- Application of Critical Accounting Policies

Overview of Holdings

Holdings, the parent company of Kmart and Sears, was formed in connection with the March 24, 2005 Merger of these two companies. The Company is a broadline retailer and, at the end of fiscal 2005, had approximately 2,300 full-line and 1,100 specialty retail stores in the United States operating through Kmart and Sears and approximately 370 full-line and specialty retail stores in Canada operating through Sears Canada, a 54%-owned subsidiary.

The Company currently conducts its operations in three business segments: Kmart, Sears Domestic and Sears Canada. Prior to the Merger, the Company operated a single business segment, Kmart. The nature of operations conducted within each of these segments is discussed within the "Business Segments" section of Item 1 in this Form 10-K**.**

Merger and Change in Fiscal Year

The Merger has been accounted for as a purchase business combination, with Kmart acquiring Sears. Accordingly, the historical financial statements of Kmart serve as the historical financial statements of Holdings, the registrant. The consolidated statements of operations and cash flows for fiscal 2005 include the results of operations of Sears subsequent to the Merger date, or from March 25, 2005 forward. Therefore, Holdings' operating results for fiscal 2005 include approximately 44 weeks of Sears' results and 52 weeks of Kmart's results.

Kmart shareholders received one share of Holdings common stock for each Kmart share owned. In all, approximately 94.9 million shares of Holdings common stock were issued in exchange for all outstanding common stock of Kmart. In aggregate, approximately 62.2 million shares of Holdings common stock were issued to Sears shareholders at a value of approximately $6.5 billion (based on the average closing price of $104.33 of Kmart's common stock during the period from November 15, 2004 through November 19, 2004, two business days before and after the date the Merger was announced). In addition, approximately $5.4 billion in cash was paid in consideration for (i) all outstanding shares of common stock of Sears, based upon the proration provisions of the agreement pursuant to which the Merger was effected, and (ii) all outstanding stock options of Sears. Including transaction costs of approximately $18 million, the total consideration paid for the acquisition of Sears was approximately $11.9 billion.

Effective March 23, 2005, the Company changed its fiscal year end from the last Wednesday in January to the Saturday closest to January 31st. As the change in fiscal year end reflects a change of only three days, the historical financial statements have not been recast to reflect this change. Sears Canada's fiscal year end is the Saturday closest to December 31st. The results of operations for Sears Canada are reported to Holdings on a one-month lag. Therefore, the consolidated statements of operations and cash flows for fiscal 2005 include operating results for Sears Canada from March 25, 2005 through December 31, 2005.

Fiscal 2005 Initiatives and Accomplishments

This Annual Report on Form 10-K reports on the ten months of progress Holdings has made as a combined company since the Merger. Management has made significant progress in integrating Sears and Kmart and in focusing the combined organization on certain key initiatives. Rather than pursuing the development of a single strategy for Holdings, the Company's management team has instead established certain key principles to guide Holdings' activities.

The Company strives to create a culture of continuous learning. Management analyzes, tests and adapts both its competitive strategies and everyday practices on an on-going basis in an effort to better serve customer needs and attract new customers to the Company's stores and services. Rather than focusing on building market share through non-value added promotions and sales events, the Company aims to consistently exceed customer expectations by providing quality services, products and solutions that earn customers' trust so as to build long-term customer relationships.

The Company is also focused on running its business for the long-term benefit of its stockholders. The Company is committed to applying the same continuous learning processes used to build customer relationships in identifying and implementing ways to improve the efficiency and effectiveness of Company operations. The objective is to improve overall profitability and capture market opportunities when and where they exist.

Though constant progress is always a priority, the Company believes it has taken significant steps in fiscal 2005 consistent with achieving its two main initiatives:

Building long-term customer relationships

To make its products, brands and service offerings more responsive to the needs of its customers and to build long-term relationships with them, the Company has made and plans to continue making a number of changes to its store formats and associated product offerings. The Company closely monitors customer response to these changes. The Company's strategies and plans will continue to evolve as it incorporates learnings from customer response to these changes. Specific initiatives and accomplishments in fiscal 2005 included:

- launching a new off-mall store format under the Sears nameplate. This mid-size store format offers customers the "best of both", meeting the everyday needs of customers as well as offering more destination-focused purchase categories. This new format was operated under the Sears Essentials nameplate during fiscal 2005. In February 2006, management decided that, on a go-forward basis, Sears Essentials and Sears Grand, the Company's other off-mall Sears format, will both operate under the Sears Grand name. As of January 28, 2006, Holdings had opened 50 Sears Essentials stores, mostly by way of converting former Kmart store locations. Management expects to begin the conversion to the Sears Grand nameplate in the first half of fiscal 2006. The Sears Essentials stores have achieved varying degrees of success. While the Company continues to believe that the format offers an attractive means for providing customers with Sears brands and appliances in off-mall locations, the Company has also achieved success selling such products in Kmart stores. As a result, the Company has reduced the number of stores planned for conversion to the Sears Grand format in fiscal 2006. In addition, the Company will continue to assess the pace of conversion to, and planned location of Sears Grand stores and the offering of Sears products in existing or remodeled Kmart stores based on customer response and the capital required;

- introducing select Sears private label branded products, including Kenmore, Craftsman and Diehard products, into certain Kmart stores, enabling Kmart to better differentiate itself from other mass market retailers;

- remodeling approximately 90 Kmart stores, where the expected financial returns justified the required capital outlay, to include Sears-brand products. The Company intends to continue its roll-out of home appliances, including Sears Kenmore products, into both Sears Grand and Kmart locations over the next several years as a means of expanding its points of distribution in response to competitor store growth. As of January 28, 2006, approximately 90 Kmart stores, including, certain of the remodeled locations, offered broad assortments of home appliances;

- completing a national roll-out of Sears credit card acceptance to all Kmart locations, and offering Kmart customers the opportunity to apply for Sears credit cards and related financial services at Kmart locations; and

- testing multiple new initiatives at select locations, including the addition of certain Sears customer services, including Sears Auto Centers, licensed businesses such as hearing and optical centers, and auto and truck rental services, to Kmart stores.

Improving Profitability

Actions taken in fiscal 2005 consistent with the Company's commitment to improving its profitability through increasing the efficiency and effectiveness of its operations included:

- initiating and continuing efforts to improve gross margins by reducing reliance on certain promotional events, particularly at Sears;

- improving efficiencies and cost effectiveness of the supply chain, including transportation synergies, the consolidation of international buying offices and a greater emphasis on direct import merchandise procurement;

- optimizing Kmart and Sears relationships with vendors and suppliers by sourcing goods on a combined basis, where possible, to obtain better costs, vendor support and terms;

integrating the home office functions of Kmart and Sears to reduce the overall cost structure of Holdings. As of January 28, 2006, Holdings had eliminated approximately 1,500 positions between Sears' and Kmart's combined home office functions;

lowering fixed costs associated with marketing expenditures by reducing the number of creative agencies utilized by Sears; and

implementing a rigorous process to ensure that the Company's capital is expended only on those efforts that improve the experience for customers and provide the opportunity for attractive returns on investment.

The financial impact of these profitability initiatives is described below in the "Results of Operations" section.

RESULTS OF OPERATIONS

Within this "Results of Operations" section, the Company discloses results of operations on both an "as reported" and a "pro forma" basis. The reported results are not necessarily representative of the Company's ongoing operations because Sears results are included only for the period of time after the March 24, 2005 Merger. Prior to that date, the reported results reflect only Kmart's results. Therefore, to facilitate an understanding of the Company's trends and on-going performance, the Company has presented pro forma results in addition to the reported results. The pro forma results adjust the reported amounts to give effect to the Merger as if it had occurred at the beginning of fiscal 2004. Thus, the pro forma results include both Kmart and Sears for both fiscal 2004 and fiscal 2005. A reconciliation of pro forma amounts to reported amounts has been included under the heading "Pro Forma Reconciliation".

The discussion of reported results for fiscal 2004 as compared to fiscal 2003 has been divided into two parts as a result of Kmart's emergence from Chapter 11 bankruptcy in fiscal 2003. As further discussed in Note 11 of Notes to Consolidated Financial Statements**,** due to the application of Fresh-Start Accounting (defined below) upon emergence from Chapter 11 bankruptcy, the reported historical financial statements of the Predecessor Company for the periods prior to May 1, 2003 generally are not comparable to those of the Successor Company. Thus, the results of operations of the Successor Company were not combined with those of the Predecessor Company for purposes of this MD&A.

References to comparable store sales amounts within the following discussion include sales for all stores operating for a period of at least 12 full months, including remodeled and expanded stores, but excluding store relocations and stores that have undergone format changes.

Finally, the Company notes that the discussion that follows should be read in conjunction with the consolidated financial statements and notes thereto included in Item 8.

Fiscal 2005 Summary

Holdings' consolidated results of operations for fiscal 2005 and fiscal 2004, presented on both a reported and a pro forma basis, are summarized below.

	Reported		Pro forma	
	2005	2004	2005	2004
millions, except per share data				
Merchandise sales and services	$ 48,911	$ 19,843	$ 53,962	$ 55,585
Credit and financial products revenues	213		299	381
Total revenues	49,124	19,843	54,261	55,966
Cost of sales, buying and occupancy	35,505	14,942	39,177	40,895
Gross margin rate	*27.4%*	*24.7%*	*27.4%*	*26.4%*
Selling and administrative	10,759	3,999	12,084	12,483
Selling and administrative expense as a percentage of total revenues	*21.9%*	*20.2%*	*22.3%*	*22.3%*
Depreciation and amortization	932	27	1,108	1,196
Provision for uncollectible credit card accounts	49		65	64
Gain on sales of assets	(39)	(946)	(40)	(356)
Gain on sale of business	(317)		(317)	
Restructuring charges	111		111	41
Total costs and expenses	47,000	18,022	52,188	54,323
Operating income	2,124	1,821	2,073	1,643
Interest expense, net	237	108	270	350
Bankruptcy-related recoveries	(40)	(59)	(40)	(59)
Other income	(38)	(3)	(48)	(69)
Income before income taxes, minority interest and cumulative effect of change in accounting principle	1,965	1,775	1,891	1,421
Income taxes	716	669	705	491
Minority interest	301		307	46
Income before cumulative effect of change in accounting principle	948	1,106	879	884
Cumulative effect of change in accounting principle, net of tax	(90)		(90)	
NET INCOME	$ 858	$ 1,106	$ 789	$ 884
Diluted earnings per share before cumulative effect of change in accounting principle	$ 6.17	$ 11.00	$ 5.40	$ 5.40
Diluted earnings per share	$ 5.59	$ 11.00	$ 4.85	$ 5.40

The following discussion is designed to provide the reader with an overview of fiscal 2005 operating results as compared to fiscal 2004, with particular emphasis on significant events and transactions that had a disproportionate effect on the Company's results for the periods presented. Further discussion regarding the Company's operating performance follows this overview section.

