

GAP INC
Form 10-Q
August 31, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934
For the quarterly period ended August 4, 2018

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934

For the transition period from _____ to _____

Commission File Number 1-7562

THE GAP, INC.

(Exact name of registrant as specified in its charter)

Delaware 94-1697231
(State or other jurisdiction (I.R.S. Employer
of incorporation or organization) Identification No.)

Two Folsom Street, San Francisco, California 94105
(Address of principal executive offices) (Zip code)

Registrant's telephone number, including area code: (415) 427-0100

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 (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files) Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The number of shares of the registrant's common stock outstanding as of August 27, 2018 was 384,708,284.

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. All statements other than those that are purely historical are forward-looking statements. Words such as “expect,” “anticipate,” “believe,” “estimate,” “intend,” “plan,” “project,” and similar expressions also identify forward-looking statements. Forward-looking statements include, but are not limited to, statements regarding the following:

- the impact of the adoption of new accounting standards;
- recognition of unrealized gains and losses from designated cash flow hedges into income;
- the impact of the Tax Cuts and Jobs Act of 2017, including adjustments to our provisional estimates of the tax effects;
- the impact of the potential settlement of outstanding tax matters;
- the impact of losses due to indemnification obligations;
- the outcome of proceedings, lawsuits, disputes, and claims;
- investing in digital and customer capabilities to support growth;
- increasing productivity by leveraging our scale and streamlining operations and processes throughout the organization;
- continuing to integrate social and environmental sustainability into business practices;
- attracting and retaining strong talent in our business and functions;
- investing strategically while maintaining operating expense discipline and driving efficiency through productivity initiative;
- continuing to transform our product to market process with development of a more efficient operating model;
- continuing our investment in customer experience to drive higher customer engagement and loyalty;
- continuing to invest in strengthening brand awareness, customer acquisition, and digital capabilities;
- current cash balances and cash flows being sufficient to support our business operations, including growth initiatives and planned capital expenditures;
- ability to supplement near-term liquidity, if necessary, with our \$500 million revolving credit facility or other available market instruments;
- the impact of the seasonality of our operations;
- dividend payments in fiscal 2018; and
- the impact of changes in internal control over financial reporting.

Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause our actual results to differ materially from those in the forward-looking statements. These factors include, without limitation, the following:

- the risk that we or our franchisees will be unsuccessful in gauging apparel trends and changing consumer preferences;
- the highly competitive nature of our business in the United States and internationally;
- the risk that failure to maintain, enhance, and protect our brand image could have an adverse effect on our results of operations;
- the risk that the failure to attract and retain key personnel, or effectively manage succession, could have an adverse impact on our results of operations;
- the risk that our investments in customer, digital, and omni-channel shopping initiatives may not deliver the results we anticipate;
- the risk that if we are unable to manage our inventory effectively, our gross margins will be adversely affected;
- the risk that we are subject to data or other security breaches that may result in increased costs, violations of law, significant legal and financial exposure, and a loss of confidence in our security measures, which could have an adverse effect on our results of operations and our reputation;
- the risk that a failure of, or updates or changes to, our information technology (“IT”) systems may disrupt our operations;
- the risk that trade matters could increase the cost or reduce the supply of apparel available to us and adversely affect our business, financial condition, and results of operations;
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the risk that changes in the regulatory or administrative landscape could adversely affect our financial condition and results of operations;

the risks to our business, including our costs and supply chain, associated with global sourcing and manufacturing;

the risk that changes in global economic conditions or consumer spending patterns could adversely impact our results of operations;

the risks to our efforts to expand internationally, including our ability to operate in regions where we have less experience;

the risks to our reputation or operations associated with importing merchandise from foreign countries, including failure of our vendors to adhere to our Code of Vendor Conduct;

the risk that our franchisees' operation of franchise stores is not directly within our control and could impair the value of our brands;

the risk that we or our franchisees will be unsuccessful in identifying, negotiating, and securing new store locations and renewing, modifying, or terminating leases for existing store locations effectively;

- the risk that foreign currency exchange rate fluctuations could adversely impact our financial results;
- the risk that comparable sales and margins will experience fluctuations;
- the risk that changes in our credit profile or deterioration in market conditions may limit our access to the capital markets and adversely impact our financial position or our business initiatives;
- the risk that natural disasters, public health crises, political crises, negative global climate patterns, or other catastrophic events could adversely affect our operations and financial results, or those of our franchisees or vendors;
- the risk that reductions in income and cash flow from our credit card agreement related to our private label and co-branded credit cards could adversely affect our operating results and cash flows;
- the risk that adoption of new accounting pronouncements will impact future results;
- the risk that we do not repurchase some or all of the shares we anticipate purchasing pursuant to our repurchase program; and
- the risk that we will not be successful in defending various proceedings, lawsuits, disputes, and claims.

Additional information regarding factors that could cause results to differ can be found in our Annual Report on Form 10-K for the fiscal year ended February 3, 2018 and our other filings with the U.S. Securities and Exchange Commission.

Future economic and industry trends that could potentially impact net sales and profitability are difficult to predict. These forward-looking statements are based on information as of August 31, 2018, and we assume no obligation to publicly update or revise our forward-looking statements even if experience or future changes make it clear that any projected results expressed or implied therein will not be realized.

We suggest that this document be read in conjunction with Management's Discussion and Analysis included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2018.

THE GAP, INC.
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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

THE GAP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Uaudited)

| (\$ and shares in millions except par value) | August 4, 2018 | February 3, 2018 | July 29, 2017 |
|--|----------------|------------------|---------------|
| ASSETS | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ 1,322 | \$ 1,783 | \$ 1,609 |
| Short-term investments | 286 | — | — |
| Merchandise inventory | 2,202 | 1,997 | 2,051 |
| Other current assets | 780 | 788 | 598 |
| Total current assets | 4,590 | 4,568 | 4,258 |
| Property and equipment, net of accumulated depreciation of \$6,063, \$5,962, and \$6,0022,832 | 2,805 | 2,643 | — |
| Other long-term assets | 588 | 616 | 716 |
| Total assets | \$ 8,010 | \$ 7,989 | \$ 7,617 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | |
| Current liabilities: | | | |
| Accounts payable | \$ 1,297 | \$ 1,181 | \$ 1,230 |
| Accrued expenses and other current liabilities | 1,026 | 1,270 | 1,062 |
| Income taxes payable | 18 | 10 | 107 |
| Total current liabilities | 2,341 | 2,461 | 2,399 |
| Long-term liabilities: | | | |
| Long-term debt | 1,249 | 1,249 | 1,248 |
| Lease incentives and other long-term liabilities | 1,080 | 1,135 | 1,025 |
| Total long-term liabilities | 2,329 | 2,384 | 2,273 |
| Commitments and contingencies (see Note 11) | | | |
| Stockholders' equity: | | | |
| Common stock \$0.05 par value | | | |
| Authorized 2,300 shares for all periods presented; Issued and Outstanding 385, 389, and 392 shares | 19 | 19 | 20 |
| Additional paid-in capital | — | 8 | — |
| Retained earnings | 3,268 | 3,081 | 2,902 |
| Accumulated other comprehensive income | 53 | 36 | 23 |
| Total stockholders' equity | 3,340 | 3,144 | 2,945 |
| Total liabilities and stockholders' equity | \$ 8,010 | \$ 7,989 | \$ 7,617 |
| See Accompanying Notes to Condensed Consolidated Financial Statements | | | |

THE GAP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Uaudited)

| | 13 Weeks Ended August 4, July 29, 2018 | | 26 Weeks Ended August 4,July 29, 2018 2017 | |
|--|--|---------|--|---------|
| (\$ and shares in millions except per share amounts) | | | | |
| Net sales | \$4,085 | \$3,799 | \$7,868 | \$7,239 |
| Cost of goods sold and occupancy expenses | 2,458 | 2,320 | 4,814 | 4,457 |
| Gross profit | 1,627 | 1,479 | 3,054 | 2,782 |
| Operating expenses | 1,229 | 1,028 | 2,427 | 2,077 |
| Operating income | 398 | 451 | 627 | 705 |
| Interest expense | 17 | 16 | 33 | 35 |
| Interest income | (7) | (4) | (13) | (7) |
| Income before income taxes | 388 | 439 | 607 | 677 |
| Income taxes | 91 | 168 | 146 | 263 |
| Net income | \$297 | \$271 | \$461 | \$414 |
| Weighted-average number of shares - basic | 387 | 395 | 388 | 397 |
| Weighted-average number of shares - diluted | 390 | 396 | 391 | 398 |
| Earnings per share - basic | \$0.77 | \$0.69 | \$1.19 | \$1.04 |
| Earnings per share - diluted | \$0.76 | \$0.68 | \$1.18 | \$1.04 |
| Cash dividends declared and paid per share | \$0.2425 | \$0.23 | \$0.485 | \$0.46 |

See Accompanying Notes to Condensed Consolidated Financial Statements

THE GAP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

| | 13 Weeks Ended August 29, 2018 | | 26 Weeks Ended August 29, 2018 | |
|---|---|-------|---|-------|
| (\$ in millions) | | | | |
| Net income | \$297 | \$271 | \$461 | \$414 |
| Other comprehensive income (loss), net of tax | | | | |
| Foreign currency translation and other, net | (16) | 21 | (23) | 17 |
| Change in fair value of derivative financial instruments, net of tax (tax benefit) of \$3, \$(12), \$(3), and \$(8) | 18 | (43) | 46 | (43) |
| Reclassification adjustment for gains on derivative financial instruments, net of (tax) tax benefit of \$-, \$-, \$9, and \$(2) | — | (1) | (6) | (5) |
| Other comprehensive income (loss), net of tax | 2 | (23) | 17 | (31) |
| Comprehensive income | \$299 | \$248 | \$478 | \$383 |

See Accompanying Notes to Condensed Consolidated Financial Statements

THE GAP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(\$ in millions)

