2005 annual report

Gap Inc.

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Robert J. Fisher
Chairman

letter from the chairman

Fiscal 2005 was a year of progress as well as challenges.

During a year where we had disappointing top line results, we still delivered solid earnings and focused on creating value for our shareholders by repurchasing 99 million shares for $2 billion and doubling our dividend. We continued to improve our financial strength and ended the year with $3 billion of cash and investments. And we made notable progress against our longer term growth initiatives, including the launch of Forth & Towne and the development of an entirely new e-commerce platform.

We fully recognize, however, that our long-term success depends on growing our top line. Gap Inc.'s Board of Directors is highly aligned in the priority of supporting management to improve the business and generate revenue growth over time.

Gap Inc.'s heritage is based on connecting with people through great style and experiences—and by making cultural connections along the way.

Under the leadership of Paul Pressler, Gap Inc. has built a strong foundation. We are a more disciplined and well-managed company today and the Board remains confident that this foundation is a competitive advantage as we work to re-connect with customers across each of our brands.

I am pleased with the progress the Board has made over the past year—both from a governance perspective and as the governing body of this company. We are a diverse group with experience that spans disciplines, industries and geographies. Even with such varied experiences, I believe the Board works well together—and is asking the tough questions necessary to challenge and guide management in the best interest of our shareholders.

In 2005, the Board maintained its commitment to continually evolve and adopt appropriate governance best practices. For example, we adopted a majority vote guideline for director elections—and we continued our proactive approach to be transparent in compensation disclosure. In addition to providing a director compensation table, we are including a CEO tally sheet in this years' proxy statement. We have also approved an improved pay-for-performance bonus structure for executives across the organization.

I'd like to personally thank the Board for its ongoing contributions and commitment. More detail on Gap Inc.'s Board of Directors is available on page 62.

My experience at Gap Inc. now spans more than two decades and I've seen many ups and downs in the business. Clearly, it is more rewarding for our shareholders when the product offering is resonating with customers. The Board and I feel strongly that Gap Inc. has the leadership, talent, systems and financial strength to return to our position as a leader in providing customers with the product and experience they expect from our brands. This will be the key to re-establishing top line growth and driving long-term shareholder value.

Paul S. Pressler
President and
Chief Executive Officer

letter to shareholders

None of us is satisfied with our overall 2005 business performance—we know we can do better. Building on our foundation of iconic brands, strong balance sheet, solid operations and talented people, we are aggressively taking actions to win back the customers we've disappointed.

Despite disappointing top line results, we have continued to focus on creating value for our shareholders. In 2005, we generated nearly $1 billion in free cash flow,* enabling us to complete a $2 billion share repurchase program and double our dividend to 18 cents per share. Reflecting our ongoing confidence in generating strong cash flow, we plan to continue our share repurchase program and increase our dividend to 32 cents per share in 2006.

Building a strong platform for growth

Just five years ago, Gap Inc. faced one of the most challenging periods in its history. Over the past three years, I'm proud that we have set the company on a course for sustainable, long-term health.

We strengthened our balance sheet, eliminating $2.9 billion in debt since 2002 and ending 2005 with $3 billion in cash and investments. We improved our operations by developing stronger relationships with sourcing vendors; building a consumer insights capability; optimizing our store fleets; and incorporating more disciplined inventory management.

In 2005, we continued to build on these operational improvements, reducing our sourcing vendor base by 10 percent; creating a new customer experience survey for all brands; closing more than 100 underperforming Gap stores; and allocating Gap and Old Navy's product sizes based on each store's unique selling history.

*See the reconciliation of free cash flow, a non-GAAP financial measure, to a GAAP measure in the table on page 13.

Most notably, this past year we built completely new online systems, resulting in what The New York Times reported are among the best e-commerce sites in retail. And we continue to receive feedback from customers that these changes have significantly improved their online shopping experience.

These operational improvements have built a strong foundation for our long-term growth strategies. And in 2005, we made great progress on key growth initiatives.

First, Gap Inc.'s square footage increased 3 percent in 2005, driven by store growth at Old Navy. We will continue to open new Old Navy stores in 2006.

Second, we expanded our brands internationally, opening an additional 13 Gap stores and introducing Banana Republic in Japan. To help us become more relevant to customers in each market, we built local merchandising and marketing teams, as well as a dedicated international design team. We also developed an international franchising capability, allowing our brands to enter smaller, more fragmented markets. Our first agreements include planned expansion to Singapore and Malaysia beginning in 2006.

Finally, we successfully launched our fourth brand, Forth & Towne, in Chicago and New York, filling a need in the marketplace to better serve boomer women. We've received consistent feedback from customers thanking us for the exceptional service, dependable fits and great style. We look forward to bringing Forth & Towne to four to five additional U.S. markets in 2006.

While we are proud of these accomplishments, we were disappointed with our 2 percent decline in net sales and 5 percent decline in comparable store sales in 2005. Reflecting on the past several quarters, as we made necessary shifts to ensure the company's long-term success, at times this created short-term distractions for our teams. Today our teams understand that, most importantly, we must offer inspiring product.

Reconnecting with our customers

Our iconic brands continue to be our greatest assets. Women's Wear Daily named Old Navy and Gap the most recognizable brands in sportswear in 2005. We've built a tremendous loyalty with our customers, which has helped us weather the ups and downs inherent in the fashion industry. To win back the customers we've disappointed, we will deliver great product, supported by effective marketing and compelling store experiences.

Gap is focused on re-establishing the brand's iconic positioning. Our product design is true to Gap's heritage and will help us regain our authority in key categories. We developed a new store design to improve the customer experience, and began rolling it out across the fleet.

And, most importantly, we put strong leaders in place to drive Gap's turnaround. In 2006, the team is focused on creating quality product faster, upgrading the environment of our top 200 adult stores, and developing inventive marketing to create buzz that Gap is back.

Banana Republic's affordable luxury positioning clearly differentiates the brand in the market. Our customers expect to find their wardrobe essentials at Banana Republic; so in 2006, we are emphasizing key items and more approachable fashion in our product assortments. We are also evolving our marketing to better reflect this focus. The launch of Banana Republic's high-quality handbag collection has been very successful, and is an example of how we'll continue to extend the brand. In 2006, we look forward to introducing a personal care line through an exclusive partnership with Inter Parfums, Inc.

Ultimately, it's the passion and commitment of our people that will drive our results and help us realize our long-term vision.

At Old Navy, value remains an important part of the brand proposition, but our customers also expect to find special, trend-right product. Delivering on this proposition requires that we develop product in a shorter time frame so we can quickly react to customer response and market trends. Now that Old Navy's designers are based in San Francisco, they're working more dynamically with the merchandising and production teams on a daily basis. And they're traveling to factories to make decisions more quickly and gain visibility to new innovations. To better showcase Old Navy's specialty product, in 2006 we will be upgrading our stores' visual merchandising, supported by the kind of creative marketing that helped make the brand famous.

Investing in our people and our communities

We remain committed to attracting, developing and retaining top talent in our industry. In 2005, we launched a new executive development program and we are also investing in leadership training for new managers. We have re-organized some of our teams to support more effective ways of working. In some cases, this has required bringing in new leaders who have the unique abilities to drive our turnaround, reinvigorate the creative spirit of our brands and harness the ideas of our teams. Our people always have been and will continue to be the heart of our company.

Our more than 150,000 employees around the world share common values, including a commitment to giving back to our communities. Gap Inc. employees volunteered nearly 155,000 hours last year to benefit charitable causes. Following the devastating hurricanes along the U.S. Gulf Coast, the company and our employees committed more than $5 million to relief efforts. This included Old Navy's shopping spree events, which helped nearly 15,000 kids who were displaced in the disaster replace some of what they lost.

The elimination of trade quotas in 2005 created a dramatic shift in our industry, as retailers now have the opportunity to consolidate their sourcing base. We are collaborating with other stakeholders to help manage the impact of this shift on economically challenged regions.

We will continue to support global efforts that promote economic development, improve factory conditions and help ensure healthy communities where we do business.

Driving our turnaround and realizing our vision

While 2005 was a challenging year, we are energized by the fact that the issues we face today are fixable. We know what needs to be done to be successful, and our teams are taking actions to improve. When our strategies take hold, we will gain tremendous leverage from the strong foundation we've built.

Supporting our vision to be the global leader in specialty apparel retailing, we will continue to reach new customers through our growth strategies:

- First, building and growing our lifestyle brands through real estate expansion and brand extensions;
- Second, expanding our brands internationally, exploring opportunities in China, and pursuing franchising in smaller, more fragmented markets;
- Third, building our online business;
- And, finally, creating new brands.

Ultimately, it's the passion and commitment of our people that will drive our results and help us realize our long-term vision. In a lot of ways, the shifts we're making today feel very natural for us: creating compelling stories through product and store experiences is the essence of our DNA. Gap Inc.'s culture is creative and fast-paced, rooted in a willingness to drive change quickly. We're all here today because we believe in the power of our brands and the future of our company.

I'm confident that our ongoing commitment to improving our core businesses, building our operating capabilities and pursuing our growth strategies will create long-term value for our shareholders.

GAP

At its core, Gap has always been about simplicity, style and emotion. In 2005, we came back to this ideal as we laid the foundation for re-establishing the brand.

We brought in seasoned executives, designers and merchants to lead the adult, kids, baby, accessories and body businesses.

And we made product our top priority. Our customers have always looked to Gap as their source for updated, casual classics—T-shirts, hoodies, great-fitting pants and, of course, denim. As part of our focus to deliver great product we're continuing to innovate. Last year, we introduced three new women's jeans fits and launched a super-soft denim line called Left Weave.

We are re-establishing the essence of our brand by building on our heritage and the strong appeal that has made Gap a cultural icon.

To improve our customer experience, we piloted a remodeled Gap store environment last spring, featuring enhanced lighting, new fixtures and a destination for denim. In 2006, we will continue to roll-out this new store design, and upgrade our top 200 adult stores.

Expanding Gap's global presence and customer base remains an important part of our long-term growth strategy. We opened an additional 17 stores internationally in 2005, and now operate about 250 Gap stores in the UK, Japan and France.

At Gap, we've always believed that how we do business is as important as what we do. In January Gap announced a partnership with PRODUCT (RED), an organization founded by Bono and Bobby Shriver dedicated to finding sustainable ways to fight HIV/AIDS in Africa through the Global Fund. As part of this business initiative, selected Gap stores around the world will sell a special collection of (RED) product with a portion of profits benefiting programs that fight HIV/AIDS. By connecting our business practices, the needs of our customers and our commitment to supporting the communities in which we do business, (RED) represents a uniquely Gap way to make a difference.

In all, we took important steps in 2005 to re-connect with our customers. Making continual progress to improve our product, marketing and store experience, we're confident we can deliver the Gap our customers know and love.

BANANA REPUBLIC

For millions of men and women, Banana Republic has come to define affordable luxury. By putting quality, details and fabrications like silk, cashmere and suede within reach of our customers, we helped an entire generation expect more from their wardrobes.

Banana Republic offers elevated design and luxurious fabrications at affordable prices.

And we remain committed to delivering versatile collections that offer covetable, uncomplicated style for the work and casual occasions of our customers' lives.

In 2005 we focused on bringing our distinct point of view to every aspect of our brand. Like our products, Banana Republic stores look luxurious while feeling approachable. From original works of art and unique architectural elements to superior service, we continue to find new ways to enhance the shopping experience.

We also simplified how we talk to our customers by sending clear, bold messages through window displays, visual merchandising and other marketing avenues. Our spring advertising campaign highlights our direction: The black and white images are modern and artful—and unmistakably Banana Republic. We also found compelling ways to connect with customers and create buzz in 2005—such as our sponsorships of Bravo Network's *Project Runway* and Sony Film's *Memoirs of a Geisha*.

As a lifestyle brand, Banana Republic is pursuing several exciting growth opportunities. We launched a collection of high-quality, Italian leather handbags this spring and see great potential in this business. We also laid the groundwork for extending our brand through personal care and are re-launching an entire line of personal care products later this year, co-developed with our industry-leading partner, Inter Parfums.