Earnings per Diluted Share

The following table summarizes Holdings' diluted earnings per share on both a reported and pro forma basis for fiscal 2005 and fiscal 2004.

	Reported		Pro Forma	
	2005	2004	2005	2004
Diluted earnings per share before cumulative effect of change in accounting principle	$ 6.17	$ 11.00	$ 5.40	$ 5.40
Cumulative effect of change in accounting principle(1)	$ (0.58)	$	$ (0.55)	$
Diluted earnings per share	$ 5.59	$ 11.00	$ 4.85	$ 5.40

(1) Effective January 27, 2005, Kmart changed its method of accounting for certain indirect buying, warehousing and distribution costs and, as a result, the Company recorded the cumulative effect of this change in accounting principle in fiscal 2005. Further information regarding this change in accounting is set forth in Note 3 of Notes to Consolidated Financial Statements.

Significant asset sales and restructuring charges greatly impacted the Company's fiscal 2005 and fiscal 2004 diluted earnings per share on both a reported and pro forma basis. Items of these types periodically affect the Company's results, but may vary significantly in amount from period to period and have a disproportionate effect on the Company's results for the periods presented. The impact of these items on diluted earnings per share is shown in the following table:

	Reported		Pro Forma	
	2005	2004	2005	2004
Diluted earnings per share impact of certain significant items:				
Gain on sale of assets(2)	$ 0.16	$ 5.78	$ 0.15	$ 1.35
Restructuring charges(3)	(0.35)		(0.33)	(0.16)
Total	$ (0.19)	$ 5.78	$ (0.18)	$ 1.19

(2) *Gain on Sale of Assets*: In fiscal 2004, Kmart completed multiple sale and lease assignment transactions, including significant transactions with The Home Depot, Inc. ("Home Depot") and Sears. These transactions resulted in aggregate gains of $946 million, or $5.78 per diluted share, being recorded as part of fiscal 2004 reported earnings as compared to $39 million, or $0.16 per diluted share, for fiscal 2005, a difference of $5.62 per diluted share. The fiscal 2004 pro forma gain on sale of assets impact of $1.35 per diluted share excludes the impact of gains recognized in fiscal 2004 for sales of properties to Sears. Further information regarding these transactions is set forth in Note 16 of Notes to Consolidated Financial Statements.

(3) *Restructuring Charges*: During fiscal 2005, the Company recorded $111 million in restructuring charges, or $0.35 per diluted share, in connection with the Merger and integration of Sears' and Kmart's headquarters support functions, as well as in connection with productivity initiatives at Sears Canada. The fiscal 2004 pro forma restructuring charges included a $41 million, or $0.16 per diluted share, charge recorded by Sears in connection with certain productivity initiatives at that entity. Further information regarding these restructuring charges is set forth in Note 5 of Notes to Consolidated Financial Statements.

In aggregate, the items set forth above lowered fiscal 2005 earnings per diluted share, on a reported and pro forma basis, by $0.19 and $0.18 per share, respectively, while increasing fiscal 2004 reported and pro forma earnings per diluted share by $5.78 and $1.19, respectively. Accordingly, from

fiscal 2004 to fiscal 2005, these items represent a difference of $5.97 and $1.37 per diluted share on a reported and pro forma basis, respectively. In assessing the Company's operating performance, management segregates these items from other operating results for the affected periods.

Revenues and Comparable Store Sales

On a reported basis, revenues increased $29.3 billion, or 148%, to $49.1 billion in fiscal 2005 versus fiscal 2004. The increase in reported revenues was due to the inclusion of Sears in fiscal 2005. On a pro forma basis, revenues declined $1.7 billion, or 3.0%, to $54.3 billion in fiscal 2005 as compared to fiscal 2004. Domestic comparable store sales were down 5.3% in the aggregate, with Sears Domestic comparable store sales declining 8.4% and Kmart comparable store sales declining 1.2%.

Kmart's comparable store sales decline in fiscal 2005 was primarily due to lower transaction volumes across most businesses. Apparel sales at Kmart increased for the year on a comparable store basis, but this improvement was more than offset by sales declines in both home goods and the food and drug business. Kmart recorded a 0.9% comparable store sales increase during the fourth quarter of fiscal 2005 as a result of a 1.0% increase in comparable store sales during the holiday period (the nine-weeks ended December 31, 2005). However, the impact of the fourth-quarter sales increase was more than offset by lower sales recorded for the balance of the year.

The sharper decline in Sears Domestic comparable store sales relative to Kmart was due mainly to efforts initiated at Sears in fiscal 2005 to improve gross margin by reducing reliance on certain promotional events. Kmart conducted similar efforts to shed unprofitable sales promotions and improve overall profitability during fiscal 2004. The Company expects the degree of comparable store sales declines at Sears to moderate in fiscal 2006 as the Company passes through the anniversary of fiscal 2005 gross margin improvement initiatives at Sears.

The disappointing performance of Sears' apparel business was also a factor in the decline of Sears' comparable store sales during fiscal 2005. Comparable store sales in Sears' overall apparel business were down 13.8% for the year. In fiscal 2005, Sears attempted a more "fashion forward" apparel offering, relying on the introduction of several new proprietary brands. Customer response to these offerings and brands did not meet management's expectations. The Company continues to adjust its apparel strategy to better meet customer demand.

The Company continues to face market share pressure as competitors open additional locations and engage in heavy promotional activity. The Company expects these trends to continue in the foreseeable future, and these trends may negatively affect the Company's future sales performance and results of operations.

Gross Margin Rate

Gross margin as a percentage of merchandise sales and services revenue ("gross margin rate") on a reported basis was 27.4% in fiscal 2005 as compared to 24.7% in fiscal 2004. This increase was primarily attributable to the fiscal 2005 addition of Sears, which had a higher overall gross margin rate than Kmart. On a pro forma basis, gross margin rate improved to 27.4% in fiscal 2005 as compared to 26.4% in fiscal 2004. The fiscal 2005 increase in pro forma gross margin rate was primarily attributable to improvement in the Sears Domestic gross margin rate, mainly as a result of improved inventory management and the utilization of more targeted clearance and promotional markdowns versus historical reliance on storewide events. This improvement in Sears Domestic gross margin rate, however, was less in the third and fourth quarters of fiscal 2005 than during the first two fiscal quarters of the year as poor customer response to full line apparel offerings resulted in additional markdowns being taken to clear fashion apparel in the second half of the year. The Company's ability to generate future improvement in overall gross margins depends on its ability to realize projected purchasing synergies and cost savings, as well as improve the profitability of clearance goods and Sears' apparel business.

Selling and Administrative Expense Rate

On a reported basis, selling and administrative expenses as a percentage of total revenues was 21.9% for fiscal 2005, as compared to 20.2% for fiscal 2004. The increase in the reported selling and administrative expense rate was primarily attributable to the fiscal 2005 addition of Sears, which had a higher cost structure than Kmart. On a pro forma basis, selling and administrative expenses as a percentage of total revenues was 22.3% for both fiscal 2005 and fiscal 2004. While selling and administrative expenses decreased by $399 million primarily as a function of reduced payroll expenditures and cost-saving initiatives, selling and administrative expenses as a percentage of total revenues was unchanged as the impact of these reductions was offset by lower expense leverage given lower overall sales, as well as increases at Sears Canada in both associate stock-based compensation expense and marketing expense. The Company's fiscal 2005 domestic selling and administrative expense rate improved by approximately 10 basis points compared to fiscal 2004.

Reduction in Debt Assumed as Part of the Merger

Subsequent to the Merger, the Company reduced domestic debt levels by $0.8 billion. This debt was primarily Sears debt included in Holdings' consolidated balance sheet subsequent to the Merger. The repayments were funded primarily from operating cash flows.

Share Repurchases

Subsequent to the Merger, through January 28, 2006, the Company repurchased approximately 5.0 million of its common shares at a total cost of approximately $0.6 billion under the Company's $1.0 billion common share repurchase program described under "Financing" below. The stock repurchases were funded from operating cash flows.

Significant Transactions

Sears Canada Credit Sale

Sears Canada completed the sale of substantially all of the assets and liabilities of its Credit and Financial Services operations to JPMorgan Chase in November 2005, and concurrently, the two parties entered into a long-term marketing and servicing alliance with an initial term of ten years. Sears Canada used a substantial portion of the proceeds generated from this sale to fund an extraordinary cash dividend and a tax-free return of stated capital to its shareholders. Holdings, as beneficial owner of approximately 54% of the outstanding common stock of Sears Canada, received $877 million in after-tax proceeds from this distribution. Additional information concerning the sale is contained in Note 4 of Notes to Consolidated Financial Statements.

Orchard Supply Hardware

In November 2005, the Company completed a transaction resulting in the private equity fund of Ares Management LLC ("Ares") investing cash for 19.9% of the voting stock of Orchard Supply Hardware Stores Corporation ("OSH"). Prior to the Ares investment, OSH was a wholly-owned subsidiary of the Company. The private equity fund invested $59 million in cash for the 19.9% equity interest and a three-year option to purchase, for $127 million, additional shares of OSH that currently represent 30.2% of OSH's outstanding voting stock. This structure allowed the Company to realize immediate value for OSH, a chain of hardware stores based in California that is not central to the Company's core business, while continuing to participate in the additional value the Company believes the OSH management team and Ares can create.

Sears Canada Take-Over Bid

In December 2005, Holdings announced its intention to acquire the remaining 46% interest in Sears Canada that it does not already own. The Company commenced a take-over bid for the remaining interest in Sears Canada on February 9, 2006. The Company has offered C$16.86 (Canadian dollars) per share, or approximately C$835 million ($720 million U.S. dollars), for the minority interest. The take-over bid is open for acceptance until March 17, 2006. The Company believes that 100% ownership of Sears Canada would allow Sears Canada to be able to compete with the other Canadian retailers and the Canadian operations of major U.S. retailers.

Holdings Results

Fiscal 2005 Compared to Fiscal 2004

The consolidated statement of operations for fiscal 2005 is not comparable to that for fiscal 2004 because the prior year does not include Sears' results. Additionally, the consolidated statement of operations for fiscal 2005 is not representative of the Company's operations as it only includes Sears' results of operations after the Merger, or from March 25, 2005 forward. For these reasons, the Company believes that an understanding of its reported results, trends and on-going performance is not complete without presenting results on a pro forma basis. Accordingly, the Company has provided an analysis of operating results for fiscal 2005 as compared to fiscal 2004 on both a reported and a pro forma basis.