26 Weeks Ended
August 4July 29,
2018 2017

| | \$461 | \$414 |
|---|---------|---------|
| Cash flows from operating activities: | | |
| Net income | 280 | 279 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | (29) | (30) |
| Amortization of lease incentives | 48 | 42 |
| Share-based compensation | 12 | 13 |
| Non-cash and other items | 24 | (27) |
| Deferred income taxes | | |
| Changes in operating assets and liabilities: | | |
| Merchandise inventory | (224) | (203) |
| Other current assets and other long-term assets | (46) | (23) |
| Accounts payable | 104 | (49) |
| Accrued expenses and other current liabilities | (180) | (111) |
| Income taxes payable, net of prepaid and other tax-related items | 62 | 160 |
| Lease incentives and other long-term liabilities | 34 | 21 |
| Net cash provided by operating activities | 546 | 486 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (326) | (275) |
| Insurance proceeds related to loss on property and equipment | — | 59 |
| Purchases of short-term investments | (322) | — |
| Sales and maturities of short-term investments | 36 | — |
| Other | (6) | — |
| Net cash used for investing activities | (618) | (216) |
| Cash flows from financing activities: | | |
| Payments of current maturities of debt | — | (67) |
| Proceeds from issuances under share-based compensation plans | 33 | 14 |
| Withholding tax payments related to vesting of stock units | (20) | (14) |
| Repurchases of common stock | (200) | (200) |
| Cash dividends paid | (188) | (182) |
| Other | (1) | — |
| Net cash used for financing activities | (376) | (449) |
| Effect of foreign exchange rate fluctuations on cash, cash equivalents, and restricted cash | (11) | 8 |
| Net decrease in cash, cash equivalents, and restricted cash | (459) | (171) |
| Cash, cash equivalents, and restricted cash at beginning of period | 1,799 | 1,797 |
| Cash, cash equivalents, and restricted cash at end of period | \$1,340 | \$1,626 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest during the period | \$38 | \$38 |
| Cash paid for income taxes during the period, net of refunds | \$61 | \$130 |

See Accompanying Notes to Condensed Consolidated Financial Statements

THE GAP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. Basis of Presentation

The Condensed Consolidated Balance Sheets as of August 4, 2018 and July 29, 2017, and the Condensed Consolidated Statements of Income and the Condensed Consolidated Statements of Comprehensive Income for the thirteen and twenty-six weeks ended August 4, 2018 and July 29, 2017, and the Condensed Consolidated Statements of Cash Flows for the twenty-six weeks ended August 4, 2018 and July 29, 2017 have been prepared by The Gap, Inc. (the “Company,” “we,” and “our”). In the opinion of management, such statements include all adjustments (which include normal recurring adjustments) considered necessary to present fairly our financial position, results of operations, and cash flows as of August 4, 2018 and July 29, 2017 and for all periods presented. The Condensed Consolidated Balance Sheet as of February 3, 2018 has been derived from our audited financial statements.

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and disclosures normally included in the notes to the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) have been omitted from these interim financial statements, although the Company believes that the disclosures made are adequate to make the information not misleading. We suggest that you read these Condensed Consolidated Financial Statements in conjunction with the Consolidated Financial Statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended February 3, 2018.

The results of operations for the thirteen and twenty-six weeks ended August 4, 2018 are not necessarily indicative of the operating results that may be expected for the 52-week period ending February 2, 2019.

Note 2. Accounting Policies

Accounting Pronouncements Recently Adopted

Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board (“FASB”) issued accounting standards update (“ASU”) No. 2014-09, Revenue from Contracts with Customers, to clarify the principles of recognizing revenue and create common revenue recognition guidance between U.S. GAAP and International Financial Reporting Standards.

On February 4, 2018, we adopted ASU No. 2014-09 and related amendments (collectively “ASC 606”) using the modified retrospective transition method and recorded an increase to opening retained earnings of \$36 million, net of tax, related primarily to breakage revenue for gift cards and credit vouchers, outstanding loyalty points, and reimbursements of loyalty program discounts. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods.

The Company’s revenues include merchandise sales at stores, online, and through franchise agreements. We also receive revenue sharing from our credit card agreement for private label and co-branded credit cards, and breakage revenue related to our gift cards, credit vouchers, and outstanding loyalty points, which are realized based upon historical redemption patterns. For online sales, ship-from-stores sales, and catalog sales, the Company has elected to treat shipping and handling as fulfillment activities and not a separate performance obligation. Accordingly, we recognize revenue for our single performance obligation related to online sales, ship-from-store sales, and catalog sales at the time control of the merchandise passes to the customer, which is generally at the time of shipment. We also record an allowance for estimated returns based on our historical return patterns and various other assumptions that management believes to be reasonable, which are presented on a gross basis on our Condensed Consolidated Balance Sheet. Revenues are presented net of any taxes collected from customers and remitted to governmental authorities.

Our credit card agreement provides for certain payments to be made to us, including a share of revenue from the performance of the credit card portfolios and reimbursements of loyalty program discounts. We have identified separate performance obligations related to our credit card agreement that includes both providing a license and an obligation to redeem loyalty points issued under the loyalty rewards program. Revenue related to our obligation to

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redeem loyalty points is deferred until those loyalty points are redeemed. With the adoption of ASC 606, income related to our credit card agreement is now classified within net sales in our Condensed Consolidated Statement of Income.

We also have franchise agreements with unaffiliated franchisees to operate Gap, Banana Republic, and Old Navy stores in a number of countries throughout Asia, Europe, Latin America, the Middle East, and Africa. Under these agreements, third parties operate, or will operate, stores that sell apparel and related products under our brand names. We have identified separate performance obligations related to our franchise agreements that include both providing our franchise partners with a license and an obligation to supply franchise partners with our merchandise. Our obligation to provide a license is satisfied when subsequent sales occur and our obligation to supply franchise partners with our merchandise is satisfied when control transfers. As of the quarter ended August 4, 2018, there were no material contract liabilities related to our franchise agreements.

We defer revenue when cash payments are received in advance of performance for unsatisfied obligations related to our gift cards, credit vouchers, outstanding loyalty points, and reimbursements of loyalty program discounts associated with our credit card agreement. The opening balance of deferred revenue for these obligations was \$232 million and \$201 million for the twenty-six and thirteen weeks ended August 4, 2018, respectively. We recognized revenue of \$145 million and \$87 million related to the opening balance during the twenty-six and thirteen weeks ended August 4, 2018, respectively. The closing balance of deferred revenue related to gift cards, credit vouchers, outstanding loyalty points, and reimbursements of loyalty program discounts was \$194 million as of the quarter ended August 4, 2018. We expect that the majority of our revenue deferrals as of the quarter ended August 4, 2018 will be recognized in the next 12 months as our performance obligations are satisfied.

For the thirteen and twenty-six weeks ended August 4, 2018, the impact of applying ASC 606 primarily resulted in an increase in net sales driven by a reclassification of \$96 million and \$192 million, respectively, for revenue sharing associated with our credit card programs and breakage revenue for gift cards and credit vouchers, which were previously recorded as a reduction to operating expenses in our Condensed Consolidated Statements of Income. Net sales for the thirteen and twenty-six weeks ended August 4, 2018 also increased by \$43 million and \$87 million, respectively, due to the reclassification of reimbursements of loyalty program discounts associated with our credit card programs, which were previously recorded as a reduction to cost of goods sold and occupancy expenses in our Condensed Consolidated Statements of Income. There were no other material impacts to the Condensed Consolidated Statements of Income resulting from the application of ASC 606 during the thirteen or twenty-six weeks ended August 4, 2018.

In addition, with the adoption of ASC 606 we now recognize allowances for estimated sales returns on a gross basis rather than net basis on our Condensed Consolidated Balance Sheet. For the quarter ended August 4, 2018, we recorded a right of return asset for merchandise we expect to receive back from customers of \$38 million, which is recorded within other current assets on our Condensed Consolidated Balance Sheet, and a liability for refunds payable of \$86 million, which is recorded within accrued expenses and other current liabilities on our Condensed Consolidated Balance Sheet. For the quarter ended August 4, 2018, the net amount under the previous guidance would have been \$45 million recorded as accrued expenses and other current liabilities on our Condensed Consolidated Balance Sheet. Accordingly, the impact of the change in accounting standard is an increase of \$38 million to other current assets on our Condensed Consolidated Balance Sheet and an increase of \$41 million to accrued expenses and other current liabilities on our Condensed Consolidated Balance Sheet.

See Note 12 of Notes to Condensed Consolidated Financial Statements “Segment Information” for disaggregation of revenue by brand and by region.

Statement of Cash Flows: Restricted Cash

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows: Restricted Cash, which amended the presentation of restricted cash within the statement of cash flows. The new guidance requires that restricted cash be added to cash and cash equivalents on the statement of cash flows. On February 4, 2018, we adopted ASU 2016-18 on a retrospective basis. The retrospective adoption increased our beginning and ending cash and cash equivalent balances within our Condensed Consolidated Statements of Cash Flows to include restricted cash balances. The adoption had no other material impacts to our Condensed Consolidated Statements of Cash Flows and had no impact on our results of operations or financial position.

Amounts included in restricted cash primarily represent cash that serves as collateral for our insurance obligations. Any cash that is legally restricted from use is classified as restricted cash. If the purpose of restricted cash is related to acquiring a long-term asset, liquidating a long-term liability, or is otherwise unavailable for a period longer than one year from the balance sheet date, the restricted cash is included within other long-term assets on our Condensed Consolidated Balance Sheets. Otherwise, restricted cash is included within other current assets on our Condensed Consolidated Balance Sheets.