Banana Republic continued reaching new customers in 2005. Based on demand from our petite customers, we began testing stand-alone petite stores in Boston, Los Angeles, Seattle, St. Louis and Washington, D.C. We also introduced Banana Republic in Japan, opening six new stores.

Looking forward, Banana Republic will continue to deliver on our creative reputation and our brand promise of affordable luxury for men and women.

OLD NAVY

Great fashion at a great price in a fun shopping environment is the hallmark of Old Navy.

But in competing specifically against value-based retailers in 2005, we had to strengthen our price offering and communicate more aggressively. As a result, our product and merchandising became less differentiated in the eyes of our customers.

This year, we're readjusting that balance and reinvigorating our product, store experience and marketing.

This renewed focus on our specialty proposition is inspiring our merchants to bring a strong point of view to our stores through more on-trend product assortments.

Great fashion at a great price in a fun shopping environment is the hallmark of Old Navy.

For instance, we launched Old Navy Special Edition denim during the holidays to meet the increasing customer demand for uniquely styled jeans. Today, our denim products feature better washes, details and embroidery.

We are further highlighting our great product through an improved in-store experience and creative marketing.

In order to better showcase product and make our stores easier to shop, we reduced the number of signs in our stores and are also replenishing merchandise more quickly.

During the year, we expanded our marketing mix to include new in-store promotions, such as our famous "Scratcher" games, that helped bring customers—and fun—to Old Navy stores.

We also continued to reach out to new customers by rolling out Old Navy Maternity to more than 100 stores, improving our plus-size offerings, and opening more than 70 new stores in the United States and Canada.

Although it will take some time to see results, we're working hard to get these elements right. For us, there's nothing better than bringing fun, fashion and value to the whole family.

FORTH & TOWNE

Over 36 years, Gap Inc. launched and grew three of the most recognized brands in apparel. Last fall, we added one more name to our portfolio: Forth & Towne.

Targeting women over 35, Forth & Towne was a concept whose time had come: We conducted a two-year study of the U.S. apparel market, and discovered enormous potential for a brand dedicated to serving boomer women. More importantly, we talked extensively to customers we knew well: women who grew up shopping Gap, Banana Republic and Old Navy.

Our history and expertise is in developing great brands—and we feel well-positioned to offer great style in a beautiful, comfortable setting for this important customer segment.

Their feedback about what they wanted—from fit and style to comfort and convenience—is the basis and guiding inspiration for Forth & Towne.

Our new brand offers all these elements under one roof, which we feel clearly differentiates Forth & Towne in the marketplace. Upon our launch last fall, we received overwhelmingly positive response. The product was what customers had asked for: stylish, age-appropriate pieces that fit well and that allow them to express their femininity and individuality.

Offering four separate brands in one intimate shopping space, each collection is tailored to a different facet of our customer's busy lifestyle, from work and going out to casual occasions and weekend activities.

Allegory features classics with a twist for women who appreciate a traditional look: tailored pants, beautifully cut blazers, refined sweaters. For the woman who grew up with Gap, **Gap Edition** offers casual sportswear that's youthful, optimistic and age appropriate. **Vocabulary** offers eclectic and unique style, with embellished and decorative pieces for the individualist. **Prize** is designed for a woman who's fashion-conscious, offering wearable trends in flattering silhouettes.

The store experience was a critical area of focus as we developed Forth & Towne. For instance, at the center of each store is a beautiful fitting salon. Spacious and inviting, each room features three-way mirrors, adjustable lighting and fashion accessories within easy reach.

With four stores in Chicago and one in New York, Forth & Towne has received great customer response, and we look forward to expansion in four to five additional markets this year.

Gap Inc. has a proven history of building enduring, iconic brands and we are proud to continue that legacy with Forth & Towne.

gap inc. direct

Gap Inc. Direct—with its gap.com, bananarepublic.com and oldnavy.com websites—is one of the largest online apparel retailers in the U.S. In 2005, Gap Inc. Direct generated close to $600 million in net sales.

Our websites extend the reach of our brands by offering an easy way for customers to shop. And in 2005 we developed an entirely new e-commerce platform and redesigned our websites — offering an even more convenient and interactive shopping experience for our customers.

During 2005, we embarked on a major project to improve the online shopping experience for customers.

Customers have responded positively to the innovative tools and new features launched last fall. For example, shoppers can now quickly view size availability and add items to their bag without leaving the webpage they are browsing. We know that about one-third of our customers like to preview our merchandise online before visiting our stores. So we created a more interactive experience for pre-shoppers, including a feature that highlights outfit recommendations.

Following the launch, we saw an increase in traffic, sales and customer satisfaction across all three sites. Our new e-commerce platform successfully handled its highest volume ever and online sales grew 20 percent during the fourth quarter of 2005.

The investments we made last year will lay the foundation for future innovation and online growth at Gap Inc. In 2006, we'll continue to launch new features to enhance the online shopping experience for our customers.

social responsibility

In 2005, we approached our social responsibility efforts with the same level of energy and commitment that we applied to other aspects of our business, investing generously in a variety of programs that are helping to strengthen both our company and the many communities we serve.

Creating Better Working Conditions in Garment Factories

As a major apparel retailer, improving working conditions in garment factories approved to do business with us continues to be one of our top priorities.

Our team of factory monitors, which remains among the largest in the apparel industry, personally inspected 96% of the factories authorized for Gap Inc. production for all of last fiscal year. The team also underwent extensive training to improve its ability to find violations, such as discrimination, that have historically been hard to detect.

Through organizations such as the MFA Forum, the Ethical Trading Initiative (ETI) and Social Accountability International (SAI), we continued working with partners from the private, government and non-governmental sectors to address some of the garment industry's most intractable challenges, such as the need for a universal set of labor standards.

And perhaps most important, we took another step toward building labor standards directly into our business practices by piloting our new integrated Vendor Scorecard, which will enable our sourcing team to consider labor standards along with factors such as speed and quality when determining where to place orders.

Building Stronger Communities

In addition to our work in garment factories last year, we used our unique reach and assets to provide help and hope to communities in need around the globe.

Here in the United States, Gap Inc. contributed more than $5 million in cash and clothing to hurricane relief efforts. In addition to providing immediate assistance to 1,300 employees, we created Old Navy's Field Trip 4 Fun, which offered fun-filled shopping sprees in Old Navy stores to nearly 15,000 kids who were displaced or otherwise affected by the storms.

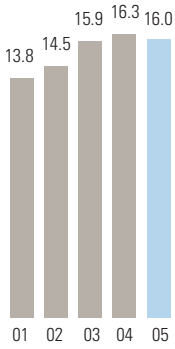
And more than a year after the tsunami struck in Southeast Asia, Gap Inc. employees on the ground in Sri Lanka, India and other countries in the region continued to work with local governments and relief organizations to address basic needs and administer the $2.3 million donation we made in 2004.

In total, Gap Inc. made more than $23 million in cash and in-kind contributions last year, while employees donated approximately 155,000 hours of their time to causes they care about.

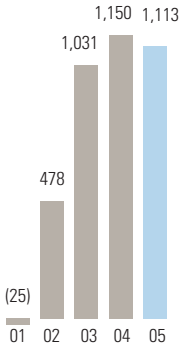
Protecting the Environment

In 2005, we announced our goal as a voluntary member of the U.S. EPA's Climate Leaders program to reduce greenhouse gas emissions by 11 percent per square foot between 2003 and 2008. We also continued working with suppliers to monitor wastewater from laundry facilities against the apparel industry's voluntary water quality guidelines.

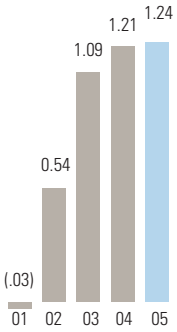
financial highlights



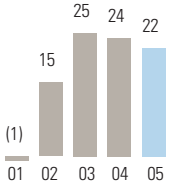
NET SALES
(in billions of dollars)



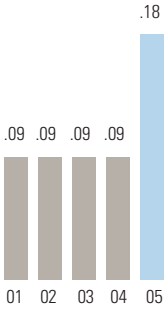
NET EARNINGS (LOSS)
(in millions of dollars)



EARNINGS (LOSS) PER SHARE–DILUTED
(in dollars)



RETURN ON AVERAGE SHAREHOLDERS' EQUITY
(percent)



DIVIDENDS PAID PER SHARE
(in dollars)

NET SALES PER AVERAGE GROSS SQUARE FOOT*
(in dollars)
*52-week basis

key financial statistics

	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Operating Results (in millions)			
Net sales	$ 16,023	$ 16,267	$ 15,854
Percentage change year-to-year	(2%)	3%	10%
Earnings before income taxes	$ 1,793	$ 1,872	$ 1,684
Percentage change year-to-year	(4%)	11%	110%
Net earnings	$ 1,113	$ 1,150	$ 1,031
Percentage change year-to-year	(3%)	12%	116%
Cash Flows (in millions)			
Net cash provided by operating activities	$ 1,551	$ 1,597	$ 2,160
Net cash provided by (used for) investing activities	286	183	(2,318)
Net cash used for financing activities	(2,040)	(1,796)	(636)
Effect of exchange rate fluctuations on cash	(7)	-	28
Net decrease in cash and equivalents	$ (210)	$ (16)	$ (766)
Net cash provided by operating activities	$ 1,551	$ 1,597	$ 2,160
Less: Net purchases of property and equipment	(600)	(419)	(261)
Free cash flow (a)	$ 951	$ 1,178	$ 1,899
Per Share Data			
Net earnings--diluted	$ 1.24	$ 1.21	$ 1.09
Dividends paid	0.18	0.09	0.09
Statistics			
Net earnings as a percentage of net sales	6.9%	7.1%	6.5%
Return on average assets	11.8%	11.1%	9.8%
Return on average shareholders' equity	21.5%	24.0%	25.2%
Current ratio	2.70:1	2.81:1	2.63:1
Number of store locations open at year-end	3,053	2,994	3,022
Comparable store sales increase (decrease) percentage	(5%)	0%	7%

(a) Free cash flow is a non-GAAP measure. We believe free cash flow is an important metric, as it represents a measure of how profitable a company is on a cash basis after the deduction of capital expenses, as most companies require capital expenditures to build and maintain stores and purchase new equipment to keep the business growing. We use this metric internally, as we believe our sustained ability to grow this measure is an important driver of value creation.

gap inc. financials 2005

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FIVE-YEAR SELECTED DATA

The following selected financial data are derived from the Consolidated Financial Statements of Gap Inc. (the "Company"). The data set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Company's Consolidated Financial Statements and notes herein.

