**A NOTE ON THE RITE AID ANALYSIS; AND A POX ON THE FASB**

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Last time we discussed [Rite Aid and claimed the balance sheet was in shambles](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/643). Some fellow accounting professors objected to the analysis, so we need to respond to them. We’ll answer the criticism and point out the big point that they all missed.

You will recall that Rite Aid’s most recent balance sheets has total assets of $7,364, total liabilities of $9,951, and shareholders’ equity of $(2,587). As before, all amounts are in millions of U.S. dollars. We then said our estimate of the present value of the operating leases was $5,939, thereby increasing total debts to $15,890 and causing shareholders’ equity to dip to $(8,526).

The criticism we received concerns the hit to equity. They state that the entire amount should not go against equity but that a sizeable amount should be in assets.

The criticism is well taken—up to a point. Our analysis indicated that the assets were over half depreciated, so only a relatively small portion would be added to the left-hand side of the balance sheet. Besides, as Rite Aid is a Pennsylvania corporation, we have been in several of the stores, and we think that the fair value of the leases needs to be written down. At that point we took a short cut and assumed none of it would be there. It made the work a lot shorter and helped us to make our point succinctly.

But, since our friends and associates want a full-blown adjustment instead of this raw short cut, here goes. We adjust the income statement by taking out rental expense and by adding in depreciation, interest, and the differential income tax. We adjust the assets in the balance sheet for the leased resources minus their accumulated depreciation. We adjust the current debts for the present value of next year’s lease payment. We adjust noncurrent debts for the present value of the remaining lease payments and for deferred income taxes. Finally, we adjust the stockholders’ equity for the cumulative effect of past year differences in the firm’s net income.

What we find is the following:

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | Reported | Adjusted |
| Revenues | 26,121  | 26,121  |
| Expense | 26,490  | 26,472  |
| Net income | (368) | (351) |
|  |  |  |  |
|  |  |  |  |
|  |  |  |  |
| Current assets | 4,504  | 4,504  |
| Plant |  | 2,860  | 5,177  |
| Total assets | 7,364  | 9,681  |
|  |  |  |  |
| Current debts | 2,570  | 3,547  |
| Long-term debts |  | 7,381  | 12,438  |
| Total debts |  | 9,951  | 15,985  |
| Equity |  | (2,586) | (6,304) |
| Total |  | 7,364  | 9,681  |

Yes, the total assets are larger by $2.3 billion, but notice that the total debts are larger by $6 billion and the shareholders’ equity is lower by $3.7 billion. (The liabilities are higher than the $5.9 we previously mentioned because now we are including the deferred income tax effect.)

So the criticism is correct inasmuch as the full $5.9 billion does not decrease equity, only $3.7 billion. But given that we originally just wanted a rough approximation, we still don’t think it was off as badly as our colleagues thought. As they are obviously are watching carefully, we promise not to take this short cut again.

Having said that mea culpa, let’s observe that the thrust of our previous work is correct. The balance sheet of Rite Aid *is* in shambles and the losses *are* habitual. Operating cash flows are higher than reported, as we explained in the previous column, but that implies that financing cash outflows are correspondingly worse. Rite Aid *is* in trouble.

Before leaving this topic, let’s take a step back and reflect upon the exercise. As financial analysts, we make these estimates because we prefer to be approximately accurate in the corporate accounts rather than using the precisely wrong accounts in the reported financial statements. These estimates involve assumptions and so will always contain error, and pundits will always be in a position to question the estimation process. If we could only eliminate this estimating process!

Ah, but we can—by requiring business enterprises to capitalize all lease obligations instead of inventing fictions like capital and operating leases. What our colleagues should have done after criticizing our crude first estimates is to have lambasted the FASB for its carelessness, its cowardice, its fearfulness, and its inability to get much done any more. We need better lessee accounting. If lessees capitalized all leases, as they should, there would be no need for people like us to estimate these things.

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