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within our Condensed Consolidated Balance Sheets to the total shown in our Condensed Consolidated Statements of Cash Flows:

(\$ in millions)

| | August 4, 2018 | February 3, 2018 | July 29, 2017 |
|--|----------------|------------------|---------------|
|--|----------------|------------------|---------------|

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| | | | |
|---|----------|----------|----------|
| Cash and cash equivalents | \$ 1,322 | \$ 1,783 | \$ 1,609 |
| Restricted cash included in other current assets | — | 1 | 1 |
| Restricted cash included in other long-term assets | 18 | 15 | 16 |
| Total cash, cash equivalents, and restricted cash shown in the Condensed Consolidated Statement of Cash Flows | \$ 1,340 | \$ 1,799 | \$ 1,626 |

Recognition and Measurement of Financial Assets and Financial Liabilities

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, that updates certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. We adopted this ASU on February 4, 2018 with no material impact to our Condensed Consolidated Financial Statements.

Accounting Pronouncements Not Yet Adopted

Except as noted below, the Company has considered all recent accounting pronouncements and has concluded that there are no recent accounting pronouncements that may have a material impact on its Condensed Consolidated Financial Statements, based on current information.

In February 2016, the FASB issued ASU No. 2016-02, Leases. Under the new guidance, lessees will be required to recognize a lease liability and a right-of-use asset for all leases (with the exception of short-term leases) at the commencement date. ASU 2016-02, as amended, is effective for fiscal years and interim periods within those years beginning after December 15, 2018. The ASU can be adopted either as of the effective date without restating prior periods or retrospectively by restating prior periods. We are assessing the impact of this ASU on our Consolidated Financial Statements, but it will result in a material increase in our long-term assets and liabilities. We are also assessing our method of adoption. We will adopt the ASU beginning in the first quarter of fiscal 2019.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities. The amendments are intended to better align an entity's risk management activities and financial reporting for hedging relationships through changes to the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The ASU is effective for fiscal years and interim periods within those years beginning after December 15, 2018. We are currently assessing the potential impact of this ASU on our Consolidated Financial Statements. We will adopt the ASU beginning in the first quarter of fiscal 2019.

Note 3. Debt and Credit Facilities

As of August 4, 2018, February 3, 2018, and July 29, 2017, the estimated fair value of our \$1.25 billion aggregate principal amount of 5.95 percent notes (the "Notes") due April 2021 was \$1.31 billion, \$1.33 billion, and \$1.36 billion, respectively, and was based on the quoted market price of the Notes (level 1 inputs) as of the last business day of the respective fiscal quarter. The aggregate principal amount of the Notes is recorded in long-term debt on the Condensed Consolidated Balance Sheets, net of the unamortized discount.

We have a \$500 million, five-year, unsecured revolving credit facility (the "Facility"), which is scheduled to expire in May 2023. There were no borrowings and no material outstanding standby letters of credit under the Facility as of August 4, 2018.

We maintain multiple agreements with third parties that make unsecured revolving credit facilities available for our operations in foreign locations (the "Foreign Facilities"). These Foreign Facilities are uncommitted and are generally available for borrowings, overdraft borrowings, and the issuance of bank guarantees. The total capacity of the Foreign Facilities was \$56 million as of August 4, 2018. As of August 4, 2018, there were no borrowings under the Foreign Facilities. There were \$15 million in bank guarantees issued and outstanding primarily related to store leases under the Foreign Facilities as of August 4, 2018.

We have bilateral unsecured standby letter of credit agreements that are uncommitted and do not have expiration dates. As of August 4, 2018, we had \$13 million in standby letters of credit issued under these agreements.

Our 15 billion Japanese yen, four-year, unsecured term loan ("Japan Term Loan") with repayments of 2.5 billion Japanese yen paid on January 15 of each year, and a final repayment of 7.5 billion Japanese yen, which was due on January 15, 2018, was paid in full in June 2017. Interest was payable at least quarterly based on an interest rate equal to the Tokyo Interbank Offered Rate plus a fixed margin.

Note 4. Fair Value Measurements

There were no purchases, sales, issuances, or settlements related to recurring level 3 measurements during the thirteen and twenty-six weeks ended August 4, 2018 or July 29, 2017. There were no transfers of financial assets or liabilities

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into or out of level 1 and level 2 during the thirteen and twenty-six weeks ended August 4, 2018 or July 29, 2017.

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Financial Assets and Liabilities

Financial assets and liabilities measured at fair value on a recurring basis and cash equivalents are as follows:

| (\$ in millions) | Fair Value Measurements at Reporting Date Using | | | |
|-----------------------------------|--|-----------|-------------------------------------|---------------------------------|
| | Quoted Prices in Active Markets for Identical Assets | | Significant Other Observable Inputs | Significant Unobservable Inputs |
| | August 4, 2018 | (Level 1) | (Level 2) | (Level 3) |
| Assets: | | | | |
| Cash equivalents | \$ 481 | \$ 21 | \$ 460 | \$ — |
| Short-term investments | 286 | 109 | 177 | — |
| Derivative financial instruments | 40 | — | 40 | — |
| Deferred compensation plan assets | 53 | 53 | — | — |
| Total | \$ 860 | \$ 183 | \$ 677 | \$ — |
| Liabilities: | | | | |
| Derivative financial instruments | \$ 7 | \$ — | \$ 7 | \$ — |
| (\$ in millions) | Fair Value Measurements at Reporting Date Using | | | |
| | Quoted Prices in Active Markets for Identical Assets | | Significant Other Observable Inputs | Significant Unobservable Inputs |
| | February 3, 2018 | (Level 1) | (Level 2) | (Level 3) |
| Assets: | | | | |
| Cash equivalents | \$ 527 | \$ 37 | \$ 490 | \$ — |
| Derivative financial instruments | 14 | — | 14 | — |
| Deferred compensation plan assets | 47 | 47 | — | — |
| Total | \$ 588 | \$ 84 | \$ 504 | \$ — |
| Liabilities: | | | | |
| Derivative financial instruments | \$ 43 | \$ — | \$ 43 | \$ — |
| (\$ in millions) | Fair Value Measurements at Reporting Date Using | | | |
| | Quoted Prices in Active Markets for Identical Assets | | Significant Other Observable Inputs | Significant Unobservable Inputs |
| | July 29, 2017 | (Level 1) | (Level 2) | (Level 3) |
| Assets: | | | | |
| Cash equivalents | \$ 555 | \$ 96 | \$ 459 | \$ — |
| Derivative financial instruments | 20 | — | 20 | — |
| Deferred compensation plan assets | 46 | 46 | — | — |
| Total | \$ 621 | \$ 142 | \$ 479 | \$ — |
| Liabilities: | | | | |
| Derivative financial instruments | \$ 52 | \$ — | \$ 52 | \$ — |

We have highly liquid investments classified as cash equivalents, which are placed primarily in time deposits and money market funds. With the exception of our available-for-sale investments noted below, we value these investments at their original purchase prices plus interest that has accrued at the stated rate.

Our available-for-sale securities are comprised of investments in debt securities. These securities are recorded at fair value using market prices. As of August 4, 2018, the Company held \$286 million of available-for-sale securities with maturity dates greater than three months and less than two years within short-term investments on the Condensed Consolidated Balance Sheets. In addition, as of August 4, 2018, the Company held \$14 million of available-for-sale debt securities with maturities of less than three months at the time of purchase within cash and cash equivalents on the Condensed Consolidated Balance Sheets. Unrealized gains or losses on available-for-sale debt securities included in accumulated other comprehensive income were immaterial as of August 4, 2018. The Company regularly reviews

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its available-for-sale debt securities for other-than-temporary impairment. For the thirteen and twenty-six weeks ended August 4, 2018, the Company did not consider any of its securities to be other-than-temporarily impaired and, accordingly, did not recognize any impairment loss.

Derivative financial instruments primarily include foreign exchange forward contracts. The currencies hedged against changes in the U.S. dollar are Canadian dollars, Japanese yen, British pounds, Euro, Mexican pesos, Chinese yuan, and Taiwan dollars. The fair value of the Company's derivative financial instruments is determined using pricing models based on current market rates. Derivative financial instruments in an asset position are recorded in other current assets or other long-term assets on the Condensed Consolidated Balance Sheets. Derivative financial instruments in a liability position are recorded in accrued expenses and other current liabilities or lease incentives and other long-term liabilities on the Condensed Consolidated Balance Sheets.

We maintain the Gap Inc. Deferred Compensation Plan ("DCP"), which allows eligible employees and non-employee directors to defer base compensation up to a maximum percentage. Plan investments are directed by participants and are recorded at market value and designated for the DCP. The fair value of the Company's DCP assets is determined based on quoted market prices, and the assets are recorded in other long-term assets on the Condensed Consolidated Balance Sheets.

Nonfinancial Assets

We review the carrying amount of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The fair value of the long-lived assets is determined using level 3 inputs and based on discounted future cash flows of the asset or asset group using a discount rate commensurate with the risk. The asset group is defined as the lowest level for which identifiable cash flows are available and largely independent of the cash flows of other groups of assets, which for our retail stores is primarily at the store level.

There were no material impairment charges recorded for long-lived assets for the thirteen and twenty-six weeks ended August 4, 2018.

During the thirteen weeks ended July 29, 2017, we recorded a charge for the impairment of long-lived assets of \$11 million. The impairment charge was recorded in operating expenses in the Condensed Consolidated Statement of Income and reduced the then carrying amount of the applicable long-lived assets of \$11 million to their fair value of zero. There were no material impairment charges recorded for other long-lived assets for the thirteen weeks ended April 29, 2017.

We review the carrying amount of goodwill and other indefinite-lived intangible assets for impairment annually and whenever events or changes in circumstances indicate that it is more likely than not that the carrying amount may not be recoverable.

There were no material impairment charges recorded for goodwill or other indefinite-lived intangible assets for the thirteen and twenty-six weeks ended August 4, 2018 or July 29, 2017.