	Fiscal Year (in weeks)				
	2005 (52)	2004 (52)	2003 (52)	2002 (52)	2001 (52)
Operating Results ($ in millions)					
Net sales	$ 16,023	$ 16,267	$ 15,854	$ 14,455	$ 13,848
Cost of goods sold and occupancy expenses	10,154	9,886	9,885	9,541	9,733
Gross margin	36.6%	39.2%	37.6%	34.0%	29.7%
Operating expenses, excluding loss on early retirement of debt	$ 4,124	$ 4,296	$ 4,068	$ 3,901	$ 3,806
Loss on early retirement of debt	-	105	21	-	-
Operating margin (a)	10.9%	12.2%	11.9%	7.0%	2.2%
Net interest (income) expense (b)	$ (48)	$ 108	$ 196	$ 212	$ 96
Earnings before income taxes	1,793	1,872	1,684	801	213
Percentage of net sales	11.2%	11.5%	10.6%	5.5%	1.5%
Income taxes	$ 680	$ 722	$ 653	$ 323	$ 238
Net earnings (loss)	1,113	1,150	1,031	478	(25)
Percentage of net sales	6.9%	7.1%	6.5%	3.3%	(0.2%)
Cash dividends paid	$ 179	$ 79	$ 79	$ 78	$ 76
Purchase of property and equipment	600	419	261	308	1,026
Depreciation and amortization	625	615	675	706	741
Per Share Data					
Net earnings (loss)-basic	$ 1.26	$ 1.29	$ 1.15	$ 0.55	$ (0.03)
Net earnings (loss)-diluted	1.24	1.21	1.09	0.54	(0.03)
Dividends paid (c)	0.18	0.09	0.09	0.09	0.09
Shareholders equity (book value)	6.16	5.53	5.21	4.03	3.35
Financial Position ($ in millions, except per square foot data)					
Property and equipment, net	$ 3,246	$ 3,376	$ 3,626	$ 4,069	$ 4,487
Merchandise inventory	1,696	1,814	1,704	2,048	1,769
Total assets	8,821	10,048	10,713	10,283	8,096
Inventory per square foot (d)	43	48	45	53	47
Inventory per square foot (decrease) increase	(11%)	6.2%	(15.5%)	13.5%	(20.3%)
Working capital	$ 3,297	$ 4,062	$ 4,156	$ 2,972	$ 1,018
Current ratio	2.70:1	2.81:1	2.63:1	2.08:1	1.48:1
Total long-term debt and senior convertible notes, less current maturities (b)	$ 513	$ 1,886	$ 2,487	$ 2,896	$ 1,961
Ratio of long-term debt and senior convertible notes to shareholders' equity (e)	0.09:1	0.38:1	0.54:1	0.82:1	0.68:1
Shareholders' equity	$ 5,425	$ 4,936	$ 4,648	$ 3,526	$ 2,880
Return on average assets	11.8%	11.1%	9.8%	5.2%	(0.3%)
Return on average shareholders' equity	21.5%	24.0%	25.2%	14.9%	(0.9%)
Statistics					
Number of new store locations opened	198	130	35	115	324
Number of store locations closed	139	158	130	95	75
Number of store locations open at year-end	3,053	2,994	3,022	3,117	3,097
Net increase (decrease) in number of store locations	2%	(1%)	(3%)	1%	9%
Comparable store sales increase (decrease) percentage (52-week basis)	(5%)	0%	7%	(3%)	(13%)
Sales per square foot (52-week basis) (f)	$ 412	$ 428	$ 415	$ 378	$ 394
Square footage of store space at year-end	37,765,229	36,590,929	36,518,204	37,251,520	36,333,392
Percentage increase (decrease) in square feet	3%	0%	(2%)	3%	16%
Number of employees at year-end	153,000	152,000	153,000	169,000	165,000
Weighted-average number of shares-basic	881,057,753	893,356,815	892,554,538	875,545,551	860,255,419
Weighted-average number of shares-diluted	902,305,691	991,121,573	988,177,828	881,477,888	860,255,419
Number of shares outstanding at year-end, net of treasury stock	856,985,979	860,559,077	897,202,485	887,322,707	865,726,890

(a) Operating margin includes loss on early retirement of debt.
(b) Fiscal 2005 reduction due primarily to the March 2005 redemption of our Senior Convertible Notes. See Note B to the Consolidated Financial Statements.
(c) Fiscal 2005 dividend per share does not include a dividend of $.0222 per share declared in the fourth quarter of fiscal 2004 but paid in the first quarter of fiscal 2005.
(d) Based on year-end store square footage and inventory balances; excludes inventory related to online sales.
(e) Long-term debt includes current maturities.
(f) Based on monthly average store square footage.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Of Financial Condition and Results of Operations

Our Business

We are a global specialty retailer operating retail and outlet stores selling casual apparel, accessories, and personal care products for men, women and children under the Gap, Banana Republic, Old Navy, and Forth & Towne brand names. We operate stores in the United States, Canada, the United Kingdom, France and Japan. In addition, our U.S. customers may shop online at gap.com, bananarepublic.com and oldnavy.com. We design virtually all of our products, which are manufactured by independent sources, and sell them under our brands:

Gap. Founded in 1969, Gap stores offer extensive selections of classically styled, high quality, casual apparel at moderate price points. Products range from wardrobe basics such as denim, khakis and T-shirts to fashion apparel, accessories and personal care products for men and women, ages teen through adult. We entered the children's apparel market with the introduction of GapKids in 1986 and babyGap in 1989. These stores offer casual apparel and accessories in the tradition of Gap style and quality for children, ages newborn through pre-teen. We launched GapBody in 1998 offering women's underwear, sleepwear, swimwear and personal care products.

Old Navy. We launched Old Navy in 1994 to address the market for value-priced family apparel. Old Navy offers broad selections of apparel, shoes and accessories for adults, children and infants as well as other items, including personal care products, in an innovative, exciting shopping environment. Old Navy also offers a line of maternity and plus sizes in its stores.

Banana Republic. Acquired in 1983 with two stores, Banana Republic now offers sophisticated, fashionable collections of dress-casual and tailored apparel, shoes and accessories for men and women at higher price points than Gap. Banana Republic products range from apparel, including intimate apparel, to personal care products.

Forth & Towne. We opened the first stores of our newest retail concept in August 2005, targeting women over the age of 35. Forth & Towne offers customers smart, fashionable clothing and accessories tailored to a range of lifestyles. Forth & Towne offers great style and a dependable fit, along with a beautiful setting and exceptional service.

Online. We established Gap Online, a web-based store located at www.gap.com, in 1997. Products comparable to those carried in Gap, GapKids and babyGap stores can be purchased online. Banana Republic introduced Banana Republic Online, a web-based store located at www.bananarepublic.com, in 1999, which offers products comparable to those carried in the store collections. In 2000, we established Old Navy Online, a web-based store located at www.oldnavy.com. Old Navy Online also offers apparel and accessories comparable to those carried in the store collections. Our online businesses are offered as an extension of our store experience and are intended to strengthen our relationship with our customers.

Overview

In fiscal 2005, we made continued progress against our strategic priorities and continued to position ourselves for long-term growth. Despite disappointing top line results, we continued to deliver solid earnings, completed our $2 billion share repurchase program, doubled our dividend, and delivered on our growth initiatives. We successfully launched Forth & Towne, introduced Banana Republic in Japan, developed a franchising capability, and introduced a new e-commerce platform.

We delivered an increase in diluted earnings per share from $1.21 per share to $1.24 per share. However, continued product acceptance challenges leading to additional promotions and markdowns resulted in a 3 percent decrease in net earnings from $1.2 billion to $1.1 billion in 2005.

We have also continued to generate strong free cash flow and in fiscal 2005 our free cash flow was $951 million, which represented 85% of fiscal 2005 net earnings and reflects our ability to generate solid earnings. We define free cash flow as the net cash provided by operating activities less the purchase of property and equipment. For a reconciliation of free cash flow, a non-GAAP measure, to a GAAP measure, see the Liquidity section in this Management's Discussion and Analysis. Our solid earnings and healthy balance sheet yielded higher capital returns. Our return on average assets increased from 11.1 percent in fiscal 2004 to 11.8 percent in fiscal 2005.

Our Consolidated Balance Sheet remains strong as we ended the year with $3.0 billion in cash and short–term investments. We called our $1.4 billion convertible notes on March 11, 2005, leaving only $513 million in debt remaining on our balance sheet as of January 28, 2006. In 2005, we regained our Investment Grade rating from both Standard & Poor's and Moody's.

During 2005, we returned excess cash to shareholders by repurchasing 99 million shares for $2.0 billion and paying dividends of $0.18 per share to our shareholders. Cash distribution to shareholders will continue to play an important role in delivering shareholder returns; however, our first priority for excess cash is investing in our business in a way that meets or exceeds our return criteria. We are committed to maintaining sufficient cash on the balance sheet to support the needs of our business and withstand unanticipated business volatility. Therefore, we currently plan to keep about $2 billion of cash available. Our view on the appropriate level of available cash will change over time to reflect the changing needs of our business.

We intend to continue to deliver shareholder value through our plans to increase dividends and share repurchases in fiscal 2006. In line with this goal, we announced our plan to increase our cash dividend to $0.32 per share for fiscal 2006. Additionally, on February 23, 2006, we announced that our board of directors has authorized an additional $500 million for our share repurchase program. Our actions reflect our confidence in our ability to continue generating strong cash flow.

Our cash balances combined with our cash flow are sufficient to support our shareholder distributions and strategic growth initiatives. Our real estate strategy in fiscal 2006 includes plans to open about 175 new stores, weighted more toward Old Navy. We also plan to close about 135 stores in fiscal 2006, mainly from Gap brand in North America, as part of our strategy to optimize our real estate fleet. Most store closures will occur upon lease expiration. Our strategic initiatives include new international franchise and distribution agreements to expand Gap and Banana Republic into markets in which we do not operate. These growth strategies and initiatives will negatively impact operating expenses in fiscal 2006, but will position us to take advantage of future opportunities.

We expect operating margin to be about 10.0 percent to 10.5 percent and we also expect to generate at least $900 million in free cash flow. For a reconciliation of free cash flow, a non-GAAP measure, to a GAAP measure, see the Liquidity section in this Management's Discussion and Analysis. See the Forward-Looking Statements section below.

Looking forward, we remain committed to delivering shareholder value through cash distributions and operating performance. Our priorities for fiscal 2006 are clear. We are focused on developing improved product offerings supported by effective marketing and compelling store experiences. We will continue to pursue growth strategies including real estate expansion and brand extensions, expanding our brands internationally, building our world-class online business and creating new brands.

Forward-Looking Statements

This Annual Report 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," and similar expressions also identify forward-looking statements. Forward-looking statements include statements regarding: (i) the amount of cash available in the future; (ii) the amount and timing of dividends in fiscal 2006; (iii) our cash balances combined with our cash flow being sufficient to support our shareholder distributions and strategic growth initiatives; (iv) the number of new store openings and store closings in fiscal 2006, and weightings by brand; (v) the number of Gap store upgrades in fiscal 2006; (vi) the timing for Banana Republic's new personal care line in partnership with Inter Parfums; (vii) operating margin for fiscal 2006; (viii) free cash flow and free cash flow components in fiscal 2006; (ix) delivering shareholder value through cash distributions and operating performance; (x) pursuing growth strategies, including real estate expansion and brand extensions, expanding our brands internationally, building our online business and creating new brands; (xi) interest expense in fiscal 2006; (xii) effective tax rate for fiscal 2006; (xiii) year over year change in inventory per square foot at the end of the first quarter of fiscal 2006 and the second quarter of fiscal 2006; (xiv) capital expenditures in fiscal 2006, as well as methods for funding capital expenditures; (xv) net square footage change in fiscal 2006; (xvi) share repurchases in fiscal 2006; (xvii) the transition of certain aspects of our information technology infrastructure to IBM, and the timing and costs of that transfer; (xviii) our expectations regarding future indemnification liability; (xix) the maximum exposure and cash collateralized balance for reinsurance pool in future periods; (xx) the impact of new accounting pronouncements; (xxi) future lease payments and sublease income; and (xxii) the impact of proceedings, lawsuits, disputes and claims.

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 will be unsuccessful in gauging fashion trends and changing consumer preferences; the highly competitive nature of our business in the U.S. and internationally and our dependence on consumer spending patterns, which are influenced by numerous other factors; the risk that we will be unsuccessful in identifying and negotiating new store locations effectively; the risk that comparable store sales and margins will experience fluctuations; the risk that we will be unsuccessful in implementing our strategic, operating and people initiatives; the risk that adverse changes in our credit ratings may have a negative impact on our financing costs and capital structure in future periods; the risk that trade matters, events causing disruptions in product shipments from China and other foreign countries, or IT systems changes may disrupt our supply chain or operations; and the risk that we will not be successful in defending various proceedings, lawsuits, disputes, claims, and audits; any of which could impact net sales, costs and expenses, and/or planned strategies. 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 January 28, 2006.

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 March 17, 2006 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.