Holdings Reported Results

Fiscal 2005 Compared to Fiscal 2004

Total revenues increased $29.3 billion, or 148%, to $49.1 billion for fiscal 2005, as compared to total revenues of $19.8 billion for fiscal 2004. The increase was attributable to the addition of Sears revenues of $30.0 billion in fiscal 2005, partially offset by a decline in Kmart's revenues of $0.7 billion, or 3.8%, due to a reduction in the total number of Kmart stores in operation, including 48 converted to a Sears format, and the comparable store sales decline of 1.2% discussed above. Total fiscal 2005 revenues benefited from $153 million of sales being recorded during the first quarter of fiscal 2005 as a result of three additional days being included in the fiscal 2005 period due to the Company's change from a Wednesday to a Saturday month end.

Gross margin as a percentage of merchandise sales and services revenue was 27.4% for fiscal 2005, as compared to 24.7% for fiscal 2004. The increase was primarily attributable to the addition of Sears, which had a higher overall gross margin rate than Kmart, in fiscal 2005.

Selling and administrative expenses as a percentage of total revenues was 21.9% for fiscal 2005, as compared to 20.2% for fiscal 2004. The increase was primarily attributable to the addition of Sears, which had a higher cost structure than Kmart, in fiscal 2005.

Depreciation and amortization was $932 million for fiscal 2005, as compared to $27 million for fiscal 2004. The increase was primarily attributable to the addition of Sears, which accounted for $885 million of the combined expense in the current year.

Restructuring charges were $111 million for fiscal 2005. These charges included a $57 million charge for employee-related termination costs associated with Sears Canada restructuring initiatives implemented during fiscal 2005, including a workforce reduction of approximately 1,200 associates, as well as $54 million at Kmart for relocation assistance and employee termination-related costs associated with Holdings' home office integration efforts.

Included in operating income were gains on sales of assets of $39 million and $946 million for fiscal 2005 and fiscal 2004, respectively. During fiscal 2004, the Company entered into multiple agreements with Home Depot to sell four properties and assign 14 leased properties for an aggregate purchase price of $271 million, resulting in a total gain on sale of $253 million. Also during fiscal 2004, Kmart sold four owned properties, assigned 45 leased properties and leased one owned store to Sears for a total purchase price of approximately $576 million, resulting in a gain of $599 million. Additionally, the Company sold certain other real and personal property, resulting in net gains of $39 million and $94 million for fiscal 2005 and fiscal 2004, respectively. Included within the fiscal 2004 gains were $22 million related to the sale of owned, or assignment of leased, properties, $18 million related to the sale of the Company's Trinidad subsidiary and its associated property, $12 million related to the sale of corporate airplanes and $42 million from sales of other real and personal property.

Operating income was $2.1 billion for fiscal 2005 as compared to $1.8 billion for fiscal 2004. Fiscal 2005 included the addition of $1.4 billion in Sears operating income generated subsequent to the Merger, which was offset by the collective impact of $906 million less in gains on the sale of assets realized by Kmart in the current year and, to a lesser degree, a $148 million decline in Kmart operating income, excluding gains on asset sales. Holdings' operating income for fiscal 2005 also included a $317 million gain on sale of business, reflecting a minority interest gain on the sale of Sears Canada's Credit and Financial Services business in November 2005. This gain had no impact on Holdings' net income as its entire impact was offset by increased minority interest expense. See Note 4 of Notes to Consolidated Financial Statements for further detail.

Interest expense increased $129 million in fiscal 2005 as a result of the inclusion of Sears debt in the current year, as well as additional interest expense incurred upon the conversion of Kmart's 9% subordinated convertible notes. Bankruptcy-related recoveries declined $19 million in the current year period and represent amounts recognized from vendors who had received cash payment for pre-petition obligations. Other income increased by $35 million in the current year period primarily due to a gain of $21 million recognized in connection with the settlement pertaining to Kmart's license agreement with Footstar, Inc. ("FTS") for the operation of Kmart's footwear departments. The effective tax rate decreased to 36.4% in fiscal 2005 from 37.7% in fiscal 2004, with the decrease primarily attributable to the November 2005 sale of Sears Canada's Credit and Financial Service business being taxed at a capital gains rate, lowering the effective tax rate for fiscal 2005.

Effective January 27, 2005, the Company determined that it would be preferable to conform one of the accounting practices utilized by Kmart to that of Sears. The Company changed its method of accounting for certain indirect overhead costs from inventoriable costs to period expenses. In accordance with Accounting Principles Board Opinion No. 20, "*Accounting Changes*", a change in accounting policy to conform the acquirer's policy to that of the acquired entity is treated as a change in accounting principle. As a result of the accounting change, the Company recorded a charge of $90 million, net of taxes, in the first quarter of fiscal 2005 for the cumulative effect of this change in accounting principle. The charge represents the amount of indirect costs reflected within inventory at the beginning of fiscal 2005. See Note 3 of Notes to Consolidated Financial Statements for further detail.

Holdings Pro Forma Results

Pro Forma Fiscal 2005 Compared To Pro Forma Fiscal 2004

Total revenues declined $1.7 billion, or 3.0%, to $54.3 billion for fiscal 2005, as compared to total revenues of $56.0 billion for fiscal 2004. The decline was primarily attributable to total revenue declines of 3.9% and 3.8% at Sears Domestic and Kmart, respectively, partially offset by a 5.3% revenue increase at Sears Canada, primarily due to favorable exchange rates. Domestic comparable store sales were down 5.3% in the aggregate, with Sears Domestic comparable store sales declining 8.4% and Kmart comparable store sales declining 1.2%. The Sears Domestic comparable store sales decrease was primarily attributable to efforts initiated in fiscal 2005 to improve gross margin rates by reducing reliance on certain promotional events and, to a lesser degree, poor customer response to full line store apparel offerings, as discussed above. Kmart's comparable store sales declined primarily as a result of lower transaction volumes.

Gross margin as a percentage of merchandise sales and services revenue was 27.4% for fiscal 2005, as compared to 26.4% for fiscal 2004. The increase was primarily attributable to improvement in the Sears Domestic gross margin rate, mainly as a result of improved inventory management and the utilization of more targeted clearance and promotional markdowns as discussed above. Sears Domestic's gross margin rate as a percentage of merchandise sales and services revenue was 29.3% for fiscal 2005, as compared to 27.4% for fiscal 2004.

Selling and administrative expenses as a percentage of total revenues was 22.3% for both fiscal 2005 and fiscal 2004. As discussed above, the Company reduced overall selling and administrative expense by $399 million in fiscal 2005; however, the impact of these reductions was mitigated by lower leverage of these expenses given lower overall sales in fiscal 2005, as well as increases at Sears Canada in both associate stock-based compensation and marketing expense.

Restructuring charges for fiscal 2005 totaled $111 million as compared to $41 million for fiscal 2004. The fiscal 2005 charges included a $57 million charge for employee-related termination costs associated with Sears Canada restructuring initiatives, including a workforce reduction of approximately 1,200 associates, as well as $54 million recorded at Kmart for relocation assistance and employee termination-related costs associated with Holdings' home office integration efforts. The $41 million charge recorded in fiscal 2004 reflected a charge recorded by Sears in the second quarter of fiscal 2004 as part of a productivity initiative.

Operating income was $2.1 billion for fiscal 2005, as compared to $1.6 billion for fiscal 2004. The increase was primarily attributable to increased operating income at Sears Domestic, which had $646 million in additional operating income during fiscal 2005. This increase was partially offset by $307 million less in gains on the sale of assets realized by Kmart in the current year and, to a lesser degree, a $148 million decline in Kmart operating income, excluding gains on asset sales, and a $78 million decline in Sears Canada's operating income, excluding the gain on sale of business in fiscal 2005. Holdings' operating income for fiscal 2005 also included a $317 million gain on sale of business, reflecting a minority interest gain on the sale of Sears Canada's Credit and Financial Services business in November 2005. This gain had no impact on Holdings' net income as its entire impact was offset by increased minority interest expense. See Note 4 of Notes to Consolidated Financial Statements for further detail.

Interest expense declined $80 million in fiscal 2005, as compared to fiscal 2004 due primarily to lower average borrowings. Bankruptcy-related recoveries decreased $19 million in the current year and represent amounts recognized from vendors who had received cash payment for pre-petition obligations. The effective tax rate increased to 37.3% in fiscal 2005 from 34.6% in fiscal 2004, with the lower fiscal 2004 effective rate attributable to the inclusion of Sears.

Holdings Reported Results

Fiscal 2004 Compared to Fiscal 2003

The discussion of reported results for fiscal 2004 as compared to fiscal 2003 has been divided into two parts as a result of Kmart Corporation's emergence from Chapter 11 bankruptcy in fiscal 2003. As further discussed in Note 11 of Notes to Consolidated Financial Statements, due to the application of Fresh-Start Accounting (defined in Note 11 of Notes to Consolidated Financial Statements) upon emergence from bankruptcy, the reported historical financial statements of the Predecessor Company for periods prior to May 1, 2003 generally are not comparable to those of the Successor Company. Thus, fiscal 2004 results have been set forth in two parts as shown in the below table.

				Predecessor Company
millions	39 Weeks Ended January 26, 2005	39 Weeks Ended January 28, 2004	13 Weeks Ended April 28, 2004	13 Weeks Ended April 30, 2003
Merchandise sales and services	$ 15,228	$ 17,190	$ 4,615	$ 6,181
Cost of sales, buying and occupancy	11,464	13,313	3,478	4,762
Gross margin	3,764	3,877	1,137	1,419
Selling, general and administrative expenses	3,022	3,470	1,004	1,421
Gain on sales of assets	(914)	(89)	(32)	
Restructuring, impairment and other charges				37
Operating income (loss)	1,656	496	165	(39)
Interest expense, net	80	127	28	57
Bankruptcy-related recoveries	(52)	(4)	(7)	
Other income		(5)	(3)	(7)
Reorganization items, net				769
Income (loss) from continuing operations before income taxes	1,628	378	147	(858)
Provision for (benefit from) income taxes	613	144	56	(6)
Income (loss) from continuing operations	1,015	234	91	(852)
Discontinued operations (net of income taxes of $0)				(10)
NET INCOME (LOSS)	$ 1,015	$ 234	$ 91	$ (862)

39 Weeks Ended January 26, 2005 Compared to 39 Weeks Ended January 28, 2004

Comparable store sales and total sales decreased 10.4% and 11.6%, respectively, for the 39 weeks ended January 26, 2005 as compared to the 39 weeks ended January 28, 2004. Factors contributing to the decline in same store and total sales included reductions in promotional events and promotional advertising in the Company's circulars, soft customer demand for apparel and increased competition at certain store locations.

Gross margin decreased $0.1 billion to $3.8 billion for the 39 weeks ended January 26, 2005, from $3.9 billion for the 39 weeks ended January 28, 2004. Gross margin rate increased to 24.7% for the 39 weeks ended January 26, 2005 from 22.5% for the 39 weeks ended January 28, 2004. Improvements in product margin contributed 270 basis points to the increase in gross margin rate during the 39 weeks ended January 26, 2005, primarily due to favorable markon, reductions in markdowns on clearance items and improvement in store inventory shrinkage. Improvements in inventory shrinkage at distribution centers as a result of improved inventory management and supply chain operations contributed 63 basis points to the increase in gross margin rate for the 39 weeks ended January 26, 2005.