Note 5. Derivative Financial Instruments

We operate in foreign countries, which exposes us to market risk associated with foreign currency exchange rate fluctuations. We use derivative financial instruments to manage our exposure to foreign currency exchange rate risk and do not enter into derivative financial contracts for trading purposes. Consistent with our risk management guidelines, we hedge a portion of our transactions related to merchandise purchases for foreign operations and certain intercompany transactions using foreign exchange forward contracts. These contracts are entered into with large, reputable financial institutions that are monitored for counterparty risk. The currencies hedged against changes in the U.S. dollar are Canadian dollars, Japanese yen, British pounds, Euro, Mexican pesos, Chinese yuan, and Taiwan dollars. Cash flows from derivative financial instruments are classified as cash flows from operating activities in the Condensed Consolidated Statements of Cash Flows.

Cash Flow Hedges

We designate the following foreign exchange forward contracts as cash flow hedges: (1) forward contracts used to hedge forecasted merchandise purchases and related costs denominated in U.S. dollars made by our international subsidiaries whose functional currencies are their local currencies; (2) forward contracts used to hedge forecasted intercompany royalty payments denominated in foreign currencies received by entities whose functional currencies

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are U.S. dollars; and (3) forward contracts used to hedge forecasted intercompany revenue transactions related to merchandise sold from our regional purchasing entity, whose functional currency is the U.S. dollar, to certain international subsidiaries in their local currencies. The foreign exchange forward contracts entered into to hedge forecasted merchandise purchases and related costs, intercompany royalty payments, and intercompany revenue transactions generally have terms of up to 24 months. The effective portion of the gain or loss on the derivative financial instruments is reported as a component of other comprehensive income and is recognized in income in the period in which the underlying transaction impacts the Condensed Consolidated Statements of Income.

Net Investment Hedges

We may also use foreign exchange forward contracts to hedge the net assets of international subsidiaries to offset the foreign currency translation and economic exposures related to our investment in the subsidiaries.

Other Derivatives Not Designated as Hedging Instruments

We use foreign exchange forward contracts to hedge our market risk exposure associated with foreign currency exchange rate fluctuations for certain intercompany balances denominated in currencies other than the functional currency of the entity with the intercompany balance. The gain or loss on the derivative financial instruments that represent economic hedges, as well as the remeasurement impact of the underlying intercompany balances, is recorded in operating expenses in the Condensed Consolidated Statements of Income in the same period and generally offset.

Outstanding Notional Amounts

We had foreign exchange forward contracts outstanding in the following notional amounts:

| (\$ in millions) | August 4, February 3, July 29, | | |
|---|--------------------------------|----------|----------|
| | 2018 | 2018 | 2017 |
| Derivatives designated as cash flow hedges | \$ 1,052 | \$ 745 | \$ 1,146 |
| Derivatives designated as net investment hedges | — | — | 30 |
| Derivatives not designated as hedging instruments | 646 | 577 | 616 |
| Total | \$ 1,698 | \$ 1,322 | \$ 1,792 |

Quantitative Disclosures about Derivative Financial Instruments

The fair values of foreign exchange forward contracts are as follows:

| (\$ in millions) | August 4, February 3, July 29, | | |
|---|--------------------------------|--------------|--------------|
| | 2018 | 2018 | 2017 |
| Derivatives designated as cash flow hedges: | | | |
| Other current assets | \$ 19 | \$ 11 | \$ 10 |
| Other long-term assets | \$ 7 | \$ — | \$ 7 |
| Accrued expenses and other current liabilities | \$ 3 | \$ 32 | \$ 26 |
| Lease incentives and other long-term liabilities | \$ 1 | \$ — | \$ 11 |
| Derivatives designated as net investment hedges: | | | |
| Other current assets | \$ — | \$ — | \$ — |
| Other long-term assets | \$ — | \$ — | \$ — |
| Accrued expenses and other current liabilities | \$ — | \$ — | \$ 3 |
| Lease incentives and other long-term liabilities | \$ — | \$ — | \$ — |
| Derivatives not designated as hedging instruments: | | | |
| Other current assets | \$ 14 | \$ 3 | \$ 3 |
| Other long-term assets | \$ — | \$ — | \$ — |
| Accrued expenses and other current liabilities | \$ 3 | \$ 11 | \$ 12 |
| Lease incentives and other long-term liabilities | \$ — | \$ — | \$ — |
| Total derivatives in an asset position | \$ 40 | \$ 14 | \$ 20 |
| Total derivatives in a liability position | \$ 7 | \$ 43 | \$ 52 |

The majority of the unrealized gains and losses from designated cash flow hedges as of August 4, 2018, will be recognized in income within the next 12 months at the then-current values, which may differ from the fair values as of August 4, 2018, shown above.

Our foreign exchange forward contracts are subject to master netting arrangements with each of our counterparties and such arrangements are enforceable in the event of default or early termination of the contract. We do not elect to offset the fair values of our derivative financial instruments on the Condensed Consolidated Balance Sheets, and as such, the fair values shown above represent gross amounts. The amounts subject to enforceable master netting arrangements are \$4 million, \$1 million, and \$13 million as of August 4, 2018, February 3, 2018, and July 29, 2017, respectively. If we did elect to offset, the net amounts of our derivative financial instruments in an asset position would be \$36 million,

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\$13 million, and \$7 million and the net amounts of the derivative financial instruments in a liability position would be \$3 million, \$42 million, and \$39 million as of August 4, 2018, February 3, 2018, and July 29, 2017, respectively.

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See Note 4 of Notes to Condensed Consolidated Financial Statements for disclosures on the fair value measurements of our derivative financial instruments.

The effective portion of gains and losses on foreign exchange forward contracts in cash flow hedging and net investment hedging relationships recorded in other comprehensive income and the Condensed Consolidated Statements of Income, on a pre-tax basis, are as follows:

| | 13 Weeks Ended August 4, 2018 | 26 Weeks Ended August 4, 2017 |
|--|-------------------------------------|-------------------------------------|
| (\$ in millions) | | |
| Derivatives in cash flow hedging relationships: | | |
| Gain (loss) recognized in other comprehensive income | \$21 \$ (55) | \$43 \$ (51) |
| Gain reclassified into cost of goods sold and occupancy expenses | \$— \$ 1 | \$3 \$ 7 |
| Gain (loss) reclassified into operating expenses | \$— \$ — | \$— \$ — |

Derivatives in net investment hedging relationships:

| | | |
|---|-------------|-------------|
| Loss recognized in other comprehensive income | \$— \$ (3) | \$— \$ (2) |
|---|-------------|-------------|

For the thirteen and twenty-six weeks ended August 4, 2018 and July 29, 2017, there were no amounts of gains or losses reclassified from accumulated other comprehensive income into net income for derivative financial instruments in net investment hedging relationships, as we did not sell or liquidate (or substantially liquidate) any of our hedged subsidiaries during the periods.

Gains and losses on foreign exchange forward contracts not designated as hedging instruments recorded in the Condensed Consolidated Statements of Income, on a pre-tax basis, are as follows:

| | 13 Weeks Ended August 4, 2018 | 26 Weeks Ended August 4, 2017 |
|--|-------------------------------------|-------------------------------------|
| (\$ in millions) | | |
| Gain (loss) recognized in operating expenses | \$12 \$ (11) | \$24 \$ (23) |

Note 6. Share Repurchases

Share repurchase activity is as follows:

| | 13 Weeks Ended August 4, 2018 | 26 Weeks Ended July 29, 2017 |
|---|-------------------------------------|------------------------------------|
| (\$ and shares in millions except average per share cost) | | |
| Number of shares repurchased (1) | 3.2 | 4.5 |
| Total cost | \$100 | \$100 |
| Average per share cost including commissions | \$30.95 | \$22.30 |
| | \$31.08 | \$23.15 |

(1)Excludes shares withheld to settle employee statutory tax withholding related to the vesting of stock units. In February 2016, the Board of Directors approved a \$1.0 billion share repurchase authorization, of which \$485 million was remaining as of August 4, 2018.

All of the share repurchases were paid for as of August 4, 2018, February 3, 2018, and July 29, 2017. All common stock repurchased is immediately retired.

Note 7. Accumulated Other Comprehensive Income

Changes in accumulated other comprehensive income by component, net of tax, are as follows:

| (\$ in millions) | Foreign Currency | Cash Flow | Total |
|-----------------------------|---------------------|--------------|-------|
| | Translation | Hedges | |
| Balance at February 3, 2018 | \$ 64 | \$ (28) | \$ 36 |

13 Weeks Ended May 5, 2018:

| | | | |
|--|------|------|------|
| Foreign currency translation and other, net | (7) | — | (7) |
| Change in fair value of derivative financial instruments | — | 28 | 28 |
| Amounts reclassified from accumulated other comprehensive income | — | (6) | (6) |
| Other comprehensive income (loss), net of tax | (7) | 22 | 15 |
| Balance at May 5, 2018 | 57 | (6) | 51 |

13 Weeks Ended August 4, 2018:

| | | | |
|--|-------|-------|-------|
| Foreign currency translation and other, net | (16) | — | (16) |
| Change in fair value of derivative financial instruments | — | 18 | 18 |
| Amounts reclassified from accumulated other comprehensive income | — | — | — |
| Other comprehensive income (loss), net of tax | (16) | 18 | 2 |
| Balance at August 4, 2018 | \$ 41 | \$ 12 | \$ 53 |

| (\$ in millions) | Foreign Currency | Cash Flow | Total |
|-----------------------------|---------------------|--------------|-------|
| | Translation | Hedges | |
| Balance at January 28, 2017 | \$ 29 | \$ 25 | \$ 54 |

13 Weeks Ended April 29, 2017:

| | | | |
|--|------|------|------|
| Foreign currency translation and other, net | (4) | — | (4) |
| Change in fair value of derivative financial instruments | — | — | — |
| Amounts reclassified from accumulated other comprehensive income | — | (4) | (4) |
| Other comprehensive loss, net of tax | (4) | (4) | (8) |
| Balance at April 29, 2017 | 25 | 21 | 46 |

13 Weeks Ended July 29, 2017:

| | | | |
|--|-------|----------|-------|
| Foreign currency translation and other, net | 21 | — | 21 |
| Change in fair value of derivative financial instruments | — | (43) | (43) |
| Amounts reclassified from accumulated other comprehensive income | — | (1) | (1) |
| Other comprehensive income (loss), net of tax | 21 | (44) | (23) |
| Balance at July 29, 2017 | \$ 46 | \$ (23) | \$ 23 |

See Note 5 of Notes to Condensed Consolidated Financial Statements for additional disclosures about reclassifications out of accumulated other comprehensive income and their corresponding effects on the respective line items in the Condensed Consolidated Statements of Income.