RESULTS OF OPERATIONS

In fiscal 2005, diluted earnings per share increased by $0.03 to $1.24 compared to $1.21 in fiscal 2004, while net earnings decreased 3 percent to $1.1 billion compared to net earnings of $1.2 billion in fiscal 2004. Operating margins decreased 1.3 percentage points to 10.9 percent in fiscal 2005, reflecting product acceptance challenges that resulted in increased promotions and markdowns.

Net Sales by Brand, Region and Channel

Net sales consist of retail sales, online sales and shipping fees received from customers for delivery of merchandise. Outlet retail sales are reflected within the respective results of each brand.

52 Weeks Ended January 28, 2006		Gap	Old Navy	Banana Republic	Other (3)	Total
Net Sales ($ in millions)						
North America (1)	Stores	$ 5,176	$ 6,588	$ 2,196	$ 5	$ 13,965
	Direct (Online)	233	268	91	3	595
Europe	Stores	825	-	-	-	825
Asia	Stores	603	-	14	-	617
Other (2)		-	-	-	21	21
Total		$ 6,837	$ 6,856	$ 2,301	$ 29	$ 16,023
Global Sales Growth (Decline)		(6%)	2%	1%	-	(2%)

52 Weeks Ended January 29, 2005		Gap	Old Navy	Banana Republic	Other (3)	Total
Net Sales ($ in millions)						
North America (1)	Stores	$ 5,510	$ 6,511	$ 2,178	$ -	$ 14,199
	Direct (Online)	236	236	91	-	563
Europe	Stores	879	-	-	-	879
Asia	Stores	591	-	-	-	591
Other (2)		24	-	-	11	35
Total		$ 7,240	$ 6,747	$ 2,269	$ 11	$ 16,267
Global Sales Growth (Decline)		(1%)	5%	9%	-	3%

52 Weeks Ended January 31, 2004		Gap	Old Navy	Banana Republic	Other (3)	Total
Net Sales ($ in millions)						
North America (1)	Stores	$ 5,557	$ 6,267	$ 2,013	$ -	$ 13,837
	Direct (Online)	220	189	77	-	486
Europe	Stores	861	-	-	-	861
Asia	Stores	610	-	-	-	610
Other (2)		57	-	-	3	60
Total		$ 7,305	$ 6,456	$ 2,090	$ 3	$ 15,854
Global Sales Growth		9%	11%	8%	-	10%

(1) North America includes the United States, Canada, and Puerto Rico.
(2) Other includes our International Sales Program and Germany. In August 2004, we sold our stores and exited the market in Germany.
(3) Other includes Forth & Towne, Business Direct and International Sales Program.

Net Sales

A store is included in comparable store sales ("Comp") when all three of the following requirements have been met: the store has been open at least one year, square footage has not changed by 15 percent or more within the past year, and the store has not been permanently repositioned within the past year. A store is included in Comp on the first day it has comparable prior year sales. Stores in which square footage has changed by 15 percent or more as a result of remodel, expansion, or reduction are excluded from Comp until the first day they have comparable prior year sales. Current year foreign exchange rates are applied to both current year and prior year Comp store sales to achieve a consistent basis for comparison.

A store is considered non-comparable ("Non-comp") when, in general, the store has no comparable prior year sales. For example, a store that has been open for less than one year, a store that has changed its square footage by 15 percent or more within the past year, or the store has been permanently repositioned within the past year is considered Non-comp. Non-store sales such as online operations are also considered Non-comp.

A store is considered "Closed" if it is temporarily closed for three or more full consecutive days or 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 then the store will be in "Non-comp" status for the same days in the following year.

52 Weeks Ended January 28, 2006	Gap (1)	Old Navy	Banana Republic	Other	Total
Increase (decrease) ($ in millions)					
2004 Net Sales	$ 7,240	$ 6,747	$ 2,269	$ 11	$ 16,267
Comparable store sales	(302)	(361)	(104)	-	(767)
Noncomparable store sales	(87)	409	130	15	467
Direct (Online)	(3)	32	-	3	32
Foreign exchange (2)	(11)	29	6	-	24
2005 Net Sales	$ 6,837	$ 6,856	$ 2,301	$ 29	$ 16,023

52 Weeks Ended January 29, 2005	Gap (1)	Old Navy	Banana Republic	Other	Total
Increase (decrease) ($ in millions)					
2003 Net Sales	$ 7,305	$ 6,456	$ 2,090	$ 3	$ 15,854
Comparable store sales	(76)	25	109	-	58
Noncomparable store sales	(155)	195	51	7	98
Direct (Online)	16	47	14	-	77
Foreign exchange (2)	150	24	5	1	180
2004 Net Sales	$ 7,240	$ 6,747	$ 2,269	$ 11	$ 16,267

(1) Includes Gap International.
(2) Foreign exchange is the translation impact of current year exchange rates versus current year sales at prior year exchange rates.

Our fiscal 2005 sales decreased $244 million, or 2 percent, compared to fiscal 2004. During fiscal 2005, our comparable store sales declined 5 percent compared to the prior year primarily due to weak traffic trends as a result of our products which did not perform to our expectations. In fiscal 2006 we continue to focus on improving our product in all brands, for each season. Our total noncomparable store sales increase was due to the 198 new store openings. Our overall net square footage increased 3 percent over the prior year. Sales productivity in fiscal 2005 was $412 per average square foot compared with $428 per average square foot in fiscal 2004. We closed 139 under-performing stores in fiscal 2005, mainly for Gap brand.

Our fiscal 2004 sales increased $413 million, or 3 percent, compared to fiscal 2003. Our first quarter performance was the strongest; however in the second half of fiscal 2004, our comparable store sales declined contributing to the relatively flat growth over the prior year, primarily driven by missed opportunities to better balance our holiday assortment with more traditional gift-giving products and challenges with the promotional environment among competitors in the retail market. Gap International comparable store sales were negatively impacted by weak product acceptance in Europe and Japan. Our total noncomparable store sales increase was due to the 130 new store openings, a majority of which occurred during the second half of the year. Our overall net square footage remained relatively flat. Sales productivity in fiscal 2004 improved to $428 per average square foot compared with $415 per average square foot in fiscal 2003. We closed 158 under-performing stores in fiscal 2004, mainly for Gap brand.

Comparable store sales percentage by brand for fiscal 2005 and 2004 were as follows:

- Gap North America reported negative 5 percent in 2005 versus positive 1 percent in 2004
- Old Navy North America reported negative 6 percent in 2005 versus flat in 2004
- Banana Republic North America reported negative 5 percent in 2005 versus positive 6 percent in 2004
- International reported negative 3 percent in 2005 versus negative 8 percent in 2004

Store count and square footage were as follows:

	January 28, 2006		January 29, 2005	
	Number of Store Locations	Sq. Ft. (in millions)	Number of Store Locations	Sq. Ft. (in millions)
Gap North America	1,335	12.6	1,396	13.0
Gap Europe	165	1.5	169	1.6
Gap Asia	91	1.0	78	0.8
Old Navy North America	959	18.4	889	17.3
Banana Republic North America	494	4.2	462	3.9
Banana Republic Japan	4	-	-	-
Forth & Towne	5	0.1	-	-
Total	3,053	37.8	2,994	36.6
Increase/(Decrease)	2%	3%	(1%)	0%

Cost of Goods Sold and Occupancy Expenses

Cost of goods sold and occupancy expenses include the cost of merchandise, inventory shortage and valuation adjustments, freight charges, costs associated with our sourcing operations, production costs, insurance costs related to merchandise and occupancy, rent, common area maintenance, real estate taxes, utilities, and depreciation for our stores and distribution centers.

Occupancy expenses are comprised of rent, depreciation and other occupancy-related expenses as noted above.

		52 Weeks Ended		Percentage of Net Sales 52 Weeks Ended		
($ in millions)	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004
Cost of Goods Sold and Occupancy Expenses	$ 10,154	$ 9,886	$ 9,885	63.4%	60.8%	62.4%

Cost of goods sold and occupancy expenses as a percentage of net sales increased 2.6 percentage points in fiscal 2005 compared with fiscal 2004. Our merchandise margin, calculated as net sales less cost of goods sold, decreased 2.2 percentage points, or $475 million, as product acceptance challenges drove additional promotions and markdowns. In addition, cost of goods sold decreased due to a reclassification of certain sourcing costs from operating expenses to cost of goods sold. While we had been classifying the majority of sourcing expenses in cost of goods sold, certain sourcing expenses had been classified in operating expenses and, as a result, approximately $42 million of year to date sourcing expenses, primarily comprised of payroll and benefit expenses for our wholly owned agent offices, were reclassified during fiscal 2005. As a percentage of sales, occupancy expenses increased compared to fiscal 2004 primarily due to the decrease in sales for stores that have been open for more than one year. In addition, occupancy expenses increased due to $50 million recognized in fiscal 2005 related to the amortization of key money paid to acquire the rights of tenancy in France. The increase was offset by a $19 million decrease in occupancy expenses from a lease accounting adjustment in the second quarter of fiscal 2005 to true-up amounts which were estimated in our fiscal 2004 financial statements. Prior to fiscal 2005, we considered key money an indefinite life intangible asset that was not amortized and in fiscal 2005, we determined that key money should more appropriately be amortized over the corresponding lease term and recorded $50 million of amortization expense representing the cumulative impact of amortizing our key money balance from fiscal 1995 through the end of fiscal 2005.

Cost of goods sold and occupancy expenses as a percentage of net sales decreased 1.6 percentage points in fiscal 2004 compared with fiscal 2003. Our merchandise margins increased 1.1 percentage points, or $390 million, due to enhanced product assortments supported by inventory management and use of sophisticated markdown optimization tools to assist us in forecasting the optimal timing and level of markdowns. We had a higher contribution of regular priced sales compared with fiscal 2003. We improved our leverage of our rent, occupancy and depreciation expenses by 0.5 percentage points in fiscal 2004 due to lower depreciation from a maturing fleet, reduced capital spending compared to historical levels and continual store fleet optimization combined with improved sales performance over the prior year. An increase in our direct (online) revenues also contributed to the improved leverage, as these sales do not incur store related rent, occupancy and depreciation expenses.

As a general business practice, we review our inventory levels in order to identify slow-moving merchandise and broken assortments (items no longer in stock in a sufficient range of sizes) and use markdowns to clear the majority of this merchandise.

Operating Expenses, Excluding Loss on Early Retirement of Debt

Operating expenses include payroll and related benefits (for our store operations, field management, distribution centers, and corporate functions), advertising, and general and administrative expenses. Also included are costs to design and develop our products, merchandise handling and receiving in distribution centers and stores, distribution center general and administrative expenses, and rent, occupancy, and depreciation for headquarter facilities.

	52 Weeks Ended			Percentage of Net Sales 52 Weeks Ended		
($ in millions)	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004
Operating Expenses, Excluding Loss on Early Retirement of Debt	$ 4,124	$ 4,296	$ 4,068	25.7%	26.4%	25.7%

Operating expenses as a percentage of net sales decreased 0.7 percentage points, or $172 million, in fiscal 2005 compared with fiscal 2004. The decrease was primarily driven by a $61 million net reversal of sublease loss reserve in the second quarter of fiscal 2005 and the reclassification of certain sourcing expenses. While we have been classifying the majority of sourcing expenses in cost of goods sold and occupancy expenses, some operating costs related to certain wholly owned agent offices that source our product had been classified in operating expenses. As a result, approximately $42 million of year to date sourcing expenses were reclassified in fiscal 2005. This reclassification had no effect on net earnings. Lower advertising expenses primarily driven by our decision not to run a holiday television campaign at Gap brand and lower bonus expense related to fiscal 2005 performance also contributed to the decrease in operating expenses.

Operating expenses as a percentage of net sales increased 0.7 percentage points, or $228 million, in fiscal 2004 compared with fiscal 2003. The increase was primarily due to higher store payroll and benefits to support increased sales, planned increases for new growth initiatives and increased advertising expenses. Gap North America ran incremental television campaigns compared to the prior year and Old Navy increased its circulars to promote sales.