Selling, general and administrative expenses decreased $0.4 billion for the 39 weeks ended January 26, 2005 to $3.0 billion, or 19.8% of sales, from $3.5 billion, or 20.2% of sales, for the 39 weeks ended January 28, 2004. The decline in SG&A was primarily due to reductions of $263 million

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in store payroll and related benefits as a result of increased operating efficiencies and reduced sales volume at the Company's stores. Reductions in expenses for weekly and mid-week circular advertising, partially offset by an increase in our electronic media advertising, contributed $69 million to the decrease in SG&A. In addition, improved workers compensation costs generated a reduction of $54 million to SG&A for the 39 weeks ended January 26, 2005.

Operating income for the 39 weeks ended January 26, 2005 was $1.7 billion, or 10.9% of sales, as compared to $0.5 billion, or 2.9% of sales, for the same period of the prior year. For the 39 weeks ended January 26, 2005 and January 28, 2004, the Company recognized $914 million and $89 million of gain on sales of assets, respectively, primarily related to sales transactions with Home Depot and Sears as further discussed in Note 16 of Notes to Consolidated Financial Statements. The increase in operating income, excluding these gains, was due to the decrease in SG&A, net of the decrease in gross margin, as noted above.

Interest expense, net for the 39 weeks ended January 26, 2005 and January 28, 2004 was $80 million and $127 million, respectively. The reduction in interest expense was mainly due to an increase of $23 million in interest income for the 39 weeks ended January 26, 2005 compared to the 39 weeks ended January 28, 2004. Interest income increased due to an increase in the Company's average cash and cash equivalents balance and an improvement on the rate of return due to improved interest rates. During the 39 weeks ended January 26, 2005 the Company also experienced a decline in debt discount accretion and interest on capital leases of $15 million and $8 million, respectively.

The effective income tax rate was 37.7% for the 39 weeks ended January 26, 2005 and 38.1% for the 39 weeks ended January 28, 2004.

13 Weeks Ended April 28, 2004 Compared to 13 Weeks Ended April 30, 2003

Comparable store and total sales for the 13 weeks ended April 28, 2004 as compared to the 13 weeks ended April 30, 2003 decreased $0.7 billion or 12.9% and $1.6 billion or 25.3%, respectively. The decrease in comparable store sales was due primarily to several Company-wide promotional events occurring in the first quarter of fiscal 2003 along with a reduction in advertising, including the frequency of mid-week circulars in fiscal 2004. Approximately $0.9 billion of the decrease in total sales was due to the closure of 316 stores in the first quarter of fiscal 2003, of which 250 stores were included in continuing operations. The remaining decrease in total sales is primarily attributable to the decrease in comparable store sales.

Gross margin decreased $0.3 billion to $1.1 billion, for the 13 weeks ended April 28, 2004, from $1.4 billion for the 13 weeks ended April 30, 2003. Gross margin rate increased to 24.6% for the 13 weeks ended April 28, 2004, from 23.0% for the 13 weeks ended April 30, 2003. Reduced depreciation, as a result of the write-off of long-lived assets in conjunction with the application of Fresh-Start Accounting favorably affected the gross margin rate 54 basis points in the fiscal 2004 period.

SG&A decreased $0.4 billion to $1.0 billion, or 21.8% of sales for the 13 weeks ended April 28, 2004, from $1.4 billion, or 23.0% of sales, for the 13 weeks ended April 30, 2003. Contributing to the decline was a reduction in advertising expenses in the fiscal 2004 period of $93 million, reduced payroll and related expenses in the Company's open stores of $62 million and reduced depreciation as a result of the write-off of long-lived assets in conjunction with the application of Fresh-Start Accounting of $86 million. SG&A included $146 million related to store closures during the 13 weeks ended April 30, 2003, as discussed above.

Operating income for the 13 weeks ended April 28, 2004 was $165 million, or 3.6% of sales, as compared to a loss of $39 million, or (0.6%) of sales, for the same period in fiscal 2003. The improvement was primarily due to the decrease in SG&A and the improvement in the Company's gross margin rate, as discussed above, partially offset by an overall decline in gross margin dollars due to the reduced store base. Operating income was also affected by net gain on sales of assets of $32 million in the first quarter of fiscal 2004 and restructuring charges of $37 million in the first quarter of fiscal 2003.

Interest expense, net for the 13 weeks ended April 28, 2004 and April 30, 2003 was $28 million and $57 million, respectively. During the 13 weeks ended April 28, 2004, $12 million of interest expense was recorded for the accretion of obligations recorded at net present value. Included in interest expense for the 13 weeks ended April 30, 2003 was $37 million of amortization of debt issuance costs associated with the Predecessor Company's Court-approved $2 billion debtor-in-possession financing facility. Interest at the stated contractual amount on unsecured debt that was not charged to earnings for the 13 weeks ended April 30, 2003 was $67 million. Interest expense is net of interest income of $5 million and $1 million for the 13 weeks ended April 28, 2004 and April 30, 2003, respectively.

The effective income tax rate was 38.1% and (0.7%) for the 13 weeks ended April 28, 2004 and April 30, 2003, respectively.

Business Segment Results

Holdings is continuing the process of integrating Kmart and Sears. To date, for purposes of reviewing results of operations and making asset-allocation decisions, senior management has continued to utilize principally the reporting structures that existed independently for Sears and Kmart prior to the Merger. As a result, the following discussion of segment operations is organized into three principal business segments: Kmart, Sears Domestic and Sears Canada.

Kmart

Kmart results and key statistics were as follows:

millions, except for number of stores	**2005**	**2004**
Merchandise sales and services	$ 19,094	$ 19,843
Cost of sales, buying and occupancy	14,462	14,942
Gross margin rate	*24.3%*	*24.7%*
Selling and administrative	3,804	3,999
Selling and administrative expenses as a percentage of total revenue	*19.9%*	*20.2%*
Depreciation and amortization	47	27
Gain on sales of assets	(40)	(946)
Restructuring charges	54	
Total costs and expenses	18,327	18,022
Operating income	$ 767	$ 1,821
Number of stores	1,416	1,480

Fiscal 2005 Compared To Fiscal 2004

Comparable store sales and total sales decreased 1.2% and 3.8%, respectively, during fiscal 2005, primarily as a result of lower transaction volumes across most businesses. Apparel sales increased for the year on a comparable store basis, but this improvement was more than offset by sales declines in both home goods and the food and drug business. Total sales benefited from $153 million of additional sales recorded during the first quarter of fiscal 2005 as a result of three additional days being included in the fiscal 2005 period due to the Company's change from a Wednesday to a Saturday month end. However, this favorable impact was more than offset by a reduction in the total number of Kmart stores in operation. A total of 60 Kmart stores were closed in fiscal 2005, including 48 Kmart stores converted to the Sears Essentials format. These store closures and conversions accounted for a 2.2% decline in total Kmart sales for fiscal 2005. The remaining balance of the decline in total sales was due to the decline in comparable store sales and the fact that fiscal 2004 total sales benefited from partial-year sales recorded in stores closed during fiscal 2004.

Gross margin as a percentage of merchandise sales and services revenue was 24.3% in fiscal 2005, as compared to 24.7% for fiscal 2004. The decline in gross margin rate was primarily attributable to the impact of increased occupancy and distribution costs during fiscal 2005, due in part to lower expense leverage given lower sales levels in fiscal 2005, as well as increased utilities and transportation expense stemming from higher energy price levels prevalent during fiscal 2005. These items collectively reduced Kmart's gross margin rate in fiscal 2005 by approximately 50 basis points. Excluding the impact of distribution and occupancy costs, Kmart's gross margin rate increased by approximately 10 basis points over fiscal 2004 levels. This improvement reflected overall improved margin management in a number of businesses, most notably within the hardlines and food and drug businesses, partially offset by the impact of higher markdown levels and clearance activity in those Kmart stores preparing for conversion to the Sears Essentials format. Within the hardlines business, comparable store sales, gross margin rate and gross margin dollars all increased relative to fiscal 2004 levels; however, the better than expected gross margin rate improvement within food and drug for fiscal 2005 came at the expense of lower sales and total gross margin dollars versus fiscal 2004. The Company's fiscal 2006 plans include efforts to increase food and drug sales and, thereby, the total gross margin dollars generated by that business, which may negatively impact its gross margin rate.

Selling and administrative expenses as a percentage of total revenues was 19.9% for fiscal 2005, as compared to 20.2% for fiscal 2004. The improvement in rate is primarily a function of reductions in payroll and benefits costs, which were approximately $150 million lower in fiscal 2005, as compared to fiscal 2004, primarily due to reduced performance-based incentive expense. The reduction in payroll and benefits expense accounted for a 20 basis point improvement in Kmart's overall selling and administrative expense rate. Selling and administrative expenses declined approximately $44 million for fiscal 2005 as compared to fiscal 2004 at those store locations that were either closed or converted to the Sears Essentials format during fiscal 2005.

Restructuring charges related to Holdings' home office integration efforts were $54 million during fiscal 2005, including $36 million for relocation assistance and $18 million for employee termination-related costs.

Operating income for fiscal 2005 decreased compared to fiscal 2004 primarily due to $906 million less in gains on the sale of assets realized in the current year and, to a lesser degree, a decline in sales and gross margin, and the restructuring charges of $54 million recorded in the current year period, offset by lower selling and administrative expense.

Sears Domestic

The consolidated statement of operations for Holdings for fiscal 2005 includes Sears Domestic results from March 25, 2005 forward. It does not reflect a full year for Sears Domestic or any prior year operating results for comparison. The Company believes that an understanding of its reported results and its ongoing financial performance is not complete without presenting the Sears Domestic results of operations on a pro forma basis. The presentation below provides the results of operations on a reported and pro forma basis.

Sears Domestic results and key statistics were as follows:

	Reported	Pro Forma	
	2005	**2005**	**2004**
millions, except for number of stores			
Merchandise sales and services	$ 25,868	$ 30,038	$ 31,254
Cost of sales, buying and occupancy	18,221	21,239	22,682
Gross margin rate	*29.6%*	*29.3%*	*27.4%*
Selling and administrative	5,968	7,039	7,340
Selling and administrative expense as a percentage of total revenues	*23.1%*	*23.4%*	*23.5%*
Depreciation and amortization	769	911	992
Loss (gain) on sales of assets	1		(4)
Restructuring charges			41
Total costs and expenses	24,959	29,189	31,051
Operating income	$ 909	$ 849	$ 203
Number of:			
Full-line Stores(1)	924		873
Specialty Stores	1,128		1,153
Total Domestic Sears Stores	2,052		2,026

(1) Fiscal 2005 includes 866 Full-line store and 58 Sears Essentials/Grand stores; Fiscal 2004 includes 869 Full-line stores and 4 Sears Grand stores

Sears Domestic Pro Forma Results

The discussion below pertains to pro forma information in the table above, which compares Sears Domestic's results for fiscal 2005 with Sears Domestic's results for fiscal 2004. These pro forma results have been prepared assuming the Merger occurred at the beginning of fiscal 2004.