Note 8. Share-Based Compensation

Share-based compensation expense recognized in the Condensed Consolidated Statements of Income, primarily in operating expenses, is as follows:

| (\$ in millions) | 13 Weeks Ended August 4, 2018 | 26 Weeks Ended August 4, 2017 |
|------------------------------|-------------------------------------|-------------------------------------|
| Stock units | \$ 22 | \$ 18 |
| Stock options | 4 | 3 |
| Employee stock purchase plan | 1 | 1 |
| | \$ 38 | \$ 33 |
| | 8 | 7 |
| | 2 | 2 |

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| | | | | |
|--|------|-------|-------|-------|
| Share-based compensation expense | 27 | 22 | 48 | 42 |
| Less: Income tax benefit | (6) | (8) | (12) | (16) |
| Share-based compensation expense, net of tax | \$21 | \$ 14 | \$36 | \$ 26 |

Note 9. Income Taxes

The effective income tax rate was 23.5 percent for the thirteen weeks ended August 4, 2018, compared with 38.3 percent for the thirteen weeks ended July 29, 2017. The effective income tax rate was 24.1 percent for the twenty-six weeks ended August 4, 2018, compared with 38.8 percent for the twenty-six weeks ended July 29, 2017. The decrease in the effective tax rates was primarily due to the reduction in the U.S. federal statutory tax rate from 35 percent to 21 percent, enacted as part of the Tax Cuts and Jobs Act of 2017 (the “TCJA”).

On December 22, 2017, the Securities and Exchange Commission (“SEC”) issued SEC Staff Accounting Bulletin (“SAB”) No. 118 to address the application of FASB ASC Topic 740, Income Taxes, in reporting periods that include December 22, 2017. SAB No. 118, codified under ASU 2018-05 in March 2018, permits organizations to report provisional amounts during a measurement period for the specific income tax effects of the TCJA for which the accounting under ASC Topic 740 will be incomplete but a reasonable estimate can be determined. The measurement period ends when an organization has obtained, prepared and analyzed the information needed to complete the accounting requirements under ASC Topic 740, not to extend beyond one year from the enactment date of the TCJA. During the fourteen weeks ended February 3, 2018, we recorded an estimated net charge of \$57 million for the effects of the enactment of TCJA, primarily due to the impact of the one-time transition tax on the deemed repatriation of foreign income and the impact of TCJA on deferred tax assets and liabilities. During the thirteen weeks ended May 5, 2018, we did not make any measurement period adjustments related to our provisional estimated net charge. During the thirteen weeks ended August 4, 2018, we made certain immaterial measurement period adjustments to our fiscal 2017 provisional estimated net charge of \$57 million for the impacts of deferred tax assets and liabilities subject to the TCJA rate reduction. We will continue to evaluate the TCJA, collect and prepare necessary data, and interpret additional guidance issued by the U.S. Treasury Department and Internal Revenue Service (“IRS”), including the proposed regulations regarding the computation of the one-time transition tax on the deemed repatriation of foreign income. In accordance with SAB No. 118, we will complete our accounting for the tax effects of the TCJA during fiscal 2018 and adjustments to our provisional estimated net charge may materially impact our provision for income taxes and effective tax rate in the period in which the adjustments are made.

The TCJA includes a provision to tax global intangible low-taxed income (“GILTI”) of foreign subsidiaries, a base erosion anti-abuse tax (“BEAT”) measure that taxes certain payments between a U.S. corporation and its subsidiaries, and favorable tax treatment for certain Foreign Derived Intangible Income (“FDII”), effective for us beginning fiscal 2018. Our provisional estimates for GILTI, BEAT, and FDII do not materially impact our effective income tax rate for the thirteen and twenty-six weeks ended August 4, 2018.

The Company conducts business globally, and as a result, files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of business, we are subject to examination by taxing authorities throughout the world, including such major jurisdictions as the United States, Canada, France, the United Kingdom, China, Hong Kong, Japan, and India. We are no longer subject to U.S. federal income tax examinations for fiscal years before 2009, and with few exceptions, we are also no longer subject to U.S. state, local, or non-U.S. income tax examinations for fiscal years before 2008.

The Company is in continual discussions with taxing authorities regarding tax matters in the various U.S. and foreign jurisdictions in the normal course of business. As of August 4, 2018, we have not identified any gross unrecognized tax benefits where it is reasonably possible we will recognize a decrease within the next 12 months.

Note 10. Earnings Per Share

Weighted-average number of shares used for earnings per share is as follows:

| | 13 Weeks Ended (shares in millions) | 26 Weeks Ended August 4, 2018 |
|---|---|-------------------------------------|
| Weighted-average number of shares - basic | 387 395 | 388 397 |
| Common stock equivalents | 3 1 | 3 1 |
| Weighted-average number of shares - diluted | 390 396 | 391 398 |

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The above computations of weighted-average number of shares – diluted exclude 6 million and 11 million shares related to stock options and other stock awards for the thirteen weeks ended August 4, 2018 and July 29, 2017, respectively, and 6 million and 9 million shares related to stock options and other stock awards for the twenty-six weeks ended August 4, 2018 and July 29, 2017, respectively, as their inclusion would have an anti-dilutive effect on earnings per share.

Note 11. Commitments and Contingencies

We are a party to a variety of contractual agreements under which we may be obligated to indemnify the other party for certain matters. These contracts primarily relate to our commercial contracts, operating leases, trademarks, intellectual property, financial agreements, and various other agreements. Under these contracts, we may provide certain routine indemnifications relating to representations and warranties (e.g., ownership of assets, environmental or tax indemnifications), or personal injury matters. The terms of these indemnifications range in duration and may not be explicitly defined. Generally, the maximum obligation under such indemnifications is not explicitly stated, and as a result, the overall amount of these obligations cannot be reasonably estimated. Historically, we have not made significant payments for these indemnifications. We believe that if we were to incur a loss in any of these matters, the loss would not have a material effect on our Condensed Consolidated Financial Statements taken as a whole.

As a multinational company, we are subject to various proceedings, lawsuits, disputes, and claims ("Actions") arising in the ordinary course of our business. Many of these Actions raise complex factual and legal issues and are subject to uncertainties. As of August 4, 2018, Actions filed against us included commercial, intellectual property, customer, employment, and data privacy claims, including class action lawsuits. The plaintiffs in some Actions seek unspecified damages or injunctive relief, or both. Actions are in various procedural stages and some are covered in part by insurance. As of August 4, 2018, February 3, 2018, and July 29, 2017, we recorded a liability for an estimated loss if the outcome of an Action is expected to result in a loss that is considered probable and reasonably estimable. The liability recorded as of August 4, 2018, February 3, 2018, and July 29, 2017 was not material for any individual Action or in total. Subsequent to August 4, 2018 and through the filing date of this Quarterly Report on Form 10-Q, no information has become available that indicates a change is required that would be material to our Condensed Consolidated Financial Statements taken as a whole.

We cannot predict with assurance the outcome of Actions brought against us. Accordingly, developments, settlements, or resolutions may occur and impact income in the quarter of such development, settlement, or resolution. However, we do not believe that the outcome of any current Action would have a material effect on our Condensed Consolidated Financial Statements taken as a whole.

Fire at the Fishkill Distribution Center

On August 29, 2016, a fire occurred in one of the buildings at a Company-owned distribution center campus in Fishkill, New York. The Company maintains property and business interruption insurance coverage and, based on the provisions of the Company's insurance policies, the Company recorded insurance recoveries based on the determination that recovery of certain fire-related costs was probable. In January 2018, the Company agreed upon a final settlement with its insurers.

During the thirteen weeks ended July 29, 2017, the Company agreed upon a partial insurance settlement and recorded a gain of \$64 million, primarily related to property and equipment, representing the excess over the loss on fire-related recoverable costs, which was recorded in operating expenses in the Condensed Consolidated Statement of Income. During the twenty-six weeks ended July 29, 2017, we allocated \$59 million of advance payments of insurance proceeds to the loss on property and equipment based on the current estimate of recovery of certain fire-related costs, and the amount has been reported as insurance proceeds allocated to loss on property and equipment, a component of cash flows from investing activities, in the Condensed Consolidated Statement of Cash Flows.

Note 12. Segment Information

The Gap, Inc. is a global retailer that sells apparel, accessories, and personal care products under the Old Navy, Gap, Banana Republic, Athleta, and Intermix brands. We identify our operating segments according to how our business activities are managed and evaluated. As of August 4, 2018, our operating segments included Old Navy Global, Gap Global, Banana Republic Global, Athleta, and Intermix. We have determined that each of our operating segments share similar economic and other qualitative characteristics, and therefore the results of our operating segments are aggregated into one reportable segment as of August 4, 2018.