Operating margin, excluding loss on early retirement of debt, was 10.9 percent, 12.8 percent, and 12.0 percent in fiscal 2005, 2004 and 2003, respectively. For fiscal 2006, we expect operating margin to be about 10.0 to 10.5 percent, including the impact of the adoption of SFAS 123(R).

Included in operating expenses are costs related to store closures and sublease loss reserves. The following discussion should be read in conjunction with Note E to the Consolidated Financial Statements.

During the second fiscal quarter of 2005 we completed our assessment of available space and future office facility needs and decided that we would occupy one of our vacant leased properties in San Francisco. As a result, in the same quarter the sublease loss reserve of $58 million associated with this space at April 30, 2005 was reversed and planning efforts to design and construct leasehold improvements for occupation in 2006 began. We further reduced the reserve by $3 million based on our decision to occupy certain additional office space.

In prior years, we considered our headquarter facilities' space needs and identified and abandoned excess facility space. As a result of these actions, we recorded sublease loss charges of $77 million in fiscal 2002. During fiscal 2004 and 2003, due to continued weakness in the commercial real estate market, we revised our sublease income and sublease commencement projections and assumptions related to headquarter facilities in our San Francisco and San Bruno campuses and recorded additional sublease loss charges of $5 million and $9 million, respectively.

In August 2004, we sold our stores and exited the market in Germany. In fiscal 2003, we recognized a charge to operating expense of $14 million for asset write-downs. The actual net selling price approximated our initial estimate. This decision represented a strategic move toward re-allocating our international resources to optimize growth in our other existing markets and focusing our attention on more attractive, longer-term growth opportunities in new markets.

Loss on Early Retirement of Debt

	52 Weeks Ended			Percentage of Net Sales 52 Weeks Ended		
($ in millions)	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004
Loss on Early Retirement of Debt	$ -	$ 105	$ 21	-	0.6%	0.1%

In line with our fiscal 2004 objective of reducing long-term debt, we reduced our outstanding debt by repurchasing $596 million of domestic debt in advance of its scheduled maturity date during fiscal 2004. We performed a net present value analysis on our outstanding debt and determined that it would be beneficial to repurchase the debt early even though we incurred $105 million in loss on early retirement of debt due to premiums paid and write-off of issuance costs. During fiscal 2003, we incurred $21 million in loss on early retirement of debt for the repurchase of €23 million of our euro bond ($27 million) and the repurchase of $141 million of domestic debt.

Interest Expense

	52 Weeks Ended			Percentage of Net Sales 52 Weeks Ended		
($ in millions)	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004
Interest Expense	$ 45	$ 167	$ 234	0.3%	1.0%	1.5%

The decrease of $122 million in interest expense for fiscal 2005, compared with fiscal 2004, was primarily due to the lower debt level as a result of our March 2005 redemption of the convertible notes, debt repurchases, and scheduled debt maturity.

The decrease of $67 million in interest expense for fiscal 2004, compared with fiscal 2003, was primarily due to the lower debt balances resulting from our debt repurchases and scheduled debt maturity as well as savings from lower facility fees on our new credit facility.

We anticipate that fiscal 2006 interest expense will be about $40 million.

Interest Income

	52 Weeks Ended			Percentage of Net Sales 52 Weeks Ended		
($ in millions)	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004
Interest Income	$ 93	$ 59	$ 38	0.6%	0.4%	0.2%

The continued increase in interest income is primarily due to a rising interest environment, which resulted in higher yields on our investments.

Income Taxes

	52 Weeks Ended			Percentage of Net Sales 52 Weeks Ended		
($ in millions)	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004	Jan. 28, 2006	Jan. 29, 2005	Jan. 31, 2004
Income Taxes	$ 680	$ 722	$ 653	4.2%	4.4%	4.1%
Effective tax rate	37.9%	38.6%	38.8%			

The decrease in the effective tax rate in fiscal 2005 from fiscal 2004 is primarily driven by the impact of a favorable tax settlement related to the U.S.– Japan Income Tax Treaty.

The decrease in the effective tax rate in fiscal 2004 from fiscal 2003 was primarily driven by an improvement in the mix of earnings from domestic and international operations and improved earnings performance.

We currently expect the fiscal 2006 effective tax rate to be about 39 percent due to the absence of the favorable tax settlement realized in 2005 and the more pronounced impact of our Japan business, which is subjected to a higher tax rate than that of the U.S. The actual rate will ultimately depend on several variables, including the mix of earnings between domestic and international operations, and the overall level of earnings.

In October 2004, Congress enacted, and the President signed into law, the American Jobs Creation Act of 2004. Among its numerous changes in the tax law this Act included a tax relief provision allowing corporate taxpayers a reduced tax rate on dividends received from controlled foreign corporations if certain conditions are satisfied. We have reviewed the provisions of the new law and have concluded that we will not benefit from these changes. Therefore there is no effect on income tax expense (or benefit) for the period as a result of the Act's repatriation provisions.

FINANCIAL CONDITION

Liquidity

The following sets forth certain measures of our liquidity:

($ in millions)	January 28, 2006	January 29, 2005	January 31, 2004
Working capital (a)	$ 3,297	$ 4,062	$ 4,156
Current ratio (a)	2.70:1	2.81:1	2.63:1

(a) Our working capital and current ratio calculations include restricted cash.

Free Cash Flow

Free cash flow is a non-GAAP measure. We believe free cash flow is an important metric, as it represents a measure of how much cash a company has available after the deduction of capital expenditures, as we require regular capital expenditures to build and maintain stores and purchase new equipment to keep the business growing. We use this metric internally, as we believe our sustained ability to increase free cash flow is an important driver of value creation.

The following table reconciles free cash flow, a non-GAAP financial measure, to a GAAP financial measure.

	52 Weeks Ended		
($ in millions)	January 28, 2006	January 29, 2005	January 31, 2004
Net cash provided by operating activities	$ 1,551	$ 1,597	$ 2,160
Net cash provided by (used for) investing activities	286	183	(2,318)
Net cash used for financing activities	(2,040)	(1,796)	(636)
Effect of exchange rate fluctuations on cash	(7)	-	28
Net decrease in cash and equivalents	$ (210)	$ (16)	$ (766)
Net cash provided by operating activities	$ 1,551	$ 1,597	$ 2,160
Less: Net purchases of property and equipment	(600)	(419)	(261)
Free cash flow	$ 951	$ 1,178	$ 1,899

The following table sets forth our projected minimum fiscal 2006 free cash flow components to accomplish our target to generate minimum free cash flow of at least $900 million:

($ in millions)	Projected Fifty-Three Weeks Ending February 3, 2007
Projected minimum net cash provided by operating activities	$ 1,575
Less: Projected net purchase of property and equipment	(675)
Projected minimum fiscal 2006 free cash flow	$ 900

We delivered a healthy $951 million in free cash flow, which represented 85% of net earnings. Our solid earnings continue to generate strong free cash flow. Free cash flow as a percent of net earnings was 102% and 184% for fiscal 2004 and 2003, respectively. For the year ended January 28, 2006, our free cash flow decreased $227 million compared to the prior year primarily due to higher capital expenditures, which were associated with new store openings and store remodels as we invest in our future.

In addition, we renegotiated our letter of credit agreements, which increased our financial flexibility and decreased most of our restricted cash balance on our consolidated balance sheet. (See Note B to the Consolidated Financial Statements).

We are committed to maintaining sufficient cash to support the needs of our business and withstand unanticipated business volatility; therefore, we plan to keep $2 billion of cash available. We will continue to evaluate our $2 billion cash balance target over time to reflect the changing needs of our business.

Cash Flows from Operating Activities

	52 Weeks Ended		
($ in millions)	January 28, 2006	January 29, 2005	January 31, 2004
Net earnings	$ 1,113	$ 1,150	$ 1,031
Adjustments to reconcile net earnings to net cash provided by operating activities			
Depreciation and amortization	625	615	675
Other non-cash reconciling adjustments	(74)	(23)	180
Change in merchandise inventory	114	(90)	385
Other changes in operating assets and liabilities	(227)	(55)	(111)
Net cash provided by operating activities	$ 1,551	$ 1,597	$ 2,160

Our largest source of operating cash flows is cash collections from our customers. Our primary uses of cash include personnel related expenses, merchandise inventory purchases, payment of taxes, occupancy and capital expenditures. Net cash provided by operating activities decreased $46 million compared with fiscal 2004. The decrease in source of cash from fiscal 2004 is primarily due to the decrease in accounts payable mainly as a result of lower merchandise inventory levels, and the decrease in accrued expenses, driven primarily by the decreased bonus as a result of fiscal 2005 performance. These decreases were offset by an increase in source of cash due to the decreased inventory balance as a result of disciplined inventory management.

For fiscal 2004, the $563 million decrease in cash provided by operating activities compared with fiscal 2003 was due to increased purchases to replenish our inventory to support our increased sales activity. In addition, higher tax payments due to our stronger earnings performance required more cash.

Inventory management remains an area of focus. We continue to execute against our strategies to optimize inventory productivity and more tightly manage the receipt and timing of our inventory, while maintaining appropriate in-store merchandise levels and product assortment to support sales growth. Inventory per square foot at January 28, 2006 was $43, an 11 percent decrease over fiscal 2004 primarily due to earlier Spring and later Summer product flow. Inventory per square foot at January 29, 2005 was $48, a 6 percent increase over fiscal 2003 primarily due to earlier Easter and Spring product flow and also missed holiday opportunities.

We fund inventory expenditures during normal and peak periods through cash flows from operating activities and available cash. Our business follows a seasonal pattern, peaking over a total of about 13 weeks during the back-to-school and holiday periods. During fiscal 2005, fiscal 2004, and fiscal 2003, these periods accounted for 32 percent, 32 percent, and 33 percent, respectively, of our annual net sales. The seasonality of our operations may lead to significant fluctuations in certain asset and liability accounts between fiscal year-end and subsequent interim periods.

We expect the percent decrease in inventory per square foot at the end of both the first and second quarters of 2006 to be in the low single digits compared to last year.

Cash Flows from Investing Activities

	52 Weeks Ended		
($ in millions)	January 28, 2006	January 29, 2005	January 31, 2004
Purchase of property and equipment	$ (600)	$ (419)	$ (261)
Proceeds from sale of property and equipment	27	-	1
Purchase of short-term investments	(1,768)	(1,813)	(1,202)
Maturities of short-term investments	1,645	2,072	442
Change in restricted cash	959	337	(1,303)
Change in other assets	23	6	5
Net cash provided by (used for) investing activities	$ 286	$ 183	$ (2,318)

For fiscal 2005, net cash provided by investing activities increased $103 million compared with fiscal 2004, as we released $959 million of cash required as collateral to our letter of credit agreements. Maturities of short-term investments reinvested were less than purchases of new investments in fiscal 2005, compared to the prior year. For fiscal 2004, net cash used for investing activities decreased $2.5 billion compared with fiscal 2003. Maturities of short-term investments reinvested were greater than purchases of new investments in fiscal 2004 compared to the prior year, and we released $337 million of restricted cash required as collateral to our letter of credit agreements.

In fiscal 2005 and 2004, capital expenditures totaled approximately $600 million and $419 million, respectively. The majority of these expenditures in both fiscal years were used for new store locations, store remodels and information technology.