Pro Forma Fiscal 2005 Compared To Pro Forma Fiscal 2004

Merchandise sales and services revenues declined $1.2 billion, or 3.9%, to $30.0 billion for fiscal 2005, as compared to total revenues of $31.3 billion for fiscal 2004. The decline was due to an aggregate 8.4% decrease in comparable store sales, with decreases across all retail formats, partially offset by an increase in the total number of Sears Domestic stores in operation, mainly the opening of 54 Sears Essentials and Sears Grand locations, as well as strong Home Services sales. The decline in Sears Domestic comparable store sales primarily reflects the efforts initiated in fiscal 2005 to improve gross margin rates and, to a lesser extent, the weaker than anticipated customer response to fashion offerings within the full-line stores discussed above.

Gross margin as a percentage of merchandise sales and services revenue was 29.3% for fiscal 2005, as compared to 27.4% for fiscal 2004. The 190 basis point increase was primarily attributable to improved inventory management and the utilization of more targeted clearance and promotional markdowns versus historical reliance on storewide events. Gross margin rates improved across all full-line store merchandise categories with the exception of fashion apparel and home fashions, where higher than expected clearance markdowns were taken to clear goods that received poor customer response. The margin benefit derived from better inventory management was partially offset by lower expense leverage relative to occupancy costs due to lower sales levels and higher utilities and energy costs during fiscal 2005.

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Selling and administrative expenses as a percentage of total revenues was 23.4% for fiscal 2005, as compared to 23.5% for fiscal 2004. Selling and administrative expenses decreased by $301 million as Sears reduced costs across a number of areas, most notably within marketing ($226 million reduction) and headquarters expenses ($99 million reduction) partially offset by higher expenses in other areas, including a $27 million increase in Merger-related costs. Though the overall selling and administrative expense rate improved in fiscal 2005 as a result of savings generated from these cost-saving initiatives, the impact of these reductions was mitigated by lower expense leverage given lower sales levels in fiscal 2005.

Depreciation and amortization expense declined $81 million for fiscal 2005 due primarily to lower capital expenditure levels and additional depreciation recognized in fiscal 2004 in connection with shortening the estimated remaining useful lives of certain information technology assets that were sold to an outside IT service provider during the year.

Operating income increased $646 million as a result of the increased gross margin, lower selling and administrative costs, and lower depreciation and amortization expense, as well as the comparable prior year period being unfavorably impacted by a $41 million charge recorded in the second quarter of fiscal 2004 as part of a productivity initiative.

Sears Canada

Sears Canada, a consolidated, 54%-owned subsidiary of Sears, conducts retail and credit operations. In November 2005, Sears Canada completed the sale of its Credit and Financial Services operations.

The results of operations for Sears Canada are reported to Holdings on a one-month lag. Therefore, the consolidated statement of operations for fiscal 2005 includes operating results for Sears Canada from March 25, 2005 through December 31, 2005. The Company believes that an understanding of its reported results and its ongoing financial performance is not complete without presenting the Sears Canada results of operations on a pro forma basis. The presentation below provides the results of operations on a reported and pro forma basis.

Sears Canada results and key statistics were as follows:

	Reported	Pro Forma	
	2005	2005	2004
millions, except for number of stores			
Merchandise sales and services	$ 3,949	$ 4,830	$ 4,488
Credit and Financial Products revenues	213	299	381
Total revenues	4,162	5,129	4,869
Cost of sales, buying and occupancy	2,822	3,476	3,271
Gross margin rate	*28.5%*	*28.0%*	*27.1%*
Selling and administrative	987	1,241	1,144
Selling and administrative as a percentage of revenues	*23.7%*	*24.2%*	*23.5%*
Depreciation and amortization	116	150	177
Provision for uncollectible credit card accounts	49	65	64
Gain on sales of assets			(5)
Gain on sale of business	(317)	(317)	
Restructuring charges	57	57	
Total costs and expenses	3,714	4,672	4,651
Operating income	$ 448	$ 457	$ 218
Number of:			
Full-line Stores	123		121
Specialty Stores	252		219
Total Sears Canada Stores	375		340

Sears Canada Pro Forma Results

The discussion below pertains to pro forma information in the table above, which compares Sears Canada's results for fiscal 2005 with Sears Canada's results for fiscal 2004. These pro forma results have been prepared assuming the Merger occurred at the beginning of fiscal 2004.

Pro Forma Fiscal 2005 Compared To Pro Forma Fiscal 2004

Total revenues increased 5.3% in fiscal 2005. The increase was due primarily to favorable exchange rates. Excluding the impact of exchange rates, total revenues were flat versus fiscal 2004.

The gross margin rate for fiscal 2005 as compared to fiscal 2004 increased primarily due to the combined effect of improved inventory management, which resulted in less liquidation losses, and favorable exchange rates related to the purchase of imported merchandise.

Selling and administrative expense as a percentage of total revenues for fiscal 2005 increased primarily due to increased associate stock-based compensation and, to a lesser extent, increased marketing costs. The stock-based compensation increase accounted for approximately 40 basis points of the total increase in the selling and administrative expense rate and resulted mainly from an increase in Sears Canada's share price subsequent to its announcement of a definitive agreement to sell substantially all assets and liabilities of its Credit and Financial Services operations, as well as changes in Sears Canada's associate stock plan to provide for early vesting of unvested options and allow associates to take cash payments in lieu of shares.

Restructuring charges of $57 million were recognized during fiscal 2005 for productivity initiatives, which included a workforce reduction of approximately 1,200 associates.

Operating income increased $239 million in fiscal 2005 as compared to fiscal 2004. A gain on sale of business totaling $317 million was recorded to reflect the minority interest gain on the sale of Sears Canada's Credit and Financial Services business in November 2005. This gain had no impact on Holdings' net income as its entire impact was offset by increased minority interest expense. See Note 4 of Notes to Consolidated Financial Statements for further detail. Excluding this gain, operating income declined $78 million in fiscal 2005 due primarily to the $57 million restructuring charge recorded in the third quarter of 2005 and higher selling and administrative expenses, partially offset by increased gross margin.

On November 15, 2005, Sears Canada completed the sale of substantially all assets and liabilities of its Credit and Financial Services operations. Accordingly, the credit and financial product revenues of $299 million and $381 million for the pro forma fiscal years ended 2005 and 2004, respectively, are not expected to re-occur.

PRO FORMA RECONCILIATION

The following tables provide a reconciliation from the as reported results to the pro forma results presented above for Sears Holdings for the years ended January 28, 2006 and January 26, 2005, respectively, as well as for Sears Domestic and Sears Canada for the years ended January 28, 2006 and January 29, 2005, respectively.

Sears Holdings

millions, except per share data	Year Ended January 28, 2006				Year Ended January 26, 2005			
	As Reported	**Pre-merger Activity[1]**	**Purchase Acctng**	**Pro Forma**	**As Reported**	**Pre-merger Activity[1]**	**Purchase Acctng**	**Pro Forma**
Merchandise sales and services	$ 48,911	$ 5,051	$	$ 53,962	$ 19,843	$ 35,742	$	$ 55,585
Credit and financial products revenues	213	86		299		381		381
Total revenues	49,124	5,137		54,261	19,843	36,123		55,966
Cost of sales, buying and occupancy	35,505	3,672		39,177	14,942	25,945	8[2]	40,895
Selling and administrative	10,759	1,314	11[3]	12,084	3,999	8,418	66[3]	12,483
Depreciation and amortization	932	147	29[4]	1,108	27	984	185[4]	1,196
Provision for uncollectible credit card accounts	49	16		65		64		64
Gain on sales of assets	(39)	(1)		(40)	(946)	(9)	599[5]	(356)
Gain on sale of business	(317)			(317)				
Restructuring charges	111			111		41		41
Total costs and expenses	47,000	5,148	40	52,188	18,022	35,443	858	54,323
Operating income (loss)	2,124	(11)	(40)	2,073	1,821	680	(858)	1,643
Interest expense (income), net	237	35	(2)[6]	270	108	265	(23)[6]	350
Bankruptcy-related recoveries	(40)			(40)	(59)			(59)
Other income	(38)	(10)		(48)	(3)	(66)		(69)
Income before income taxes, minority interest and cumulative effect of change in accounting principle	1,965	(36)	(38)	1,891	1,775	481	(835)	1,421
Income tax expense (benefit)	716	4	(15)[7]	705	669	141	(319)[7]	491
Minority interest	301	6		307		46		46
Income before cumulative effect of change in accounting principle	948	(46)	(23)	879	1,106	294	(516)	884
Cumulative effect of change in accounting principle, net of tax	(90)			(90)				
NET INCOME (LOSS)	$ 858	$ (46)	$ (23)	$ 789	$ 1,106	$ 294	$ (516)	$ 884
Diluted earnings per share before cumulative effect of change in accounting principle	$ 6.17			$ 5.40	$ 11.00			$ 5.40
Diluted earnings per share	$ 5.59			$ 4.85	$ 11.00			$ 5.40

(1) Represents the 2005 results of operations for the period January 30, 2005 through March 24, 2005 for Sears Domestic and the period January 2, 2005 through March 24, 2005 for Sears Canada and the 2004 results of operations for the period February 1, 2004 through January 29, 2005 for Sears Domestic and the period January 4, 2004 through January 1, 2005 for Sears Canada.

(2) Represents an increase to cost of sales, buying and occupancy expense resulting from the adjustment to Sears' inventory based on the adjustment of such assets to fair value.

(3) Represents an increase to selling and administrative expense resulting from the adjustment to Sears' pension and postretirement plans based on the adjustment of such liabilities to fair value.

(4) Represents an increase in depreciation and amortization expense resulting from the adjustment to Sears' property and equipment and identifiable intangible assets based on the adjustment of such assets to fair value.

(5) During fiscal 2004, Sears acquired ownership or leasehold interest in 50 Kmart stores for approximately $576 million, and Kmart recognized a gain on the sale amounting to $599 million. This adjustment eliminates the gain on the sale recognized by Kmart.

(6) Represents a decrease to interest expense resulting from the adjustment to Sears debt based on the adjustments of such liabilities to fair value.

(7) Represents the aggregate pro forma effective income tax effect of notes (2) through (6) above.