Net sales by brand and region are as follows:

| (\$ in millions) | Old Navy Global | Gap Global | Banana Republic Global | Other (3) | Total | Percentage of Net Sales | % |
|-----------------------------------|-----------------------|---------------|------------------------------|--------------|---------|-------------------------------|---|
| 13 Weeks Ended August 4, 2018 (1) | | | | | | | |
| U.S. (2) | \$1,816 | \$728 | \$514 | \$264 | \$3,322 | 82 | % |
| Canada | 151 | 94 | 58 | — | 303 | 7 | |
| Europe | — | 145 | 3 | — | 148 | 4 | |
| Asia | 11 | 229 | 22 | — | 262 | 6 | |
| Other regions | 14 | 29 | 7 | — | 50 | 1 | |
| Total | \$1,992 | \$1,225 | \$604 | \$264 | \$4,085 | 100 | % |

| (\$ in millions) | Old Navy Global | Gap Global | Banana Republic Global | Other (3) | Total | Percentage of Net Sales | % |
|----------------------------------|-----------------------|---------------|------------------------------|--------------|---------|-------------------------------|---|
| 13 Weeks Ended July 29, 2017 (1) | | | | | | | |
| U.S. (2) | \$1,596 | \$719 | \$492 | \$231 | \$3,038 | 80 | % |
| Canada | 133 | 91 | 54 | — | 278 | 7 | |
| Europe | — | 148 | 3 | — | 151 | 4 | |
| Asia | 12 | 252 | 24 | — | 288 | 8 | |
| Other regions | 16 | 22 | 6 | — | 44 | 1 | |
| Total | \$1,757 | \$1,232 | \$579 | \$231 | \$3,799 | 100 | % |

| (\$ in millions) | Old Navy Global | Gap Global | Banana Republic Global | Other (3) | Total | Percentage of Net Sales | % |
|-----------------------------------|-----------------------|---------------|------------------------------|--------------|---------|-------------------------------|---|
| 26 Weeks Ended August 4, 2018 (1) | | | | | | | |
| U.S. (2) | \$3,406 | \$1,408 | \$993 | \$533 | \$6,340 | 81 | % |
| Canada | 278 | 171 | 108 | 1 | 558 | 7 | |
| Europe | — | 280 | 7 | — | 287 | 4 | |
| Asia | 23 | 513 | 47 | — | 583 | 7 | |
| Other regions | 30 | 57 | 13 | — | 100 | 1 | |
| Total | \$3,737 | \$2,429 | \$1,168 | \$534 | \$7,868 | 100 | % |

| (\$ in millions) | Old Navy Global | Gap Global | Banana Republic Global | Other (3) | Total | Percentage of Net Sales | % |
|----------------------------------|-----------------------|---------------|------------------------------|--------------|---------|-------------------------------|---|
| 26 Weeks Ended July 29, 2017 (1) | | | | | | | |
| U.S. (2) | \$3,022 | \$1,387 | \$929 | \$433 | \$5,771 | 80 | % |
| Canada | 244 | 168 | 99 | 1 | 512 | 7 | |
| Europe | — | 281 | 7 | — | 288 | 4 | |
| Asia | 21 | 502 | 48 | — | 571 | 8 | |
| Other regions | 32 | 52 | 13 | — | 97 | 1 | |
| Total | \$3,319 | \$2,390 | \$1,096 | \$434 | \$7,239 | 100 | % |

Net sales for the thirteen and twenty-six weeks ended August 4, 2018 reflect the adoption of the new revenue recognition standard, which resulted in an increase to net sales of \$139 million and \$279 million, respectively, for (1) revenue sharing and reimbursements of loyalty program discounts associated with the Company's credit card programs, as well as breakage revenue for our gift cards and credit vouchers. Prior period amounts have not been restated and continue to be reported under accounting standards in effect for those periods.

(2) U.S. includes the United States, Puerto Rico, and Guam.

(3) Primarily consists of net sales for the Athleta and Intermix brands.

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Net sales by region are allocated based on the location of the store where the customer paid for and received the merchandise or the distribution center or store from which the products were shipped.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

OUR BUSINESS

We are a global retailer offering apparel, accessories, and personal care products for men, women, and children under the Old Navy, Gap, Banana Republic, Athleta, and Intermix brands. We have Company-operated stores in the United States, Canada, the United Kingdom, France, Ireland, Japan, Italy, China, Hong Kong, Taiwan, and Mexico. We have franchise agreements with unaffiliated franchisees to operate Gap, Banana Republic, and Old Navy stores throughout Asia, Europe, Latin America, the Middle East, and Africa. Under these agreements, third parties operate, or will operate, stores that sell apparel and related products under our brand names. Our products are also available to customers online through Company-owned websites and through the use of third parties that provide logistics and fulfillment services. In addition to operating in the specialty, outlet, online, and franchise channels, we also use our omni-channel capabilities to bridge the digital world and physical stores to further enhance our shopping experience for our customers. Our omni-channel services, including order-in-store, reserve-in-store, find-in-store, and ship-from-store, as well as enhanced mobile experiences, are tailored uniquely across our portfolio of brands. Most of the products sold under our brand names are designed by us and manufactured by independent sources. We also sell products that are designed and manufactured by branded third parties, primarily at our Intermix brand.

OVERVIEW

During the first quarter of fiscal 2018, we adopted the new revenue recognition standard, ASC 606, using the modified retrospective transition method and recorded an increase to opening retained earnings of \$36 million, net of tax. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. The adoption of the new revenue recognition standard did not have a significant impact to net income for the first half of fiscal 2018, but did have a significant impact to the presentation of net sales, cost of goods sold and occupancy expenses, and operating expenses in the Condensed Consolidated Statement of Income. The presentation changes primarily consist of \$96 million and \$192 million for the thirteen and twenty-six weeks ended August 4, 2018, respectively, for revenue sharing associated with our credit card programs and breakage revenue for gift cards and credit vouchers, which now is recorded as net sales and previously was recorded as a reduction to operating expenses in our Condensed Consolidated Statements of Income; and \$43 million and \$87 million for the thirteen and twenty-six weeks ended August 4, 2018, respectively, for reimbursements of loyalty program discounts associated with our credit card programs, which now is recorded as net sales and previously was recorded as a reduction to cost of goods sold and occupancy expenses in our Condensed Consolidated Statements of Income. See Note 2 of Notes to Condensed Consolidated Financial Statements for additional disclosures about the adoption of the new revenue standard.

Financial results for the second quarter of fiscal 2018 are as follows:

Net sales for the second quarter of fiscal 2018 increased 8 percent compared with the second quarter of fiscal 2017. Comparable sales for the second quarter of fiscal 2018 increased 2 percent compared with a 1 percent increase for the second quarter of fiscal 2017.

Gross profit for the second quarter of fiscal 2018 was \$1.6 billion compared with \$1.5 billion for the second quarter of fiscal 2017. Gross margin for the second quarter of fiscal 2018 was 39.8 percent compared with 38.9 percent for the second quarter of fiscal 2017.

Operating margin for the second quarter of fiscal 2018 was 9.7 percent compared with 11.9 percent for the second quarter of fiscal 2017, which includes a gain on insurance proceeds of \$64 million related to the fire that occurred at the Fishkill, New York Company-owned distribution center.

Net income for the second quarter of fiscal 2018 was \$297 million compared with \$271 million for the second quarter of fiscal 2017.

Diluted earnings per share was \$0.76 for the second quarter of fiscal 2018 compared with \$0.68 for the second quarter of fiscal 2017.

During the first half of fiscal 2018, we distributed \$388 million to shareholders through share repurchases and dividends.

Our business priorities for fiscal 2018 remain as follows:

•

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offering product that is consistently brand-appropriate and on-trend with high customer acceptance, with a focus on expanding our advantage in core businesses and loyalty categories;
investing in digital and customer capabilities to support growth;
• creating a unique and differentiated converged retail shopping experience that attracts new customers and builds loyalty, with focus on both the physical and digital expressions of our brands;
increasing productivity by leveraging our scale and streamlining operations and processes throughout the organization;
• continuing to integrate social and environmental sustainability into business practices to support long term growth; and
attracting and retaining strong talent in our businesses and functions.

In fiscal 2018, we are focused on investing strategically in the business while maintaining operating expense discipline and driving efficiency through our productivity initiative. One of our primary objectives is to continue transforming our product to market process, with the development of a more efficient operating model, allowing us to more fully leverage our scale. To enable this, we have a number of product, supply chain, and IT initiatives underway. Furthermore, we expect to continue our investment in customer experience to drive higher customer engagement and loyalty across all of our brands and channels, resulting in market share gains. Finally, we will continue to invest in strengthening brand awareness, customer acquisition, and digital capabilities. Underpinning these strategies is a focus on utilizing data, analytics, and technology to respond faster while making decisions that will fuel market share gains and lead to a more nimble organization.

RESULTS OF OPERATIONS

Net Sales

See Note 12 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 in this Form 10-Q, for net sales by brand and region.

Comparable Sales ("Comp Sales")

Fiscal 2018 consists of 52 weeks versus 53 weeks in fiscal 2017. Due to the 53rd week in fiscal 2017, in order to maintain consistency, comparable ("Comp") sales for the second quarter of fiscal 2018 and the first half of fiscal 2018 are compared to the thirteen and twenty-six weeks ended August 5, 2017.

The percentage change in Comp Sales by global brand and for The Gap, Inc., as compared with the preceding year, is as follows:

| | 13 Weeks Ended August 4, 2017 | 26 Weeks Ended August 4, 2018 |
|------------------------|-------------------------------------|-------------------------------------|
| Old Navy Global | 5 % | 4 % |
| Gap Global | (5)% | (2)% |
| Banana Republic Global | 2 % | (5)% |
| The Gap, Inc. | 2 % | 1 % |

Comp Sales include merchandise sales in Company-operated stores and merchandise sales through online channels in those countries where we have existing comparable store sales. The calculation of The Gap, Inc. Comp Sales includes the results of Athleta and Intermix, but excludes the results of our franchise business.

A store is included in the Comp Sales calculations when it has been open and operated by the Company for at least one year and the selling square footage has not changed by 15 percent or more within the past year. A store is included in the Comp Sales calculations on the first day it has comparable prior year sales. Stores in which the selling square footage has changed by 15 percent or more as a result of a remodel, expansion, or reduction are excluded from the Comp Sales calculations until the first day they have comparable prior year sales.

A store is considered non-comparable ("Non-comp") when it has been open and operated by the Company for less than one year or has changed its selling square footage by 15 percent or more within the past year.

