**RITE AID: IS MANAGEMENT SELLING DRUGS OR USING THEM?**

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***Grumpy Old Accountants, August 2011***

The answer appears to be BOTH! It has been just over a decade since this drug store chain achieved notoriety for the financial reporting shenanigans perpetrated by its senior management. As you may recall, the Company’s Vice Chairman, CEO, and CFO conducted an [accounting fraud scheme](http://www.sec.gov/news/press/2002-92.htm) which, among other things, significantly overstated the Company’s income in every quarter from May 1997 to May 1999. This fraud resulted in the largest restatement (at that time) of pre-tax income and net income, $2.3 billion and $1.6 billion, respectively. We are sorry to report that the “accounting games” continue, presumably with the blessing of their ten-yeared (pun intended) auditor, Deloitte.

On December 5, 1999, Rite Aid [installed a new management team](http://www.riteaid.com/company/about/history.jsf) presumably to turn the company around by improving the Company’s balance sheet, operations, and financial performance. Evidently, growth played a role in this “turn around,” especially significantly increasing intangibles which consistently rose from 13.5 percent of assets in 2000 to almost 26 percent in 2007, when management was forced to end its goodwill and intangible asset charades. (See our May 16, 2011 post on [“Goodwill Games.”](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/89))

A simple [Altman Z-score](http://www.investopedia.com/terms/a/altman.asp#axzz1UiyQQ9wK) analysis confirms the Company’s historically weak financial condition and incentive for financial gamesmanship. For the past decade, Rite Aid’s Z-score averaged 2.19, however the Company earned scores of less than two, in three of the past 11 years, and the remaining eight years showed scores no higher than 2.7 in any one year. And the Z-score picture is even bleaker if one capitalizes all of the Company’s operating lease commitments and ends the “off-balance sheet financing” scam. This adds almost another $7 billion of assets and debt to the balance sheet, and drives Rite Aid’s Z-score down to 1.21 for a bankruptcy probability of 11 percent. It’s no wonder that the Company, has made Jason Notte’s list of [10 companies that could go bankrupt](http://www.minyanville.com/businessmarkets/articles/thestreet-bankruptcy-mismanagement-bad-debts-internet/12/17/2010/id/31758).

So what kinds of games are being played? Well, do you wonder why Rite Aid adopts a non-standard income statement format that omits gross profit? Yes, you guessed it…the gross margin numbers are not pretty. Gross margin is 29.23% and has been slowly declining to 28.55% in 2010.

And the margins are declining even with pseudo gross profit contributions from LIFO layer liquidations during the last three years. Surely management didn’t trigger these intentionally? What if we told you that the [Beneish Earnings Manipulation](http://www.investopedia.com/terms/b/beneishmodel.asp#axzz1UiyQQ9wK) model shows signs of earnings manipulation in every year since 2000, with the highest manipulation probability for FYE 28 February 2010.

Or maybe the uncoupling of operating cash flows and operating earnings between 2001 and 2008 gets your attention. Between 2001 and 2005, the Company’s Excess Cash Margin metric reveals a significant growth in earnings that outpaces increases in operating cash flow (OCF). Then, in 2006 the trend dramatically reverses with OCF growth outpacing operating earnings primarily on the strength of receivable securitization, as well as receivable and inventory liquidations in 2008. Why did this occur? Only one explanation makes sense to us: *overly aggressive revenue recognition after the management change followed by forced asset liquidations as the Company’s true prospects showed themselves.*

Still not convinced there is an “earnings quality” problem? Check out what drives net income between 2003 and 2006. Apparently, the Company’s growth strategy failed, so it had to turn to “creative tax accounting” to meet promised expectations. During this time period, Rite Aid’s bottom line was driven by income tax benefits related to the reversal of its deferred tax asset valuation allowance. Interestingly enough, management did this immediately after the Enron and WorldCom debacles, and right after Sarbanes Oxley was enacted. The pressure for a bottom line must really have been intense.

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| Year ended (dollars in millions) | **3-4-2004** | **2-26-2005** | **3-4-2006** | **3-3-2007** |
| Income tax benefit |  48.795 |  168.471 | 1,229.752 |  13.244 |
| Net income before tax |  34.584 |  134.007 |  43.254 |  13.582 |
|  |  |  |  |  |
| Net income |  83.379 |  302.478 | 1,273.006 |  26.826 |
| Tax benefit to net income |  58.52% |  55.70% |  96.6% |  49.37% |
|  |  |  |  |  |
| Valuation allowance | 1,650.967 | 1,436.570 |  259.602 |  239.836 |

This accrual reversal is absolutely incredible given that the Company reported losses from continuing operations in all three of the preceding three years! This three-year look-back is a common “rule of thumb” to justify the reversal of tax valuation allowances, and it clearly was breached. Exactly where is the proof that taxable income will be generated in the future against which deferred tax assets will be applied? Equally troubling is complete lack of disclosure detail on why the reversal was justified. When over half of the bottom line is due to a questionable accrual reversal, one would think some specifics are warranted. And of course, where was Deloitte? Apparently, the Deloitte auditors picked right up where KPMG left off in 1999, and chose to look the other way on the accrual reversal (or are they on some of the meds their client sells). To their credit, however, apparently Deloitte recognized the error of their ways and required the Company to reinstate the tax asset valuation allowance in increments during the past three years. What changed? Probably the realization that their client was not going to make it, and that their work would likely be scrutinized more closely once Rite Aid ultimately collapses under its debt burden.

And let’s not forget that for this same period of time, the Company was required by the SEC to restate its financial statements for [errors](http://www.riteaid.com/company/news/news_details.jsf?itemNumber=687) in accounting for rent during construction periods and leasehold improvement amortization. More carelessness when it comes to financial reporting.

Still want more proof? Then just check out the Company’s most recent 10K disclosure of non-GAAP measures. Why does management even bother? Do they really think investors will believe that the adjusted EBITDA numbers are better? Or is management really this deluded? Whatever the case, this disclosure simply confirms that management cares little about financial statement transparency, and puts a premium on reporting fiction.

|  |  |  |  |
| --- | --- | --- | --- |
| Year ended | 2-28-2009 | 2-28-2010 | 2-28-2011 |
| (in millions) |  |  |  |
| GAAP net loss |  (2,915.420) |  (506.676) |  (555.424) |
| Adjusted EBITDA |  991.147 |  924.974 |  858.962 |
|  |  |  |  |

What’s the real bottom line? This is just another great example of how a firm’s compliance with GAAP, and an auditor’s following of GAAS do little to insure financial reporting transparency. Before you look at Rite Aid’s financial statements, take a heavy dose of their pain meds…you’ll need them.

*Additional insights regarding Rite Aid’s reporting can be found at:*

8 Companies Facing Bankruptcy in 2011 - <http://smarterspend.com/2011/02/8-companies-facing-bankruptcy-in-2011/>

Businesses on the Brink: Change or Fail? - <http://finance.yahoo.com/career-work/article/109251/businesses-on-the-brink-change-or-fail??mod=career-leadership>

The Right Price for Rite Aid - <http://seekingalpha.com/article/59535-the-right-price-for-rite-aid>

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*