Sears Domestic

	Year Ended January 28, 2006				Year Ended January 29, 2005			
millions	As Reported	Pre-merger Activity[(1)]	Purchase Acctng	Pro Forma	As Reported	Pre-merger Activity[(1)]	Purchase Acctng	Pro Forma
Merchandise sales and services	$ 25,868	$ 4,170	$	$ 30,038	$	$ 31,254	$	$ 31,254
Cost of sales, buying and occupancy	18,221	3,018		21,239		22,680	2(2)	22,682
Selling and administrative	5,968	1,060	11(3)	7,039		7,274	66(3)	7,340
Depreciation and amortization	769	116	26(4)	911		811	181(4)	992
Loss (Gain) on sales of assets	1	(1)				(4)		(4)
Restructuring charges						41		41
Total costs and expenses	24,959	4,193	37	29,189		30,802	249	31,051
Operating income (loss)	$ 909	$ (23)	$ (37)	$ 849	$	$ 452	$ (249)	$ 203

Sears Canada

	Year Ended January 28, 2006				Year Ended January 29, 2005			
millions	As Reported	Pre-merger Activity[(1)]	Purchase Acctng	Pro Forma	As Reported	Pre-merger Activity[(1)]	Purchase Acctng	Pro Forma
Merchandise sales and services	$ 3,949	$ 881	$	$ 4,830	$	$ 4,488	$	$ 4,488
Credit and financial product revenues[(5)]	213	86		299		381		381
Total revenues	4,162	967		5,129		4,869		4,869
Cost of sales, buying and occupancy	2,822	654		3,476		3,265	6(2)	3,271
Selling and administrative	987	254		1,241		1,144		1,144
Depreciation and amortization	116	31	3(4)	150		173	4(4)	177
Provision for uncollectible credit card accounts	49	16		65		64		64
Gain on sales of assets						(5)		(5)
Gain on sale of business	(317)			(317)				
Restructuring charges	57			57				
Total costs and expenses	3,714	955	3	4,672		4,641	10	4,651
Operating income (loss)	$ 448	$ 12	$ (3)	$ 457	$	$ 228	$ (10)	$ 218

(1) Represents the 2005 results of operations for the period January 30, 2005 through March 24, 2005 for Sears Domestic and the period January 2, 2005 through March 24, 2005 for Sears Canada and the 2004 results of operations for the period February 1, 2004 through January 29, 2005 for Sears Domestic and the period January 4, 2004 through January 1, 2005 for Sears Canada.

(2)

Represents an increase to cost of sales, buying and occupancy expense resulting from the adjustment of Sears' inventory to fair value.

(3) Represents an increase to selling and administrative expense resulting from the adjustment to Sears' pension and postretirement plans based on the adjustment of such liabilities to fair value.

(4) Represents an increase in depreciation and amortization expense resulting from the adjustment to Sears' property and equipment and identifiable intangible assets based on the adjustment of such assets to fair value.

(5) On November 15, 2005, the Company completed the sale of substantially all assets and liabilities of Sears Canada's Credit and Financial Services operations. Accordingly, the credit and financial product revenues of $299 million and $381 million for the pro forma fiscal years ended 2005 and 2004, respectively, are not expected to re-occur.

ANALYSIS OF CONSOLIDATED FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents include all highly liquid investments with original maturities of three months or less at the date of purchase. The Company's cash and cash equivalents balances as of the fiscal years ended January 28, 2006 and January 26, 2005 are detailed in the following table.

millions	2005	2004
Domestic cash		
Invested cash	$ 3,208	$ 2,820
Cash posted as collateral	466	584
Credit card deposits in transit	102	31
Total domestic cash and cash equivalents	3,776	3,435
Sears Canada	664	
Total cash and cash equivalents	$ 4,440	$ 3,435

The Company's invested cash may include, from time to time, investments in, but not limited to, commercial paper, U.S. federal, state and municipal government securities, floating-rate notes, repurchase agreements and money market funds. All invested cash amounts are readily available to the Company and included $634 million and $0 million as of fiscal year end 2005 and fiscal year end 2004, respectively, invested in support of the Company's wholly-owned captive insurance subsidiary.

The Company has posted cash collateral for certain outstanding letters of credit and self-insurance programs. Such cash collateral is classified within cash and cash equivalents given its ready availability to the Company as the Company has the ability to substitute letters of credit at any time for this cash collateral.

Credit card deposits in transit include deposits in-transit from banks for payments related to third-party credit card and debit card transactions, including those generated on the Sears Card and Sears MasterCard products.

The Company classifies outstanding checks in excess of funds on deposit within Other current liabilities and reduces cash and cash equivalents when these checks clear the bank on which they were drawn. Outstanding checks in excess of funds on deposit were $444 million and $143 million for the fiscal year ended 2005 and 2004, respectively.

Operating Activities and Cash Flows

Holdings generated approximately $2.3 billion in operating cash flows during fiscal 2005, as compared to $1.1 billion in fiscal 2004. As a retailer, Holding's primary source of operating cash flows is the sales of goods and services to customers, while the primary use of cash in operations is to fund the purchase of merchandise inventories.

The Company had total merchandise inventories of approximately $9.1 billion as of January 28, 2006 compared to $3.3 billion as of January 26, 2005. The increase in reported merchandise inventories is mainly due to the acquisition of Sears. Total Sears merchandise inventories were approximately $5.7 billion as of January 28, 2006. Sears Domestic merchandise inventories totaled $5.0 billion as of January 28, 2006 compared to pro forma Sears Domestic merchandise inventories of approximately $5.5 billion as of January 29, 2005. The reduction in Sears Domestic merchandise inventories was primarily the result of improved inventory management controls implemented during fiscal 2005.

Investing Activities and Cash Flows

Net cash flows provided by investing activities totaled $0.6 billion in fiscal 2005, as compared to $0.3 billion in fiscal 2004. Investing cash flows in both years were heavily impacted by a number of significant transactions.

Fiscal 2005 reflects the receipt of $2.0 billion in proceeds from the sale of Sears Canada's Credit and Financial Services business in November 2005. This transaction is further described in Note 4 of Notes to Consolidated Financial Statements. Fiscal 2005 investing activity cash flows also reflect the cash paid in connection with the Merger, a $1.0 billion net cash outflow.

Fiscal 2004 investing activities included the receipt of approximately $562 million in cash from multiple sale and lease assignment transactions relative to certain Kmart properties, including significant transactions with Home Depot and Sears. These transactions are further described in Note 16 of Notes to Consolidated Financial Statements.

During fiscal 2005, the Company spent $546 million on capital expenditures compared to $230 million and $868 million spent by Kmart and Sears, respectively, during the prior year. The current year spending of $546 million excludes approximately $40 million of capital expenditures made by Sears during the period January 30, 2005 through March 24, 2005 (pre-Merger period). Significant capital projects during fiscal 2005 included opening 50 Sears Essentials and four Sears Grand locations, as well as remodeling approximately 90 Kmart locations to include Sears brand products inside, most notably home appliances.

The Company anticipates fiscal 2006 capital expenditure levels to be similar in amount to fiscal 2005 levels; however, in the normal course of business, the Company considers opportunities to purchase leased operating properties, as well as offers to sell owned, or assign leased, operating and non-operating properties. These transactions may, individually or in the aggregate, result in material proceeds or outlays of cash and cause the Company's capital expenditure levels to vary from period to period. In addition, the Company reviews leases that will expire in the short-term to determine the appropriate action to take with respect to them. During fiscal 2005, the Company purchased 19 previously leased operating properties for $98 million.

Financing Activities and Cash Flows

Net cash used in financing activities was $2.0 billion in fiscal 2005, as compared to $53 million in fiscal 2004. Subsequent to the Merger, the Company reduced its domestic debt levels by $0.8 billion. This debt was primarily Sears debt included on Holdings' consolidated balance sheet subsequent to the Merger. Sears and its subsidiaries had approximately $3.9 billion of debt, $0.9 billion of securitized borrowings, and $0.5 billion of capital lease obligations at the time of the Merger. The fiscal 2005 repayments were funded primarily from operating cash flows.

The Company received $59 million in cash from Ares' November 2005 19.9% investment in the voting stock of OSH and receipt of a three-year option to purchase, for $127 million, additional shares of OSH that currently represent 30.2% of OSH's outstanding voting stock.

Holdings generated $169 million of debt proceeds, net of $7 million in issuance costs, in fiscal 2005 as a result of financing obtained by OSH subsidiaries concurrent with the Ares investment in 19.9% of the voting stock of OSH. At the time of the Ares investment, OSH subsidiaries entered into a series of arrangements for $250 million in financing, consisting of a $130 million senior secured revolving credit facility and a $120 million commercial mortgage-backed loan. Approximately $56 million of the revolving credit facility was drawn down at closing. A portion of the proceeds was used by OSH to fund a dividend to Holdings that included $225 million in cash which was available to be used for Holdings' general corporate purposes.

In addition, during fiscal 2005, the Company repurchased approximately 5.0 million of its common shares at a total cost of approximately $0.6 billion under the Company's $1.0 billion common share repurchase program. The stock repurchases were funded from operating cash flows. The program was approved by the Company's Board of Directors during the third quarter of fiscal 2005, and as of January 28, 2006, the Company had approximately $0.4 billion of remaining authorization under the program.

Net cash used for financing activities was $53 million in fiscal 2004 due to payments on capital lease obligations and mortgages payable.

Uses and Sources of Liquidity

The Company's primary need for liquidity is to fund seasonal working capital requirements of its retail businesses, capital expenditures and for general corporate purposes. The Company believes that these needs will be adequately funded by the Company's operating cash flows, credit terms from vendors, current balances in cash and cash equivalents and, to the extent necessary, borrowings under the Company's $4.0 billion, five-year credit agreement (the "Credit Agreement") (described below). At January 28, 2006, $3.6 billion was available under this facility. While the Company expects to use the Credit Agreement as its primary funding source, it may also access the public debt markets on an opportunistic basis. Additionally, the Company may from time to time consider selective strategic transactions to create value and improve performance, which may include acquisitions, dispositions, restructurings, joint ventures and partnerships. Transactions of these types may result in material proceeds or cash outlays. For example, on December 5, 2005, Holdings announced its offer to acquire the 46% interest in Sears Canada that it does not already own for a purchase price of $720 million. Holdings expects to fund the proposed acquisition with cash on hand.

The Company's year end fiscal 2005 and 2004 outstanding borrowings were as follows:

millions	January 28, 2006	January 26, 2005
Short-term borrowings:		
Unsecured commercial paper	$ 178	$
Long-term debt, including current portion:		
Convertible subordinated notes, net		43
Notes and debentures outstanding	2,974	52
Capital lease obligations	864	316
Total borrowings	$ 4,016	$ 411

The increase in total borrowings from January 26, 2005 was due primarily to the acquisition of Sears. Sears and its subsidiaries had approximately $3.9 billion of debt, $0.9 billion of securitized borrowings, and $0.5 billion of capital lease obligations at the time of the Merger.