A store is considered "Closed" if it is temporarily closed for three or more full consecutive days or it is permanently closed. When a temporarily closed store reopens, the store will be placed in the Comp/Non-comp status it was in prior to its closure. If a store was in Closed status for three or more days in the prior year, the store will be in Non-comp status for the same days the following year.

Current year foreign exchange rates are applied to both current year and prior year Comp Sales to achieve a consistent basis for comparison.

Store Count and Square Footage Information

Net sales per average square foot are as follows:

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| | |
|-----------------|-----------------|
| 13 Weeks | 26 Weeks |
| Ended | Ended |
| August 14, 2018 | August 14, 2017 |
| 2018 | 2017 |

Net sales per average square foot (1) \$ 90 \$ 85 169 \$ 160

(1) Excludes net sales associated with our online and franchise businesses. Online sales includes both sales through our online channels as well as ship-from-store sales.

Store count, openings, closings, and square footage for our stores are as follows:

| | February 3, 2018 | 26 Weeks Ended August 4, 2018 | | August 4, 2018 |
|-------------------------------------|---------------------------------|----------------------------------|-------------------------------|---------------------------------|
| | Number of Store Locations | Number of Stores Opened | Number of Stores Closed | Number of Store Locations |
| Old Navy North America | 1,066 | 30 | 2 | 1,094 18.1 |
| Old Navy Asia | 14 | — | — | 14 0.2 |
| Gap North America | 810 | 4 | 14 | 800 8.2 |
| Gap Asia | 313 | 9 | 3 | 319 3.1 |
| Gap Europe | 155 | 5 | 5 | 155 1.3 |
| Banana Republic North America | 576 | 3 | 9 | 570 4.8 |
| Banana Republic Asia | 45 | 2 | 3 | 44 0.2 |
| Athleta North America | 148 | 7 | 1 | 154 0.6 |
| Intermix North America | 38 | — | 1 | 37 0.1 |
| Company-operated stores total | 3,165 | 60 | 38 | 3,187 36.6 |
| Franchise | 429 | 47 | 37 | 439 N/A |
| Total | 3,594 | 107 | 75 | 3,626 36.6 |
| Increase (decrease) over prior year | | | | (0.4)% 0.3 % |

| | January 28, 2017 | 26 Weeks Ended July 29, 2017 | | July 29, 2017 |
|-------------------------------|------------------------------|----------------------------------|-------------------------------|---------------------------------|
| | Number of Store Locations | Number of Stores Opened | Number of Stores Closed | Number of Store Locations |
| Old Navy North America | 1,043 | 13 | 5 | 1,051 17.5 |
| Old Navy Asia | 13 | — | — | 13 0.2 |
| Gap North America | 844 | 3 | 13 | 834 8.6 |
| Gap Asia | 311 | 3 | 9 | 305 2.9 |
| Gap Europe | 164 | — | 5 | 159 1.4 |
| Banana Republic North America | 601 | 3 | 8 | 596 5.0 |
| Banana Republic Asia | 48 | 1 | 1 | 48 0.2 |
| Banana Republic Europe | 1 | — | 1 | — — |
| Athleta North America | 132 | 1 | — | 133 0.6 |
| Intermix North America | 43 | — | 3 | 40 0.1 |
| Company-operated stores total | 3,200 | 24 | 45 | 3,179 36.5 |
| Franchise | 459 | 22 | 18 | 463 N/A |
| Total | 3,659 | 46 | 63 | 3,642 36.5 |
| Decrease over prior year | | | | (2.4)% (3.4)% |

Gap and Banana Republic outlet and factory stores are reflected in each of the respective brands.

Net Sales

Our net sales for the second quarter of fiscal 2018 increased \$286 million, or 8 percent, compared with the second quarter of fiscal 2017 primarily driven by an increase in Comp Sales for Old Navy Global, an increase in new stores, and the impact of significant presentation changes of \$139 million resulting from the adoption of the new revenue recognition standard.

Our net sales for the first half of fiscal 2018 increased \$629 million, or 9 percent, compared with the first half of fiscal 2017 primarily driven by an increase in Comp Sales for Old Navy Global, the impact of significant presentation

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changes of \$279 million resulting from the adoption of the new revenue recognition standard, and a net favorable impact of foreign exchange of \$65 million. The foreign exchange impact is the translation impact if net sales for the first half of fiscal 2017 were translated at exchange rates applicable during the first half of fiscal 2018.

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Cost of Goods Sold and Occupancy Expenses

| | 13 Weeks Ended August 4, July 29, 2018 | 26 Weeks Ended August 4, July 29, 2017 | 13 Weeks Ended August 4, July 29, 2018 | 26 Weeks Ended August 4, July 29, 2017 |
|--|--|--|--|--|
| (\$ in millions) | | | | |
| Cost of goods sold and occupancy expenses | \$2,458 | \$2,320 | \$4,814 | \$4,457 |
| Gross profit | \$1,627 | \$1,479 | \$3,054 | \$2,782 |
| Cost of goods sold and occupancy expenses as a percentage of net sales | 60.2 % | 61.1 % | 61.2 % | 61.6 % |
| Gross margin | 39.8 % | 38.9 % | 38.8 % | 38.4 % |

Cost of goods sold and occupancy expenses decreased 0.9 percentage points as a percentage of net sales in the second quarter of fiscal 2018 compared with the second quarter of fiscal 2017.

Cost of goods sold increased 0.3 percentage points as a percentage of net sales in the second quarter of fiscal 2018 compared with the second quarter of fiscal 2017, primarily driven by lower product margin at Gap Global, and higher online shipping costs. This was partially offset by a favorable impact from presentation changes resulting from the adoption of the new revenue recognition standard.

Occupancy expenses decreased 1.2 percentage points as a percentage of net sales in the second quarter of fiscal 2018 compared with the second quarter of fiscal 2017, primarily driven by presentation changes resulting from the adoption of the new revenue recognition standard, store closures, and an increase in online sales without a corresponding increase in occupancy expenses.

Cost of goods sold and occupancy expenses decreased 0.4 percentage points as a percentage of net sales in the first half of fiscal 2018 compared with the first half of fiscal 2017.

Cost of goods sold increased 0.8 percentage points as a percentage of net sales in the first half of fiscal 2018 compared with the first half of fiscal 2017, primarily driven by higher online shipping costs, higher inventory write-offs at Gap Global, and lower product margin at Gap Global. This was partially offset by a favorable impact from presentation changes resulting from the adoption of the new revenue recognition standard.

Occupancy expenses decreased 1.2 percentage points as a percentage of net sales in the first half of fiscal 2018 compared with the first half of fiscal 2017, primarily driven by presentation changes resulting from the adoption of the new revenue recognition standard, an increase in online sales without a corresponding increase in occupancy expenses, and store closures.

Operating Expenses

| | 13 Weeks Ended August 4, July 29, 2018 | 26 Weeks Ended August 4, July 29, 2017 | 13 Weeks Ended August 4, July 29, 2018 | 26 Weeks Ended August 4, July 29, 2017 |
|---|--|--|--|--|
| (\$ in millions) | | | | |
| Operating expenses | \$1,229 | \$1,028 | \$2,427 | \$2,077 |
| Operating expenses as a percentage of net sales | 30.1 % | 27.1 % | 30.8 % | 28.7 % |
| Operating margin | 9.7 % | 11.9 % | 8.0 % | 9.7 % |

Operating expenses increased \$201 million, or 3.0 percentage points as a percentage of net sales in the second quarter of fiscal 2018 compared with the second quarter of fiscal 2017. Operating expenses increased \$350 million, or 2.1 percentage points as a percentage of net sales in the first half of fiscal 2018 compared with the first half of fiscal 2017. The increase in operating expenses for the second quarter and first half of fiscal 2018 compared with the respective periods of 2017 was primarily due to the following:

• presentation changes resulting from the adoption of the new revenue recognition standard;
 • a gain on insurance proceeds of \$64 million in the second quarter of fiscal 2017 related to the fire that occurred at the Fishkill, New York Company-owned distribution center; and
 • an increase in expenses related to payroll and benefits, primarily at stores and distribution centers due to increased volume.

Interest Expense

| | 13 Weeks | 26 Weeks |
|------------------|----------------|----------------|
| | Ended | Ended |
| (\$ in millions) | August 4, 2018 | August 4, 2017 |
| | 2018 | 2017 |
| Interest expense | \$ 17 | \$ 16 |
| | \$ 33 | \$ 35 |

Interest expense primarily includes interest on overall borrowings and obligations mainly related to our \$1.25 billion 5.95 percent Notes.

Income Taxes

| | 13 Weeks | 26 Weeks |
|--------------------|----------------|----------------|
| | Ended | Ended |
| (\$ in millions) | August 4, 2018 | August 4, 2017 |
| | 2018 | 2017 |
| Income taxes | \$ 91 | \$ 168 |
| | \$ 146 | \$ 263 |
| Effective tax rate | 23.5% | 38.3% |
| | 24.1% | 38.8% |

The decrease in the effective tax rate for the second quarter and first half of fiscal 2018 compared with the respective periods of fiscal 2017 is primarily due to the reduction in the U.S. federal statutory tax rate from 35% to 21%, enacted as part of the Tax Cuts and Jobs Act of 2017 (the “TCJA”).

During the fourth quarter of fiscal 2017, we calculated our best estimate of the impact associated the TCJA one-time transition tax on the deemed repatriation of foreign income and the impact of TCJA on deferred tax assets and liabilities. During the thirteen weeks ended August 4, 2018, we made certain immaterial measurement period adjustments to our fiscal 2017 provisional estimated net charge of \$57 million for the impacts of deferred tax assets and liabilities subject to the TCJA rate reduction. We continue to evaluate the TCJA, collect and prepare necessary data, and interpret additional guidance issued by the U.S. Treasury Department and Internal Revenue Service (“IRS”) and will complete our accounting for the impact of the TCJA during fiscal 2018.

