**STILL SEARCHING FOR “THE ‘RITE’ STUFF”**

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There are no academy awards in the offing for Rite Aid’s version of the 1983 test pilot film classic. Recently, [the Company released its 10-K](http://www.sec.gov/Archives/edgar/data/84129/000104746912004644/a2208945z10-k.htm), and things are still a mess. No rocket science here. Rite Aid cannot earn a profit and cash flows are dwindling even with an extra week of operations included (2011 was a 53 week fiscal year). And the balance sheet is disgraceful. The Company just cannot seem to do anything “rite!” Maybe management would have done better with a comedy like “Failure to Launch.”

Things have only worsened since we initially visited the Company in [Rite Aid: Is Management Selling Drugs or Using Them?](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/265) It has not posted a positive earnings number since 2007. Sure, the net loss is less than it was for the past few years, but a loss is still a loss, and remember, it had an extra week for this year’s performance reports. It continues to bleed lease termination and impairment charges, as well as losses on debt modifications and retirements. Yet, managers continue to perpetuate a turnaround façade via “improving” adjusted EBITDA numbers which suggest almost a $1 billion in “real” earnings. Instead, the Company needs a dramatically new business model that emphasizes operating effectiveness and efficiency. Only then will revenues rise, and cost of sales and other operating costs decline, both requirements for the Company’s delivering a profit. We understand that the Company has implemented cost cutting initiatives, but when will see some believable and meaningful results?

The balance sheet remains in shambles. Okay, there are enough current assets to cover current liabilities, but that’s the end of any good news in the balance sheet. Total assets are $7,364 (all accounts are in millions of dollars), while total liabilities are $9,951, thereby yielding a shareholders’ deficit of $(2,587). How this firm avoids corporate bankruptcy we just don’t know!

Actually, the balance sheet condition is much worse because the Company has humongous lease obligations that are carried “off-balance sheet.” Using the data in financial statement note 10, we estimate the present value of the Company’s lease liabilities to be $5,939. This adjustment increases total liabilities to $15,890, causing the stockholders’ deficit to worsen to $(8,526).

At least Rite Aid does not carry goodwill on its books any more, having written off the last vestiges of this intangible “asset” in 2009. The only remaining reported intangibles are for favorable leases and for prescription files. Oh please…favorable leases for a Company in this financial condition…we would be inclined to reduce the favorable lease asset, but the amounts are just not big enough to fret over given the “death watch” status of the Company.

However, to its credit, Rite Aid has not followed the example of Citicorp and some other banks that pumped earnings up by recognizing gains due to market value declines of debt due to problems in its own creditworthiness. This practice is a sham even if condorsed (condoned and endorsed) by the FASB.

Even though the cash flow statement does provide some positive news, reported cash flows are a bit down (and again there was that extra week in the fiscal period). Cash flows from operating activities were $(325), $395, and $266 for 2009-2011, while free cash flows were $(519), $209, and $16, respectively. So, Rite Aid is reporting a positive free cash flow, albeit smaller than last year’s.

Ironically, if the Company would capitalize all of its operating leases, the cash flow picture improves considerably! That’s because rental expenditures under operating lease accounting are displayed as operating activities; however, when leases are capitalized, the cash flows are divided between interest payments and payments against the lease obligation, the latter payments being properly categorized as financing cash flows. Interest payments are still considered part of operating activities. Thus, adjusted free cash flows paint a rosier picture for Rite Aid: they are $(45), $691, and $545 for 2009-2011.

Given the Company’s precarious state, why doesn’t the auditor, Deloitte & Touche, issue a going concern report? After all, [Rite Aid’s troubles make it a bankruptcy candidate](http://seekingalpha.com/article/318277-rite-aid-s-troubles-make-it-a-bankruptcy-candidate). Clearly, profits are negative for five years, and there are significantly more liabilities than assets. Perhaps the auditor also adjusts operating leases to obtain the healthier free cash flow numbers that we have estimated, and deduces that the firm can survive. If so, then the auditor should persuade, if not require, Rite Aid to capitalize all of its leases.

Taking a long term perspective, most of the troubles endured by Rite Aid over the last several years seem a result of the failed Eckerd and Brooks business combination, which it bought from the Jean Coutu Group. In short, Rite Aid paid too much for the business. When the subsidiary did not generate enough cash flows, Rite Aid borrowed to the hilt, and has been operating under a heavy debt burden ever since. (As a side note the Jean Coutu Group recently sold a substantial number of its Rite Aid shares, reducing its ownership to about 20 percent.)

Finally, we observe that Rite Aid has net operating loss carryforwards of $9,394. One might suspect that these carryforwards would make the company a takeover target. Unfortunately, there are significant restrictions (and uncertainties) on how an acquirer might extract value from these tax attributes (e.g., Section 382 Change of Control Limitations and SRLY Restrictions). Further, the fact that Jean Coutu Group disposed of shares suggests there are few, if any, suitors in the wings. This is not surprising at all, given that the Company has no apparent competitive advantage.

We cannot predict Rite Aid’s future, but to continue, it needs a viable business strategy, supported by a realistic business model, that controls cost and reduces liabilities. We wish the firm luck.

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