In May 2005, the Finance Committee of the Company's Board of Directors authorized the repurchase, subject to market conditions and other factors, of up to $500 million of the outstanding indebtedness of the Company and its subsidiaries in open market or privately negotiated transactions. The source of funds for the purchases is expected to be the Company's cash from operations or borrowings under the Credit Agreement. During the year ended January 28, 2006, the Company's subsidiary, Sears Roebuck Acceptance Corp. ("SRAC"), repurchased $156 million of its outstanding notes, thereby reducing the unused balance of this authorization to $344 million

On January 31, 2005, Kmart entered into an agreement with Holdings and certain affiliates of ESL Investments, Inc. ("ESL"). Pursuant to this agreement, ESL affiliates converted, in accordance with their terms, all of the outstanding 9% convertible subordinated notes of Kmart and six months of accrued interest into an aggregate of 6.3 million shares of Kmart common stock. In consideration of

ESL's conversion of the notes prior to maturity, ESL received a $3 million payment from Kmart. The cash payment was equivalent to the approximate discounted after-tax cost of the future interest payments that would have otherwise been paid by Kmart to ESL and its affiliates in the absence of the early conversion. In conjunction with the conversion, the Company recognized the remaining related unamortized debt discount of $17 million as interest expense.

The Company uses interest rate swaps to synthetically convert fixed-rate debt to variable-rate debt to manage its exposure to interest rate risks. The interest rate swaps qualify as fair value hedges in accordance with SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*", and are recorded on the balance sheets at market value with an offsetting entry to the underlying hedged debt.

During fiscal 2005, the Company terminated interest rate swaps with a notional value of approximately $1.0 billion that had converted certain of the Company's fixed-rate debt to floating-rate debt. The Company's variable rate borrowings were reduced to approximately $474 million as a result of these interest rate swap terminations and the retirement of certain of the Company's variable-rate debt. The Company received $60 million in cash proceeds from the swap terminations, representing the aggregate fair value of these swaps as of the termination date. As the hedges related to these swaps qualified for hedge accounting, an offsetting adjustment was recorded to the carrying amount of the designated hedged debt, which remains outstanding, and this adjustment will be amortized into interest expense over the remaining term of the debt.

Debt Ratings

The ratings of the Company's domestic debt securities as of January 28, 2006 appear in the table below:

	Moody's Investors Service	Standard & Poor's Ratings Services	Fitch Ratings
Unsecured long-term debt	Ba1	BB+	BB
Unsecured commercial paper	NP	B-1	B

Credit Agreement

The Credit Agreement, which expires March 2010, is available for general corporate purposes and includes a $1.5 billion letter of credit sublimit. The Credit Agreement is a revolving credit facility under which SRAC and Kmart Corporation are the borrowers. The Credit Agreement is guaranteed by Holdings and certain of its direct and indirect subsidiaries and is secured by a first lien on domestic inventory, credit card accounts receivable and the proceeds thereof. Availability under the Credit Agreement is determined pursuant to a borrowing base formula, based on domestic inventory and credit card accounts receivable, subject to certain limitations. As of January 28, 2006, the Company had $428 million of letters of credit outstanding under the Credit Agreement with $3.6 billion of availability remaining under the Credit Agreement. There were no direct borrowings under the facility during fiscal 2005. The Credit Agreement does not contain provisions that would restrict borrowings or letter of credit issuances based on material adverse changes or credit ratings. The Company capitalized $20 million of debt issuance costs in connection with entering into the Credit Agreement. These costs are being amortized over the five-year life of the Credit Agreement.

Letter of Credit Agreement

The Company has an additional letter of credit agreement (the "LC Agreement") with a commitment amount of up to $600 million. The LC Agreement expires in August 2007. As of January 28, 2006, there were $366 million of letters of credit outstanding under the LC Agreement.

Under the terms of the LC Agreement, the Company has the ability to post cash, inventory or letters of credit, including letters of credit issued under the Credit Agreement, as collateral. However, the Credit Agreement prohibits the Company from using inventory as collateral under the LC Agreement. The cash collateral account is subject to a pledge and security agreement pursuant to which if the Company elects to post cash collateral, it must maintain cash in an amount equal to 100.5% of the face value of letters of credit outstanding. The Company had $368 million posted as collateral under the LC Agreement as of January 28, 2006. The Company continues to classify the cash collateral as cash and cash equivalents due to its ability to substitute these letters of credit with letters of credit under the Credit Agreement, which does not require cash collateral, and its ability to provide letters of credit under the Credit Agreement as collateral. There are no provisions in the LC Agreement that would restrict issuances based on credit ratings, but issuances could be restricted under certain circumstances based on a material adverse change.

Cash Collateral

The Company posts cash collateral for certain self-insurance programs. The Company continues to classify the cash collateral as cash and cash equivalents in the accompanying consolidated balance sheets due to the Company's ability to substitute letters of credit for the cash at any time at its discretion. As of January 28, 2006, $98 million of cash was posted as collateral for self-insurance programs.

Orchard Supply Hardware LLC ("LLC") Credit Agreement

In November 2005, LLC entered into a five-year, $130 million senior secured revolving credit facility (the "LLC Facility"), which includes a $25 million letter of credit sublimit. The LLC Facility is available for LLC's general corporate purposes and is secured by a first lien on substantially all of LLC's non-real estate assets. Availability under the LLC Facility is determined pursuant to a borrowing base formula based on inventory and accounts and credit card accounts receivable, subject to certain limitations. As of January 28, 2006, $61 million was outstanding under this facility $56 million in borrowings and $5 million in outstanding letters of credit.

Contractual Obligations and Off-Balance-Sheet Arrangements

Information concerning our obligations and commitments to make future payments under contracts such as debt and lease agreements, and under contingent commitments, is aggregated in the following tables.

		Payments Due by Period			
Contractual Obligations	**Total**	**Within 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
millions					
Operating leases	$ 7,344	$ 844	$ 1,419	$ 1,079	$ 4,002
Short-term debt	178	178			
Capital lease obligations	1,719	173	302	276	968
Royalty license fees(1)	245	109	120	16	
Pension funding obligations	1,247	227	582	438	
Long-term debt	4,110	647	1,048	816	1,599
Total contractual obligations	$ 14,843	$ 2,178	$ 3,471	$ 2,625	$ 6,569

(1) The Company pays royalties under various merchandise license agreements, which are generally based on sales of products covered under these agreements. The Company currently has license agreements for which it pays royalties, including those to use the Thalia Sodi, Jaclyn Smith, Joe Boxer, Martha Stewart Everyday and Route 66 trademarks. Royalty license fees represent the minimum Holdings is obligated to pay, regardless of sales, as guaranteed royalties under these license agreements.

Other Commercial Commitments

millions	Bank Issued	SRAC Issued	Other	Total
Standby letters of credit	$ 762	$ 118	$	$ 880
Commercial letters of credit	109	103		212
Secondary lease obligations and performance guarantee			125	125

Sears Canada Take-Over Bid

In December 2005, the Company entered into a lock-up agreement with Natcan Investment Management, Inc. ("Natcan"), pursuant to which Natcan agreed to tender all Sears Canada common shares (representing approximately 9% of the outstanding common shares of Sears Canada) that it owns or controls in response to the Company's take-over bid, at a price of C$16.86 per share. This agreement obligates the Company to spend approximately $141 million to purchase the Natcan shares.

Application of Critical Accounting Policies

In preparing the financial statements, certain accounting policies require considerable judgment to select the appropriate assumptions to calculate financial estimates. These estimates are complex and subject to an inherent degree of uncertainty. The Company bases its estimates on historical experience, terms of existing contracts, evaluation of trends and other assumptions that the Company believes to be reasonable under the circumstances. The Company continually evaluates the information used to make these estimates as its business and the economic environment change. Although the use of estimates is pervasive throughout the financial statements, the Company considers an accounting estimate to be critical if:

- it requires assumptions to be made about matters that were highly uncertain at the time the estimate was made, and

- changes in the estimate that are reasonably likely to occur from period to period or different estimates that could have been selected would have a material effect on the Company's financial condition, cash flows or results of operations.

Management believes the current assumptions and other considerations used to estimate amounts reflected in the financial statements are appropriate. However, if actual experience differs from the assumptions and the considerations used in estimating amounts, the resulting changes could have a material adverse effect on the Company's consolidated results of operations, and in certain situations, could have a material adverse effect on its financial condition.

Management has discussed the development and selection of these critical accounting estimates with the Audit Committee of its Board of Directors and the Audit Committee has reviewed the disclosure presented below relating to the selection of these estimates.

The following is a summary of the Company's most critical estimates.

Valuation of Inventory

Most of the Company's inventory is valued at the lower of cost or market determined primarily using the retail inventory method ("RIM"). RIM is an averaging method that is widely used in the retail industry. To determine inventory cost under RIM, inventory at its retail selling value is segregated into groupings of merchandise having similar characteristics, which are then converted to a cost basis by applying specific average cost factors for each grouping of merchandise. Cost factors represent the average cost-to-retail ratio for each merchandise group based upon the fiscal year purchasing activity for each store location. Accordingly, a significant assumption under the retail method is that inventory in each group is similar in terms of its cost-to-retail relationship and has similar turnover rates. Management monitors the content of merchandise in these groupings to prevent distortions that would have a material effect on inventory valuation.

RIM inherently requires management judgment and certain estimates that may significantly affect the ending inventory valuation as well as gross margin. Among others, two significant estimates used in inventory valuation are the level and timing of permanent markdowns (clearance markdowns used to clear unproductive or slow-moving inventory) and shrinkage. Amounts are charged to cost of sales, buying and occupancy at the time the retail value of inventory is reduced through the use of permanent markdowns.

Factors considered in the determination of permanent markdowns include current and anticipated demand, customer preferences, age of the merchandise, fashion trends and weather conditions. In addition, inventory is also evaluated against corporate pre-determined historical markdown cadences. When a decision is made to permanently markdown merchandise, the resulting gross margin reduction is recognized in the period the markdown is recorded. The timing of the decision, particularly surrounding the balance sheet date, can have a significant effect on the results of operations.

Shrinkage is estimated as a percentage of sales for the period from the date of the last physical inventory to the end of the fiscal year. Physical inventories are taken at least annually for all stores on a staggered basis throughout the year and inventory records are adjusted accordingly. The shrinkage rate from the most recent physical inventory, in combination with historical experience, is used as the standard for the shrinkage accrual following the physical inventory.

Self Insurance Reserves

The Company uses a combination of third-party insurance and/or self-insurance for a number of risks including workers' compensation, asbestos and environmental, automobile, product and general liability claims. General liability costs relate primarily to litigation that arises from store operations. Self insurance reserves include actuarial estimates of both claims filed carried at their expected ultimate settlement value and claims incurred but not yet reported. The Company's estimated claim amounts are discounted using a rate with a duration that approximates the duration of the Company's self insurance reserve portfolio. The Company's liability reflected on the consolidated balance sheets represents an estimate of the ultimate cost of claims incurred as of the balance sheet date. In estimating this liability, the Company utilizes loss development factors prepared by independent third-party actuaries. These development factors utilize historical data to project the future development of incurred losses. Loss estimates are adjusted based upon actual claims settlements and reported claims. These projections are subject to a high degree of variability based upon future inflation rates, litigation trends, legal interpretations, benefit level changes and claim settlement patterns. Although the Company does not expect the amounts ultimately paid to differ significantly from its estimates, self-insurance reserves could be affected if future claim experience differs significantly from the historical trends and the actuarial assumptions.