LIQUIDITY AND CAPITAL RESOURCES

Our largest source of cash flows is cash collections from the sale of our merchandise. Our primary uses of cash include merchandise inventory purchases, occupancy costs, personnel-related expenses, purchases of property and equipment, and payment of taxes. In addition, we may have dividend payments, debt repayments, and share repurchases. As of August 4, 2018, cash, cash equivalents, and short-term investments were \$1.6 billion, the majority of which was held in the United States and is generally accessible without any limitations.

We believe that current cash balances and cash flows from our operations will be sufficient to support our business operations, including growth initiatives and planned capital expenditures, for the next 12 months and beyond. We are also able to supplement near-term liquidity, if necessary, with our \$500 million revolving credit facility or other available market instruments.

Cash Flows from Operating Activities

Net cash from operating activities increased \$60 million during the first half of fiscal 2018 compared with the first half of fiscal 2017, primarily due to the following:

- an increase of \$153 million related to accounts payable primarily due to the timing of inventory and lease payments;
- an increase of \$47 million in net income; partially offset by
- a decrease of \$98 million in income taxes payable primarily due to the federal statutory tax rate decrease; and
- a decrease of \$69 million related to accrued expenses and other current liabilities primarily due to higher bonus payout in fiscal 2018 compared with the bonus payout in fiscal 2017.

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We fund inventory expenditures during normal and peak periods through cash flows from operating activities and available cash. Our business follows a seasonal pattern, with sales peaking during the end-of-year holiday period. The seasonality of our operations may lead to significant fluctuations in certain asset and liability accounts between fiscal year-end and subsequent interim periods.

Cash Flows from Investing Activities

Net cash used for investing activities during the first half of fiscal 2018 increased \$402 million compared with the first half of fiscal 2017, primarily due to the following:

\$286 million of net purchases of available-for-sale securities during fiscal 2018; and

\$59 million of insurance proceeds allocated to the loss on property and equipment during the first half of fiscal 2017.

Cash Flows from Financing Activities

Net cash used for financing activities during the first half of fiscal 2018 decreased \$73 million compared with the first half of fiscal 2017, primarily due to a \$67 million repayment of the Japan term loan during the first half of fiscal 2017.

Free Cash Flow

Free cash flow is a non-GAAP financial measure. We believe free cash flow is an important metric because it represents a measure of how much cash a company has available for discretionary and non-discretionary items after the deduction of capital expenditures, net of insurance proceeds related to loss on property and equipment, as we require regular capital expenditures to build and maintain stores and purchase new equipment to improve our business. We use this metric internally, as we believe our sustained ability to generate free cash flow is an important driver of value creation. However, this non-GAAP financial measure is not intended to supersede or replace our GAAP results. The following table reconciles free cash flow, a non-GAAP financial measure, from a GAAP financial measure.

| (\$ in millions) | 26 Weeks Ended | |
|---|--------------------|------------------|
| | August 29, 2018 | July 29, 2017 |
| Net cash provided by operating activities | \$546 | \$486 |
| Less: Purchases of property and equipment | (326) | (275) |
| Add: Insurance proceeds related to loss on property and equipment | — | 59 |
| Free cash flow | \$220 | \$270 |

Debt and Credit Facilities

Certain financial information about the Company's debt and credit facilities is set forth under the heading "Debt and Credit Facilities" in Note 3 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Form 10-Q.

Dividend Policy

In determining whether and at what level to declare a dividend, we consider a number of factors including sustainability, operating performance, liquidity, and market conditions.

We paid a dividend of \$0.485 per share and \$0.46 per share during the first half of fiscal 2018 and fiscal 2017, respectively. Including the dividend paid during the first half of fiscal 2018, we intend to pay an annual dividend of \$0.97 per share for fiscal 2018 compared with the annual dividend of \$0.92 per share for fiscal 2017.

Share Repurchases

Certain financial information about the Company's share repurchases is set forth under the heading "Share Repurchases" in Note 6 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Form 10-Q.

Summary Disclosures about Contractual Cash Obligations and Commercial Commitments

There have been no material changes to our contractual obligations and commercial commitments as disclosed in our Annual Report on Form 10-K as of February 3, 2018, other than those which occur in the normal course of business. See Note 11 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Form 10-Q, for disclosures on commitments and contingencies.

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Critical Accounting Policies and Estimates

Except for changes resulting from the adoption of new accounting standards during the period, there have been no significant changes to our critical accounting policies and estimates as discussed in our Annual Report on Form 10-K for the fiscal year ended February 3, 2018. See Note 2 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Form 10-Q, for disclosures on accounting policies.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our market risk profile as of February 3, 2018, is disclosed in our Annual Report on Form 10-K and has not significantly changed. See Notes 3, 4, and 5 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1, of this Form 10-Q, for disclosures on our debt, investments, and derivative financial instruments.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective.

Changes in Internal Control over Financial Reporting

There was no change in the Company's internal control over financial reporting that occurred during the Company's second quarter of fiscal 2018 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II – OTHER INFORMATION**Item 1. Legal Proceedings.**

As a multinational company, we are subject to various proceedings, lawsuits, disputes, and claims arising in the ordinary course of our business. Many of these Actions raise complex factual and legal issues and are subject to uncertainties. Actions filed against us from time to time include commercial, intellectual property, customer, employment, and data privacy claims, including class action lawsuits. The plaintiffs in some Actions seek unspecified damages or injunctive relief, or both. Actions are in various procedural stages, and some are covered in part by insurance.

We cannot predict with assurance the outcome of Actions brought against us. Accordingly, developments, settlements, or resolutions may occur and impact income in the quarter of such development, settlement, or resolution. However, we do not believe that the outcome of any current Action would have a material effect on our financial results.

Item 1A. Risk Factors.

There have been no material changes in our risk factors from those disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended February 3, 2018, other than what was previously disclosed in Part II, Item 1A of our Quarterly Report on Form 10-Q for the fiscal quarter ended May 5, 2018.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The following table presents information with respect to purchases of common stock of the Company made during the thirteen weeks ended August 4, 2018 by The Gap, Inc. or any affiliated purchaser, as defined in Exchange Act Rule 10b-18(a)(3):

| Total Number of Shares Purchased (1) | Average Price Paid Per Share Including Commissions | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or approximate dollar amount) of Shares that May Yet be Purchased Under the Plans or Programs (2) |
|--------------------------------------|--|--|---|
| Month #1 (May 6 - June 2) | 407,272 \$ 28.52 | 407,272 | \$ 573 million |
| Month #2 (June 3 - July 7) | 1,686,360 \$ 32.14 | 1,686,360 | \$ 519 million |
| Month #3 (July 8 - August 4) | 1,138,830 \$ 30.04 | 1,138,830 | \$ 485 million |
| Total | 3,232,462 \$ 30.95 | 3,232,462 | |

(1)Excludes shares withheld to settle employee statutory tax withholding related to the vesting of stock units.

(2) On February 25, 2016, we announced that the Board of Directors approved a \$1 billion share repurchase authorization, which has no expiration date.

Item 6. Exhibits.

- 10.1 Second Amended and Restated Revolving Credit Agreement dated May 31, 2018. (2).
SIXTH AMENDMENT TO AMENDED AND RESTATED CONSUMER CREDIT CARD PROGRAM AGREEMENT BY AND AMONG THE
REGISTRANT, GAP (PUERTO RICO), INC., GPS CONSUMER DIRECT, INC., GAP (APPAREL), LLC, GAP (ITM)
INC., SYNCHRONY BANK (F/K/A GE CAPITAL RETAIL BANK) AND SYNCHRONY FINANCIAL, DATED AS OF MAY 22, 2018. (1)
(2)
 - 10.3 Agreement with Neil Fiske dated June 11, 2018. (2)
 - 10.4 Agreement with Art Peck dated June 1, 2018, filed as Exhibit 10.1 to Registrant's Form 8-K on June 4, 2018,
Commission File No. 1-7562.
 - 31.1 Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer of The Gap, Inc. (Section 302 of the
Sarbanes-Oxley Act of 2002). (2)
 - 31.2 Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer of The Gap, Inc. (Section 302 of the
Sarbanes-Oxley Act of 2002). (2)
 - 32.1 Certification of the Chief Executive Officer of The Gap, Inc. pursuant to 18 U.S.C. Section 1350, as adopted
pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (3)
 - 32.2 Certification of the Chief Financial Officer of The Gap, Inc. pursuant to 18 U.S.C. Section 1350, as adopted
pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (3)
- The following materials from The Gap, Inc.'s Quarterly Report on Form 10-Q for the quarter ended August 4, 2018, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Comprehensive Income, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements. (2)

Pursuant to a request for confidential treatment, confidential portions of this Exhibit have been redacted and have
(1) been filed separately with the Securities

and Exchange Commission.

(2) Filed herewith.

(3) Furnished herewith.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

THE GAP, INC.

Date: August 31, 2018 By /s/ Arthur Peck
Arthur Peck
Chief Executive Officer

Date: August 31, 2018 By /s/ Teri List-Stoll
Teri List-Stoll
Executive Vice President and Chief Financial Officer

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Exhibit Index

- 10.1 Second Amended and Restated Revolving Credit Agreement dated May 31, 2018. (2)
Sixth Amendment to Amended and Restated Consumer Credit Card Program Agreement by and among the Registrant, Gap (Puerto Rico), Inc., GPS Consumer Direct, Inc., Gap (Apparel), LLC, Gap (ITM) Inc., Synchrony Bank (f/k/a GE Capital Retail Bank) and Synchrony Financial, dated as of May 22, 2018. (1)
- (2)
- 10.3 Agreement with Neil Fiske dated June 11, 2018. (2)
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(1) Pursuant to a request for confidential treatment, confidential portions of this Exhibit have been redacted and have been filed separately with the Securities and Exchange Commission.
(2) Filed herewith.
(3) Furnished herewith.