**Rite Aid Sees Loss for Year Widening on Charge**

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Drugstore operator Rite Aid Corp. is expecting a bigger loss as it is reducing its deferred tax assets, or tax credit with the Internal Revenue Service. The Camp Hill, Pa., company expects to record a charge tied to its valuation allowance that will widen its net loss by as much as $1 billion, or $1.38 a share. Rite Aid said it can't forecast its exact loss for its fiscal year ended March 1, as it is still finalizing the extent of the noncash tax charge, but it will be greater than the loss of 27 cents to 31 cents a share it had anticipated. It reports earnings April 10. Rite Aid said the accounting change will have no impact on its forecast for sales of $24.3 billion, its liquidity, or adjusted profit, which excludes expenses and other charges tied to its acquisition of Brooks Eckerd last summer. Rite Aid fell 10 cents, or 4%, to $2.36 in 4 p.m. New York Stock Exchange composite trading.

[**[cfo.com](http://www.cfo.com/)**](http://www.cfo.com/)**Rite Aid Struggles with Tax Break Prescription**

The pharmacy chain grapples with FAS 109 as it looks predict future income so it can claim a tax break on net operating losses � before time runs out. Robert Willens, CFO.com | US April 7, 2008

**Recently, Rite Aid Corporation made a stunning announcement. The company stated that in compliance with the accounting rule known as FAS 109, Accounting for Income Taxes, "...it expects to record a non-cash income tax expense in its fourth quarter ended March 1, 2008, related to a valuation allowance on the company's deferred tax assets..."**

The amount of the charge is substantial. Rite Aid has guided investors to expect a charge in the range of $800 million to $1 billion. Although the company states, correctly, that this charge will have no impact on its revenues, adjusted EBITDA (earnings before interest, taxes, depreciation, and amoritzation), or liquidity, Rite Aid goes on to acknowledge � with equal accuracy � that the charge will "negatively impact" the company's net loss and loss per diluted share for fiscal 2008. It will also negatively impact the company's "net worth" and its book value per share.

To get a more complete picture, consider the company's deferred tax assets. Indeed, as of the close of its most recent fiscal year, Rite Aid reported "net deferred tax assets" of $1.412 billion, after taking into account a valuation allowance of "only" $239 million. A large portion of the deferred tax assets is attributable to Rite Aid's impressive array of "carryforwards."

Thus, as of the end of its most recent fiscal year, Rite Aid was reporting:

federal net operating loss (NOL) carryforwards of $2.239 billion, which do not begin to expire until 2019\*;

state net operating loss carryforwards amounting to $3.093 billion;

**and federal capital loss carryforwards of some $238 million. This last carryforward will expire in 2008.**

Since corporate capital losses can be only be used to offset corporate capital gains, it is incumbent on Rite Aid to generate a capital gain sufficient to use its capital loss carryforward. **Without that capital gain, the carryforward will expire unused**. Also consider that the **carryforwards give rise to deferred tax assets. The deferred tax asset, in each case, represents the (undiscounted) tax savings Rite Aid can expect from the use of these items to offset income otherwise subject to taxation.**

**Valuation Allowance**

In the case of deferred tax assets, FAS 109 is clear that a valuation allowance is required if, "based on the weight of available evidence," it is more likely than not that some, or all, of the deferred tax asset will not be realized. Realizing the future tax break of an existing "deductible temporary difference" or carryforward (each of which produces deferred tax assets), depends exclusively upon the existence of sufficient taxable income of the appropriate character within the carryforward period. Appropriate character refers to the capital losses discussed above.

**If the company is uncertain about the amount of taxable income it will generate in the future, it will have to establish a valuation allowance.** The allowance should be sufficient to reduce the deferred tax asset to an amount that the company thinks it will more likely than not realize. Further, note that the effect of a change in the beginning-of-the-year balance of a valuation allowance that results from a "change in circumstances" should be included in income from continuing operations. That's, of course, if the change in circumstance causes a change in judgment about realizing the deferred tax asset.

Forming the conclusion that a valuation allowance is not needed is difficult, especially when there is "negative evidence," such as cumulative losses in recent years. Yet, the item of negative evidence is responsible for Rite Aid's decision to increase its valuation allowance. The company states that, "...The valuation allowance will be reflected as a reduction of Rite Aid's deferred tax assets and relates to the U.S. GAAP requirements for companies that have a cumulative pre-tax loss in recent years..."

Apparently, in the case of Rite Aid, there was insufficient "positive evidence" to overcome the impact of the item of negative evidence. Examples of positive evidence � which apparently Rite Aid did not possess � include, (1) existing contracts or firm sales backlogs, (2) an excess of appreciated asset value over the tax basis of the net assets, and (3) persuasive evidence that the losses (which created the carryforwards) were an aberration rather than a "continuing condition."

Nevertheless, Rite Aid goes on to say that "...it expects to be able to use its deferred tax assets when the company generates pre-tax profits in the future..." What may concern investors, however, is the violent swings that have occurred in the recent past regarding Rite Aid's net deferred tax asset balances. For example, in fiscal 2006, Rite Aid had sufficient confidence in its ability to generate taxable income of the appropriate character within the carryforward period to "release" most of its remaining valuation allowance. In turn, this resulted in an increase in "non-cash net income" of some $1.23 billion.

Now, just two years later, the company is reinstating most of the amount it had previously released. While we recognize that the need for a valuation allowance is dependent upon the presence of negative evidence, it seems unusual for the "tide of evidence" to turn so quickly from positive (in fiscal 2006) to overwhelmingly negative (in fiscal 2008). These violent swings in the net deferred asset figure � due to increases and decreases in the valuation allowance � imply, perhaps unfairly, that the company does not have the ability to predict, with even a fair degree of accuracy, its future results of operations. That lack of ability, in and of itself, might be troubling to investors.

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\*During fiscal 2002, Rite Aid experienced an ownership change within the meaning of Section 382(g) of the Internal Revenue Code. Accordingly, the amount of taxable income, for any taxable year ending after the date of the ownership change � which can be offset by pre-ownership change NOLs � is limited. NOLs incurred after such an ownership change can, for years ending after the date of the ownership change, offset an unlimited amount of taxable income. Rite Aid states that it took this limitation "into account" in establishing its valuation allowance.

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