For fiscal 2006, we expect capital expenditures to be about $675 million, primarily for new stores, remodels and information technology infrastructure and projects. We expect to open about 175 new store locations and to close about 135 store locations. New store locations will be weighted toward Old Navy, while Gap stores will account for the majority of locations closed. As a result, we expect net square footage to increase 1 to 2 percent for fiscal 2006. We expect to fund these capital expenditures with cash flows from operations and available cash. The breakdown of our fiscal 2006 capital expenditures estimate is outlined in the table below:

($ in millions)	Projected Fifty-Three Weeks Ending February 3, 2007
New stores	$ 270
Existing stores	200
Information technology	130
Headquarters and distribution centers	75
Total capital investments	$ 675

Cash Flows from Financing Activities

	52 Weeks Ended		
($ in millions)	January 28, 2006	January 29, 2005	January 31, 2004
Payments of long-term debt	$ -	$ (871)	$ (668)
Issuance of common stock	110	130	85
Purchase of treasury stock, net of reissuances	(1,971)	(976)	26
Cash dividends paid	(179)	(79)	(79)
Net cash used for financing activities	$ (2,040)	$ (1,796)	$ (636)

For fiscal 2005, cash flows used for financing activities increased $244 million compared with fiscal 2004 and increased $1.2 billion in fiscal 2004 compared to fiscal 2003. In fiscal 2005, we repurchased $2.0 billion of common stock and reissued $27 million of treasury stock for Employee Stock Purchase Plans. We also received $110 million from the issuance of common and treasury stock. In addition, we completed the redemption of our Senior Convertible notes as of March 31, 2005 and approximately $0.5 million was paid in cash redemption. See Note B to the accompanying Consolidated Financial Statements.

In fiscal 2004, we repurchased $1.0 billion of common stock and reissued $23.5 million of treasury stock for Employee Stock Purchase Plans. We received $130 million from the issuance of common and treasury stock. In addition, we repurchased $596 million of domestic notes in the open market, including the early retirement of our 2005 notes and we paid off the remaining outstanding balance of our €227 million 5-year euro bond ($275 million), which was due on September 30, 2004.

Dividend Policy

In determining whether to, and at what level to, declare a dividend, we considered a number of financial factors, including sustainability and financial flexibility, as well as other factors including operating performance and capital resources. While we intend to increase dividends over time at a rate greater than our growth in net income, we will balance future increases with the corresponding cash requirements of growing our businesses.

During fiscal 2005, we increased our annual dividends, which had been $0.09 per share to $0.18 per share. The increase in annual dividends reflects the declaration and payment of our fiscal 2005 dividends at the increased $0.045 per share per quarter. This annual dividend of $0.18 per share does not include the fourth quarter 2004 dividend of $0.0222 per share declared in the fourth quarter of fiscal 2004 but paid in the first quarter of fiscal 2005. We have revised our dividend schedule in 2005 such that all dividends are declared and paid in the same fiscal quarter.

In February 2006, we announced our intent to increase the annual dividend per share from $0.18 to $0.32 for fiscal 2006. The dividend is expected to be paid quarterly in April, July, October and January.

Stock Repurchase Program

Since the beginning of fiscal 2004, the Company has completed $3 billion of share repurchases of about 146 million shares. During fiscal 2005, we announced share repurchase authorizations totaling $2.0 billion, which we completed by the end of the fiscal year. We repurchased approximately 99 million shares of our common stock at a total cost of approximately $2.0 billion, at an average price per share of $20.29 including commissions. In February 2006, we announced the authorization of a new $500 million share repurchase program. Under this program, shares may be repurchased over 24 months.

During fiscal 2004, we repurchased approximately 48 million shares for approximately $1.0 billion, including commissions, at an average price per share of $20.92.

Credit Facility and Debt

The following discussion should be read in conjunction with Note B to the accompanying Consolidated Financial Statements.

On May 6, 2005, we entered into four separate $125 million 3-year letter of credit agreements and four separate $100 million 364-day letter of credit agreements for a total aggregate availability of $900 million, which collectively replaced our prior letter of credit agreements. Unlike the previous letter of credit agreements, the current letter of credit agreements are unsecured. Consequently, the $900 million of restricted cash that collateralized the prior letter of credit agreements was fully released in May 2005.

On August 30, 2004, we terminated all commitments under our $750 million three-year secured revolving credit facility scheduled to expire in June 2006 (the "Old Facility") and replaced the Old Facility with a new $750 million five-year unsecured revolving credit facility scheduled to expire in August 2009 (the "New Facility"). The New Facility is available for general corporate purposes, including commercial paper backstop, working capital, trade letters of credit and standby letters of credit. The facility usage fees and fees related to the New Facility fluctuate based on our long-term senior unsecured credit ratings and our leverage ratio.

The New Facility and letter of credit agreements contain financial and other covenants, including, but not limited to, limitations on liens and subsidiary debt as well as the maintenance of two financial ratios—a fixed charge coverage ratio and a leverage ratio. A violation of these covenants could result in a default under the New Facility and new letter of credit agreements, which would permit the participating banks to terminate our ability to access the New Facility for letters of credit and advances, terminate our ability to request letters of credit under the letter of credit agreements, require the immediate repayment of any outstanding advances under the New Facility, and require the immediate posting of cash collateral in support of any outstanding letters of credit under the letter of credit agreements. In addition, such a default could, under certain circumstance, permit the holders of our outstanding unsecured debt to accelerate payment of such obligations.

Letters of credit represent a payment undertaking guaranteed by a bank on our behalf to pay the vendor a given amount of money upon presentation of specific documents demonstrating that merchandise has shipped. Vendor payables are recorded in the Consolidated Balance Sheets at the time of merchandise title transfer, although the letters of credit are generally issued prior to this. As of January 28, 2006, we had $306 million in trade letters of credit issued under our letter of credit agreements totaling $900 million and there were no borrowings under our $750 million revolving credit facility.

On March 11, 2005, we called for the full redemption of our outstanding $1.4 billion aggregate in principal of our 5.75 percent senior convertible notes (the "Notes") due March 15, 2009. The redemption was completed by March 31, 2005. Note holders had the option to receive cash at a redemption price equal to 102.46 percent of the principal amount of the Notes, plus accrued interest excluding the redemption date, for a total of approximately $1,027 per $1,000 principal amount of Notes. Alternatively, note holders could elect to convert their Notes into approximately 62.03 shares of Gap Inc.

common stock per $1,000 principal amount. As of March 31, 2005, $1.4 billion of principal was converted into 85,143,950 shares of Gap Inc. common stock and approximately $0.5 million was paid in cash redemption.

In line with our fiscal 2004 objective of reducing long-term debt, we repaid $871 million in debt in fiscal 2004. This included early extinguishment of $596 million of our domestic debt and the maturity of €227 million 5-year euro bond ($275 million). We repurchased and extinguished early an aggregate of $180 million in principal amount of our notes due 2005, $91 million in principal amount of our notes due 2007 and $325 million in principal amount of our notes due 2008. We performed a net present value analysis on our outstanding debt and determined that it would be beneficial to repurchase the debt early even though we incurred $105 million in loss on early retirement of debt due to premiums paid and write-off of debt issuance costs.

Our note payable, due December 2005 ("2005 Notes"), and our note payable, due December 2008 ("2008 Notes"), have interest rates that are subject to adjustment if our credit rating is upgraded or downgraded by the rating agencies. As a result of upgrades to our long-term credit ratings in fiscal 2004, the interest rate on the 2008 Notes decreased from 10.55 percent as of year-end fiscal 2003 to 10.05 percent as of year-end fiscal 2004. The 2005 Notes were fully repaid in fiscal 2004.

Our access to the capital markets and interest expense on future financings are dependent on our senior unsecured debt rating. On February 10, 2005, Standard & Poor's upgraded our senior unsecured debt rating to investment grade, BBB- from BB+. On April 5, 2005, Moody's upgraded our senior unsecured debt rating to Baa3 from Ba1. As a result of these upgrades by the rating agencies, the interest rate payable by us on the 2008 Notes decreased by 50 basis points to 9.55 percent per annum as of June 15, 2005 and remains at this rate as of January 28, 2006.

Contractual Cash Obligations and Commercial Commitments

We are party to many contractual obligations involving commitments to make payments to third parties. The following table provides summary information concerning our future contractual obligations as of January 28, 2006. These obligations impact our short and long-term liquidity and capital resource needs. Certain of these contractual obligations are reflected in the Consolidated Balance Sheets, while others are disclosed as future obligations.

($ in millions)	Less than 1 Year	1–3 Years	3–5 Years	After 5 Years	Total
Amounts reflected in Consolidated Balance Sheets:					
Long-term debt (a)	$ -	$ 463	$ 50	$ -	$ 513
Accrued interest on long-term debt (b)	11	-	-	-	11
Other cash obligations not reflected in Consolidated Balance Sheets:					
Operating leases (c)	974	1,659	1,215	1,660	5,508
Purchase obligations and commitments (d)	2,645	292	268	495	3,700
Interest (e)	29	46	1	-	76
Total contractual cash obligations	$ 3,659	$ 2,460	$ 1,534	$ 2,155	$ 9,808

(a) Represents principal maturities, net of unamortized discount, excluding interest. See Note B to the Consolidated Financial Statements.
(b) See Note B to the Consolidated Financial Statements for discussion of our long-term debt.
(c) Payments for maintenance, insurance, taxes, and percentage rent to which we are obligated are excluded. See Note D to the Consolidated Financial Statements for discussion of our operating leases.
(d) Represents estimated open purchase orders, commitments to purchase fabric and trim to be used during the next several seasons, and commitments to purchase inventory and other goods and services in the normal course of business to meet operational requirements.
(e) Represents interest expected to be paid on our long-term debt and does not assume early debt repurchases, which would reduce the interest payments projected above.

Purchase obligations include our newly entered non-exclusive services agreement with International Business Machines Corporation ("IBM") as described in Note J to the accompanying Consolidated Financial Statements. Under the services agreement, IBM will operate certain aspects of our information technology infrastructure that are currently operated by us. The services agreement has an initial term of ten years, and we have the right to renew it for up to three additional years. We have various options to terminate the agreement, and we will pay IBM under a combination of fixed and variable charges, with the variable charges fluctuating based on our actual consumption of services. Based on the currently projected service needs, we expect to pay approximately $1.1 billion to IBM ratably over the initial 10-year term.

The services agreement has performance levels that IBM must meet or exceed. If these service levels are not met, we would in certain circumstances receive a credit against the charges otherwise due, have the right to other interim remedies, or as to material breaches have the right to terminate the services agreement. In addition, the agreement provides us certain pricing protections, and we have the right to terminate the

services agreement both for cause and for convenience (subject, in the case of termination for convenience, to our payment of a termination fee). IBM also has certain termination rights in the event of our material breach of the agreement and failure to cure.

Amounts Reflected in Consolidated Balance Sheets

We have other commercial commitments, not reflected in the table above, that were incurred in the normal course of business to support our operations, including standby letters of credit, surety bonds and bank guarantees. Amounts outstanding at January 28, 2006 relating to our standby letters of credit, surety bonds and bank guarantees were $43 million (of which $28 million was issued under the revolving credit facility lines), $54 million and $3 million, respectively.

We have other long-term liabilities reflected in the Consolidated Balance Sheets, including deferred income taxes. The payment obligations associated with these liabilities are not reflected in the table above due to the absence of scheduled maturities. Therefore, the timing of these payments cannot be determined, except for amounts estimated to be paid in fiscal 2006 that are included in current liabilities.

Other Cash Obligations Not Reflected in Consolidated Balance Sheets

The majority of our contractual obligations are made up of operating leases for our stores. Commitments for operating leases represent future minimum lease payments under non-cancelable leases. In accordance with accounting principles generally accepted in the United States, our operating leases are not recorded in the Consolidated Balance Sheets; however, the minimum lease payments related to these leases are disclosed in Note D to the accompanying Consolidated Financial Statements.

We have applied the measurement and disclosure provisions of FASB Interpretation No. ("FIN") 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others," to our agreements that contain guarantee and certain indemnification clauses. FIN 45 requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under the guarantee. As of January 28, 2006, we did not have any material guarantees that were issued or modified subsequent to December 31, 2002.

However, 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 financial condition or results of operations.