Defined Benefit Retirement Plans

The fundamental components of accounting for defined benefit retirement plans consist of the compensation cost of the benefits earned, the interest cost from deferring payment of those benefits into the future and the results of investing any assets set aside to fund the obligation. Such retirement benefits were earned by associates ratably over their service careers. Therefore, the amounts reported in the income statement for these retirement plans have historically followed the same pattern. Accordingly, changes in the obligations or the value of assets to fund them have been recognized systematically and gradually over the associate's estimated period of service. The largest drivers of experience losses in recent years have been the discount rate used to determine the present value of the obligation and the actual return on pension assets. The Company recognizes the changes by amortizing experience gains/losses in excess of the 10% corridor into expense over the associate service period and by recognizing the difference between actual and expected asset returns over a five-year period. While the accounting policy for the Sears domestic pension plans was to immediately recognize any experience gains or loss in excess of the 10% corridor, the Company has conformed the accounting for the Sears domestic plans to that of Kmart. The Sears domestic pension plans had no unrecognized experience gain or loss as of the date of the Merger.

Effective January 31, 1996, Kmart's pension plans were frozen, and associates no longer earn additional benefits under the plans. Therefore, there are no assumptions related to future compensation costs relating to the Kmart pension plans. During the first quarter of 2005, Holdings announced that the Sears domestic pension plan would be frozen effective January 1, 2006. Domestic associates will earn no additional benefits after December 31, 2005. Benefits earned through December 31, 2005 will be paid out to eligible participants following retirement.

Holdings' actuarial valuations utilize key assumptions including discount rates and expected returns on plan assets. The Company is required to consider current market conditions, including changes in interest rates and plan asset investment returns, in determining these assumptions. Actuarial assumptions may differ materially from actual results due to changing market and economic conditions, changes in investment strategies and higher or lower withdrawal rates or longer or shorter life spans of participants. The Company annually reviews its long-term return rate assumption, which is currently 8%.

Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "*Accounting for Income Taxes*" which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the financial reporting and tax bases of recorded assets and liabilities. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion of or all of the deferred tax asset will not be realized.

During the first quarter of fiscal 2005, the Company recognized a reversal of approximately $1.1 billion of its pre-Merger deferred income tax valuation allowance as a result of the Merger and the combined tax attributes resulting from it. SFAS No. 109 requires that this reversal be included in the Company's purchase accounting adjustments as a reduction to goodwill attributable to the Merger. Given the Company's current and forecasted levels of profitability, as well as its ability to realize the deferred tax assets through tax strategies if necessary, management believes that a significant portion of the deferred tax assets will more likely than not be realized.

The remaining consolidated valuation allowance as of January 28, 2006 is $330 million and relates to the uncertainty around the realization of certain state deferred tax assets all of which are contributable to Sears. The Company will continue to assess the likelihood of realization of these state deferred tax assets and will reduce the valuation allowance on such assets in the future if it becomes more likely than not that the net deferred tax assets will be utilized.

The tax balances and income tax expense recognized by the Company are based on management's interpretation of the tax laws of multiple jurisdictions. Income tax expense also reflects the Company's best estimates and assumptions regarding, among other things, the level of future taxable income, interpretation of the tax laws, and tax planning. Future changes in tax laws, changes in projected levels of taxable income, and tax planning could affect the effective tax rate and tax balances recorded by the Company.

Domestic and foreign tax authorities periodically audit the Company's income tax returns. These audits include questions regarding its tax filing positions, including the timing and amount of deductions and the allocation of income among various tax jurisdictions. In evaluating the exposures associated with its various tax filing positions, the Company records reserves for probable losses. A number of years may elapse before a particular matter, for which the Company has established a reserve, is audited and fully resolved. Management's estimates as of the date of the financial statements reflect its best judgment giving consideration to all currently available facts and circumstances. As such, these estimates may require adjustment in the future, as additional facts become known or as circumstances change.

New Accounting Pronouncements

There were no accounting standards issued during the year ended January 28, 2006 that are reasonably likely to affect the Company's consolidated financial statements.

Cautionary Statement Regarding Forward-Looking Information

Certain statements made in this Annual Report on Form 10-K and in other public announcements by the Company contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks and uncertainties that may cause the Company's actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by these forward-looking statements. Forward-looking statements include information concerning the Company's future financial performance, business strategy, plans, goals and objectives. Statements preceded or followed by, or that otherwise include, the words "believes", "expects", "anticipates", "intends", "estimates", "plans", "forecasts", "is likely to", "projected" and similar expressions or future or conditional verbs such as "will", "should", "would", "may" and "could" are generally forward-looking in nature and not historical facts. Such statements include, but are not limited to, statements about the expected benefits of the business combination of Sears and Kmart and future financial and operating results. Such statements are based upon the current beliefs and expectations of Holdings' management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements.

The following factors, among others, could cause actual results to differ from those set forth in the forward-looking statements:

- the risk that the businesses of Sears and Kmart will not be integrated successfully;
- failure to realize synergies and cost-savings from the Merger;
- the effects of substantial headquarters workforce reductions;
- the ability to attract, motivate and retain key executives and other associates;
- disruption from the Merger making it more difficult to maintain relationships with customers, employees and suppliers;
- competitive conditions in the retail and related services industries;
- changes in consumer confidence, tastes, preferences and spending, including the impact of fuel costs on spending patterns;
- marketplace demand for the products of the Company's key brand partners as well as the engagement of appropriate new brand partners;
- operational or financial difficulties at any of the Company's business partners;

the availability and level of consumer debt;

the successful execution of, and customer response to, strategic initiatives, including the full-line store strategy, the conversion of Kmart stores to a Sears nameplate and the integration of other new store locations;

the pace of growth in store locations, which may be higher or lower than anticipated;

the possibility that new business and strategic options for one or more business segments will be identified, potentially including selective acquisitions, dispositions, restructurings, joint ventures and partnerships;

trade restrictions, tariffs, and other factors potentially affecting the ability to do business with qualified vendors and access products in an efficient manner;

the ability to successfully implement initiatives to improve inventory management capabilities;

unanticipated increases in paper, postage or printing costs;

anticipated cash flow and the ability of the Company to maintain sufficient operating cash flow and liquidity;

changes in interest rates;

the outcome of pending and/or future legal proceedings and bankruptcy claims;

social and political conditions such as war, political unrest and terrorism or natural disasters;

the possibility of negative investment returns in pension plans;

volatility in financial markets;

the terms and availability of debt financing;

changes in debt ratings, credit spreads and cost of funds;

unexpected difficulties accessing the public debt markets;

the impact of seasonal buying patterns, which are difficult to forecast with certainty; and

general economic conditions and normal business uncertainty.

While the Company believes that its forecasts and assumptions are reasonable, it cautions that actual results may differ materially. The Company intends the forward-looking statements to speak only as of the time made and does not undertake to update or revise them as more information becomes available.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The primary market risk exposure faced by the Company is interest rate risk, which arises from the Company's debt obligations and derivative financial instruments. The Company's policy is to manage interest rate risk through the use of fixed and variable-rate funding and interest rate derivatives. As of January 28, 2006, the Company had interest rate derivatives with a notional amount of $240 million, nominal fair value and a weighted average remaining life of 1.3 years. All debt securities and derivative instruments are considered non-trading.

As of January 28, 2006, 12% of the Company's debt portfolio was variable rate (including fixed rate debt synthetically converted to variable rate through the use of derivative financial instruments). Based on the size of this variable rate debt portfolio at January 28, 2006, which totaled approximately $474 million, an immediate 100 basis point change in interest rates would have affected annual pretax funding costs by approximately $5 million. These estimates do not take into account the effect on income resulting from invested cash or the returns on assets being funded. These estimates also assume that the variable rate debt portfolio remains constant for an annual period and that the interest rate change occurs at the beginning of the period.

As of January 28, 2006, the Company had a series of foreign currency forward contracts outstanding, totaling $800 million Canadian notional value and with a weighted average remaining life of 0.1 years, designed to hedge the Company's net investment in Sears Canada against adverse changes in exchange rates. The aggregate fair value of the forward contracts as of January 28, 2006 was negative $45 million. A hypothetical 10% adverse movement in the level of the Canadian exchange rate relative to the U.S. dollar as of January 28, 2006, with all other variables held constant, would have resulted in a loss in the fair value of the Company's foreign currency forward contracts of $77 million as of January 28, 2006.

The Company actively manages the risk of nonpayment by its derivative counterparties by limiting its exposure to individual counterparties based on credit ratings, value at risk and maturities. The counterparties to these instruments are major financial institutions with credit ratings of single-A or better. In certain cases, counterparty risk is also managed through the use of collateral in the form of cash or U.S. government securities.

Item 8. Financial Statements and Supplementary Data

SEARS HOLDINGS CORPORATION

Consolidated Statements of Operations

millions, except per share data	2005	2004	39 Weeks Ended January 28, 2004	Predecessor Company 13 Weeks Ended April 30, 2003
REVENUES				
Merchandise sales and services	$ 48,911	$ 19,843	$ 17,190	$ 6,181
Credit and financial products revenues	213			
Total revenues	49,124	19,843	17,190	6,181
COSTS AND EXPENSES				
Cost of sales, buying and occupancy	35,505	14,942	13,313	4,762
Selling and administrative	10,759	3,999	3,464	1,421
Depreciation and amortization	932	27	6	
Provision for uncollectible credit card accounts	49			
Gain on sales of assets	(39)	(946)	(89)	
Gain on sale of business	(317)			
Restructuring charges	111			37
Total costs and expenses	47,000	18,022	16,694	6,220
Operating income (loss)	2,124	1,821	496	(39)
Interest expense, net	237	108	127	57
Bankruptcy-related recoveries	(40)	(59)	(4)	
Other income	(38)	(3)	(5)	(7)
Reorganization items, net				769
Income (loss) from continuing operations before income taxes, minority interest and cumulative effect of change in accounting principle	1,965	1,775	378	(858)

				Predecessor Company
Income taxes	716	669	144	(6)
Minority interest	301			
Income (loss) from continuing operations before cumulative effect of change in accounting principle	948	1,106	234	(852)
Discontinued operations (net of income taxes of $0)				(10)
Cumulative effect of change in accounting principle (net of income tax benefit of $58)	(90)			
NET INCOME (LOSS)	$ 858	$ 1,106	$ 234	$ (862)
EARNINGS (LOSS) PER COMMON SHARE				
BASIC				