As party to a reinsurance pool for workers' compensation, general liability and automobile liability, we have guarantees with a maximum exposure of $76 million, of which $10 million has already been cash collateralized. We are currently in the process of winding down our participation in the reinsurance pool. Our maximum exposure and cash collateralized balance are expected to decrease in the future as our participation in the reinsurance pool diminishes.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to adopt accounting policies and make significant judgments and estimates to develop amounts reflected and disclosed in the financial statements. In many cases, there are alternative policies or estimation techniques that could be used. We maintain a thorough process to review the application of our accounting policies and to evaluate the appropriateness of the many estimates that are required to prepare the financial statements of a large, global corporation. However, even under optimal circumstances, estimates routinely require adjustment based on changing circumstances and the receipt of new or better information.

Our significant accounting policies can be found in Note A to the Consolidated Financial Statements. The policies and estimates discussed below include the financial statement elements that are either judgmental or involve the selection or application of alternative accounting policies and are material to our financial statements. Management has discussed the development and selection of these critical accounting policies and estimates with the Audit and Finance Committee of our Board of Directors.

Merchandise Inventory

Inventory is valued using the cost method, which values inventory at the lower of the actual cost or market. Cost is determined using the first-in, first-out ("FIFO") method. Market is determined based on the estimated net realizable value, which generally is the merchandise selling price. We review our inventory levels in order to identify slow-moving merchandise and broken assortments (items no longer in stock in a sufficient range of sizes) and use markdowns to clear merchandise. We estimate and accrue shortage for the period between the last physical count and the balance sheet date. Our shortage estimate can be affected by changes in merchandise mix and changes in actual shortage trends. The change in shortage expense as a percentage of cost of goods sold was an increase of 0.6 percentage points, a decrease of 0.2 percentage points and a decrease of 1.4 percentage points for fiscal 2005, 2004 and 2003, respectively.

Long-lived Assets, Impairment and Excess Facilities

We have a significant investment in property and equipment. Depreciation and amortization are computed using estimated useful lives of up to 39 years. A reduction in these estimated useful lives would result in higher annual depreciation expense for the related assets.

In accordance with SFAS 144, we review the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Events that result in an impairment review include decisions to close a store, headquarter facility or distribution center, or a significant decrease in the operating performance of the long-lived asset. For our store assets that are identified as potentially being impaired, if the undiscounted future cash flows of the long-lived assets are less than the carrying value, we recognize a loss equal to the difference between the carrying value and the asset's fair value. The fair value of the store's long-lived assets is estimated using the discounted future cash flows of the assets based upon a rate that approximates our weighted-average cost of capital. Our estimate of future cash flows is based upon our experience, knowledge and third-party advice or market data. However, these estimates can be affected by factors such as future store profitability, real estate demand and economic conditions that can be difficult to predict. We recorded a charge for the impairment of store assets of $3 million, $5 million, and $23 million during fiscal 2005, 2004 and 2003, respectively.

The decision to close or sublease a store, distribution center or headquarter facility space can result in accelerated depreciation over the revised estimated useful life of the long-lived asset. In addition, we record a charge and corresponding sublease loss reserve for the net present value of the difference between the contract rent obligations and the rate at which we expect to be able to sublease the properties. We estimate the reserve based on the status of our efforts to lease vacant office space, including a review of real estate market conditions, our projections for sublease income and sublease commencement assumptions. Most store closures occur upon the lease expiration.

Insurance/Self-insurance

We use a combination of insurance and self-insurance for a number of risk management activities including workers' compensation, general liability, automobile liability and employee related health care benefits, a portion of which is paid by our employees. Liabilities associated with these risks are estimated based on actuarially determined amounts, and accrued in part by considering historical claims experience, demographic factors, severity factors and other actuarial assumptions. Any actuarial projection of losses concerning our liability is subject to a high degree of variability. Among the causes of this variability are unpredictable external factors affecting future inflation rates, litigation trends, legal interpretations, benefit level changes and claim settlement patterns.

Revenue Recognition

We recognize revenue and the related cost of goods sold (including shipping costs) at the time the products are received by the customers in accordance with the provisions of Staff Accounting Bulletin No. ("SAB") 101, "Revenue Recognition in Financial Statements" as amended by SAB 104, "Revenue Recognition." Revenue is recognized for store sales at the point at which the customer receives and pays for the merchandise at the register with either cash or credit card. For online sales, revenue is recognized at the time we estimate the customer receives the product. We estimate and defer revenue and the related product costs for shipments that are in-transit to the customer. Customers typically receive goods within a few days of shipment. Such amounts were immaterial as of January 28, 2006, January 29, 2005, and January 31, 2004. Amounts related to shipping and handling that are billed to customers are reflected in net sales and the related costs are reflected in cost of goods sold and occupancy expenses.

Allowances for estimated returns are recorded based on estimated gross profit using our historical return patterns.

Upon the purchase of a gift card or issuance of a gift certificate, a liability is established for the cash value of the gift card or gift certificate. The liability is relieved and income is recorded as net sales upon redemption or as other income, which is a component of operating expenses, after sixty months, whichever is earlier. It is our historical experience that the likelihood of redemption after sixty months is remote. The liability for gift cards and gift certificates is recorded in accounts payable on the Consolidated Balance Sheets.

Income Taxes

We record reserves for estimates of probable settlements of foreign and domestic tax audits. At any point in time, many tax years are subject to or in the process of audit by various taxing authorities. To the extent that our estimates of probable settlements change or the final tax outcome of these matters is different than the amounts recorded, such differences will impact the income tax provision in the period in which such determinations are made. We also record a valuation allowance against our deferred tax assets arising from certain net operating losses when it is more likely than not that some portion or all of such net operating losses will not be realized. Our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings, changes in the expected outcome of audits or changes in the deferred tax valuation allowance.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note A to the Consolidated Financial Statements for recent accounting pronouncements, including the expected dates of adoption and estimated effects on our financial position, statement of cash flows and results of operations.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We operate in foreign countries, which exposes us to market risk associated with foreign currency exchange rate fluctuations. Our risk management policy is to hedge substantially all forecasted merchandise purchases for foreign operations using foreign exchange forward contracts. We also use forward contracts to hedge our market risk exposure associated with foreign currency exchange rate fluctuations for certain intercompany loans and balances denominated in currencies other than the functional currency of the entity holding or issuing the intercompany loan or balance. These contracts are entered into with large, reputable financial institutions, thereby minimizing the credit exposure from our counter-parties. The principal currencies hedged during fiscal 2005 were the Euro, British pound, Japanese yen, and Canadian dollar. Our use of derivative financial instruments represents risk management; we do not use derivative financial instruments for trading purposes. Additional information is presented in Note F to the Consolidated Financial Statements.

We have performed a sensitivity analysis as of January 28, 2006 and January 29, 2005, based on a model that measures the change in fair values of our derivative financial instruments arising from a hypothetical 10 percent adverse change in the level of foreign currency exchange rates relative to the U.S. dollar with all other variables held constant. The analysis covers all foreign exchange derivative financial instruments offset by the underlying exposures. The foreign currency exchange rates used in the model were based on the spot rates in effect at January 28, 2006 and January 29, 2005. The sensitivity analysis indicated that a hypothetical 10 percent adverse movement in foreign currency exchange rates would have had an unfavorable impact on the fair values of our foreign exchange derivative financial instruments, net of the underlying exposures, of $30 million at January 28, 2006 and $23 million at January 29, 2005.

We hedge the net assets of certain international subsidiaries to offset the translation and economic exposures related to our investments in these subsidiaries. The change in fair value of the hedging instrument is reported in accumulated other comprehensive earnings (loss) within shareholders' equity to offset the foreign currency translation adjustments on the investments.

In addition, we used a cross-currency interest rate swap to swap the interest and principal payable of $50 million debt securities of our Japanese subsidiary, Gap (Japan) KK, from a fixed interest rate of 6.25 percent, payable in U.S. dollars, to 6.1 billion Japanese yen with a fixed interest rate of 2.43 percent. These debt securities are recorded on the Consolidated Balance Sheets at their issuance amount, net of unamortized discount. The derivative instruments are recorded in the Consolidated Balance Sheets at their fair value as of January 28, 2006.

We have limited exposure to interest rate fluctuations on our borrowings. The interest on our long-term debt is set at a fixed coupon, with the exception of the interest rates payable by us on our outstanding $500 million notes due December 2008, of which only $138 million remains outstanding, which are subject to change based on our long-term senior secured credit ratings. The interest rates earned on our cash and equivalents will fluctuate in line with short-term interest rates.

In March 2002, we issued $1.4 billion aggregate principal amount of 5.75 percent senior convertible notes due March 15, 2009, and received proceeds of $1.4 billion in cash, net of underwriting and other fees. On March 11, 2005, we called for the full redemption of these notes. The redemption was completed by March 31, 2005. Note holders had the option of receiving either cash at a redemption price equal to 102.46 percent of the principal amount of the note, plus accrued interest, for a total of approximately $1,027 per $1,000 principal amount of notes, or alternatively, converting their notes into approximately 62.03 shares of Gap, Inc. common stock per $1,000 principal amount. As of March 31, 2005, $1.4 billion of principal was converted into 85,143,950 shares of Gap, Inc. common stock and approximately $0.5 million was paid in cash redemption.

In November 2001, we issued $500 million aggregate principal amount of debt securities at an original annual interest rate of 8.80 percent, due December 15, 2008 (the "2008 Notes"). Interest on the notes is payable semi-annually. As a result of prior and current fiscal year changes to our long-term credit ratings the interest payable by us on the 2008 Notes was 9.55 percent per annum as of January 28, 2006. We repurchased $38 million and $325 million of the 2008 Notes during fiscal 2003 and fiscal 2004, respectively. These debt securities are recorded in the Consolidated Balance Sheets at their issuance amount net of repurchases and unamortized discount.

During fiscal 1997, we issued $500 million aggregate principal amount of debt securities, due September 15, 2007, with a fixed interest rate of 6.90 percent. Interest on these debt securities is payable semi-annually. We repurchased $83 million and $91 million of these debt securities during fiscal 2003 and fiscal 2004, respectively. These debt securities are recorded in the Consolidated Balance Sheets at their issuance amount net of repurchases and unamortized discount.

	January 28, 2006		January 29, 2005	
($ in millions)	Carrying Amount in U.S. Dollars	Fair Value (a)	Carrying Amount in U.S. Dollars	Fair Value
$500 million notes payable, 6.90%, interest due semi-annually, due September 2007	$ 325	$ 329	$ 325	$ 348
$500 million notes payable, 8.80% (9.55%), interest due semi-annually, due December 2008 (b)	138	153	138	167
$50 million notes payable, 6.25%, interest due semi-annually, due March 2009	50	51	50	53
Total long-term debt	513	533	513	568
$1.38 billion senior convertible notes payable, 5.75%, interest due semi-annually, due March 2009	-	-	1,373	1,833
Total long-term debt and senior convertible notes	$ 513	$ 533	$ 1,886	$ 2,401

(a) Based on the face amount multiplied by the market price of the note as of January 27, 2006.

(b) The interest rate payable on these notes is subject to increase (decrease) by 0.25 percent for each rating downgrade (upgrade) by the rating agencies. The rate in parentheses reflects the rate at January 28, 2006. In no event will the interest rate be reduced below the original interest rate on the note.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

Management is responsible for the preparation of the Company's consolidated financial statements and related information appearing in this report. Management believes that the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements reasonably present the Company's financial position and results of operations in conformity with generally accepted accounting principles. Management also has included in the Company's financial statements amounts that are based on estimates and judgments, which it believes are reasonable under the circumstances.

An independent registered public accounting firm audits the Company's consolidated financial statements in accordance with the standards established by the Public Company Accounting Oversight Board ("PCAOB").

The Board of Directors of the Company has an Audit and Finance Committee composed of four independent Directors. The committee meets periodically with financial management, the internal auditors and the independent registered public accounting firm to review accounting, control, auditing and financial reporting matters.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Securities Exchange Act Rule 13a-15(f). Our system of internal control is evaluated on a cost benefit basis and is designed to provide reasonable, not absolute, assurance that reported financial information is materially accurate.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the design and effectiveness of our internal control over financial reporting based on the Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations ("COSO"). Based on this evaluation, our management concluded that the Company's internal control over financial reporting was effective as of January 28, 2006.

Management's assessment of the effectiveness of internal control over financial reporting as of January 28, 2006 was audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report, which is included herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of The Gap, Inc.:

We have audited the accompanying consolidated balance sheets of The Gap, Inc. and subsidiaries as of January 28, 2006 and January 29, 2005, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended January 28, 2006. We also have audited management's assessment, included in the accompanying "Management's Report on Internal Control over Financial Reporting", that the Company maintained effective internal control over financial reporting as of January 28, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, such consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Gap, Inc. and subsidiaries as of January 28, 2006 and January 29, 2005, and the results of their operations and their cash flows for each of the three years in the period ended January 28, 2006, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of January 28, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of January 28, 2006, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Deloitte & Touche LLP

San Francisco, California
March 27, 2006

CONSOLIDATED STATEMENTS OF OPERATIONS

($ in millions except per share amounts, shares in thousands)	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Net sales	$ 16,023	$ 16,267	$ 15,854
Cost of goods sold and occupancy expenses	10,154	9,886	9,885
Gross profit	5,869	6,381	5,969
Operating expenses	4,124	4,296	4,068
Loss on early retirement of debt	-	105	21
Interest expense	45	167	234
Interest income	(93)	(59)	(38)
Earnings before income taxes	1,793	1,872	1,684
Income taxes	680	722	653
Net earnings	$ 1,113	$ 1,150	$ 1,031
Weighted average number of shares - basic	881,058	893,357	892,555
Weighted average number of shares - diluted	902,306	991,122	988,178
Earnings per share–basic	$ 1.26	$ 1.29	$ 1.15
Earnings per share–diluted	1.24	1.21	1.09

See Notes to the Consolidated Financial Statements

CONSOLIDATED BALANCE SHEETS

($ in millions except par value, shares in thousands)	January 28, 2006	January 29, 2005
Assets		
Current assets		
Cash and equivalents	$ 2,035	$ 2,245
Short-term investments	952	817
Restricted cash	55	1,015
Merchandise inventory	1,696	1,814
Other current assets	501	413
Total current assets	5,239	6,304
Property and equipment, net of accumulated depreciation	3,246	3,376
Other assets	336	368
Total assets	$ 8,821	$ 10,048
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable	$ 1,132	$ 1,240
Accrued expenses and other current liabilities	725	924
Income taxes payable	85	78
Total current liabilities	1,942	2,242
Long-term liabilities:		
Long-term debt	513	513
Senior convertible notes	-	1,373
Lease incentives and other liabilities	941	984
Total long-term liabilities	1,454	2,870
Commitments and contingencies (see Notes D and J)		
Shareholders' Equity		
Common stock $.05 par value		
Authorized 2,300,000 shares; Issued		
1,078,925 and 985,738		
shares; Outstanding 856,986		
and 860,559 shares	54	49
Additional paid-in capital	2,402	904
Retained earnings	8,133	7,181
Accumulated other comprehensive earnings	51	48
Deferred compensation	(5)	(8)
Treasury stock, at cost (221,939 and 125,179 shares)	(5,210)	(3,238)
Total shareholders' equity	5,425	4,936
Total liabilities and shareholders' equity	$ 8,821	$ 10,048

See Notes to the Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS

($ in millions)	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Cash Flows from Operating Activities			
Net earnings	$ 1,113	$ 1,150	$ 1,031
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization (a)	625	615	675
Other non-cash reconciling adjustments	(28)	57	79
Deferred income taxes	(46)	(80)	101
Change in operating assets and liabilities:			
Merchandise inventory	114	(90)	385
Other assets	(104)	(18)	5
Accounts payable	(102)	39	(10)
Accrued expenses and other current liabilities	(121)	(23)	(42)
Income taxes payable, net	(19)	(112)	(38)
Lease incentives and other liabilities	119	59	(26)
Net cash provided by operating activities	1,551	1,597	2,160
Cash Flows from Investing Activities			
Purchase of property and equipment	(600)	(419)	(261)
Proceeds from sale of property and equipment	27	-	1
Purchase of short-term investments	(1,768)	(1,813)	(1,202)
Maturities of short-term investments	1,645	2,072	442
Purchase of long-term investments	(100)	-	-
Maturities of long-term investments	100	-	-
Change in restricted cash	959	337	(1,303)
Change in other assets	23	6	5
Net cash provided by (used for) investing activities	286	183	(2,318)
Cash Flows from Financing Activities			
Payments of long-term debt (b)	-	(871)	(668)
Issuance of common stock (b)	110	130	85
Purchase of treasury stock, net of reissuances	(1,971)	(976)	26
Cash dividends paid	(179)	(79)	(79)
Net cash used for financing activities	(2,040)	(1,796)	(636)
Effect of exchange rate fluctuations on cash	(7)	-	28
Net decrease in cash and equivalents	(210)	(16)	(766)
Cash and equivalents at beginning of period	2,245	2,261	3,027
Cash and equivalents at end of period	$ 2,035	$ 2,245	$ 2,261
Supplemental disclosure of cash flow information:			
Cash paid for interest	$ 79	$ 168	$ 235
Cash paid for income taxes	738	891	616

(a) Depreciation and amortization includes the amortization of lease incentives.
(b) Does not include the non-cash conversion of our senior convertible debt of $1.4 billion to 85 million shares of common stock in March 2005. See Note B to the Consolidated Financial Statements.

See Notes to the Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In millions except share and per share amounts)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital
Balance at February 1, 2003	968,010,453	$ 48	$ 638
Issuance of common stock pursuant to stock option plans	8,143,466	1	89
Conversion of convertible debt	310		
Tax benefit from exercise of stock options by employees and from vesting of restricted stock			7
Adjustments for foreign currency translation			
Adjustments for fluctuations in fair market value of financial instruments, net of tax ($19)			
Reclassification of amounts to net earnings, net of tax ($10)			
Amortization of restricted stock and discounted stock options			
Reissuance of treasury stock			(2)
Net earnings			
Cash dividends ($.09 per share)			
Balance at January 31, 2004	976,154,229	49	732
Issuance of common stock pursuant to stock option plans	9,149,786		129
Conversion of convertible debt	434,367		7
Tax benefit from exercise of stock options by employees and from vesting of restricted stock			31
Adjustments for foreign currency translation			
Adjustments for fluctuations in fair market value of financial instruments, net of tax ($21)			
Reclassification of amounts to net earnings, net of tax ($16)			
Amortization of restricted stock and discounted stock options			
Repurchase of common stock			
Reissuance of treasury stock			5
Net earnings			
Cash dividends ($.09 per share)			
Balance at January 29, 2005	985,738,382	49	904
Issuance of common stock pursuant to stock option plans	8,042,294	1	109
Conversion of convertible debt	85,143,950	4	1,351
Tax benefit from exercise of stock options by employees and from vesting of restricted stock			19
Adjustments for foreign currency translation			
Adjustments for fluctuations in fair market value of financial instruments, net of tax ($1)			
Reclassification of amounts to net earnings, net of tax ($17)			
Amortization of restricted stock and discounted stock options			18
Repurchase of common stock			
Reissuance of treasury stock			1
Net earnings			
Cash dividends ($.18 per share)			
Balance at January 28, 2006	1,078,924,626	$ 54	$ 2,402

See Notes to the Consolidated Financial Statements

				Treasury Stock			
Retained Earnings	Accumulated Other Comprehensive Earnings (Loss)	Deferred Compensation		Shares	Amount	Total	Comprehensive Earnings (Loss)
$ 5,158	$ (17)	$ (13)		(80,687,746)	$ (2,288)	$ 3,526	$ 521
		(2)				88	
						7	
	59					59	59
	(30)					(30)	(30)
	15					15	
		6				6	
				1,736,002	27	25	
1,031						1,031	1,031
(79)						(79)	
6,110	27	(9)		(78,951,744)	(2,261)	4,648	1,060
		(4)				125	
						7	
						31	
	29					29	29
	(33)					(33)	(33)
	25					25	
		5				5	
				(47,792,200)	(1,000)	(1,000)	
				1,564,639	23	28	
1,150						1,150	1,150
(79)						(79)	
7,181	48	(8)		(125,179,305)	(3,238)	4,936	1,146
						110	
						1,355	
						19	
	(25)					(25)	(25)
	1					1	1
	27					27	
		3				21	
				(98,547,000)	(2,000)	(2,000)	
				1,787,658	28	29	
1,113						1,113	1,113
(161)						(161)	
$ 8,133	$ 51	$ (5)		(221,938,647)	$ (5,210)	$ 5,425	$ 1,089

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the 52 Weeks Ended January 28, 2006 (Fiscal 2005), January 29, 2005 (Fiscal 2004), and January 31, 2004 (Fiscal 2003).

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The Gap Inc. (the "Company," "we," "our"), a Delaware Corporation, is a global specialty retailer selling casual apparel, accessories and personal care products for men, women and children under a variety of brand names including Gap, Banana Republic, Old Navy, and Forth & Towne. Our principal markets consist of the United States, Canada, Europe and Japan, with the United States being the most significant. We sell our products through traditional retail stores, outlet stores and through our web sites.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany transactions and balances have been eliminated.

Translation adjustments result from translating foreign subsidiaries' financial statements into U.S. dollars. Balance sheet accounts are translated at exchange rates in effect at the balance sheet date. Income statement accounts are translated at average exchange rates during the year. The resulting translation adjustments are included in accumulated other comprehensive earnings in the Consolidated Statements of Shareholders' Equity.

Fiscal Year

Our fiscal year is a 52- or 53-week period ending on the Saturday closest to January 31. Fiscal 2005, 2004 and 2003 all consisted of 52 weeks. Fiscal 2006 will consist of 53 weeks.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

We have reclassified $23 million of cash provided by operating activities to cash provided by investing activities related to the non-cash portion of property and equipment purchases for fiscal 2004 in our Consolidated Statements of Cash Flows. This reclassification had no effect on the net decrease in cash and equivalents or on net earnings, as previously reported.

Cash and Equivalents

Cash and equivalents represent cash and short-term, highly liquid investments with original maturities of three months or less. Amounts in-transit from banks for customer credit card, debit card and electronic benefit transfer transactions that process in less than seven days are classified as cash and equivalents in our Consolidated Balance Sheets. The banks process the majority of these amounts within one to two business days. Outstanding checks classified in accounts payable on the Consolidated Balance Sheets totaled $67 million and $70 million as of the end of fiscal 2005 and 2004, respectively.

Short-term Investments

We have short-term investments, which generally have maturities of more than three months and less than one year from the date of purchase. Our short-term investments are classified as held-to-maturity based on our positive intent and ability to hold the securities to maturity. Primarily all securities held are U.S. government and agency securities and bank certificates of deposit and are stated at amortized cost, which approximates fair market value. Income related to these securities is reported as a component of interest income.

The tables below summarize our marketable securities as of January 28, 2006 and January 29, 2005, which are recorded as cash and equivalents on the Consolidated Balance Sheets, and our short-term investments:

January 28, 2006 ($ in millions)	Cost Basis	Accrued Interest	Amortized Cost	Fair Value	Marketable Securities	Short-term Investments
Original maturity less than 91 days:						
Money market investments	$ 239	$ -	$ 239	$ 239	$ 239	$ -
Interest bearing accounts	175	-	175	175	175	-
Commercial paper	711	2	713	713	711	-
Certificates of deposit	50	-	50	50	50	-
Agency discount notes	443	2	445	445	443	-
Original maturity greater than 91 days:						
Certificates of deposit	130	3	133	133	-	133
Agency discount notes	731	10	741	741	-	741
Agency bonds	77	1	78	78	-	78
	$ 2,556	$ 18	$ 2,574	$ 2,574	$ 1,618	$ 952

January 29, 2005 ($ in millions)	Cost Basis	Accrued Interest	Amortized Cost	Fair Value	Marketable Securities	Short-term Investments
Original maturity less than 91 days:						
Money market investments	$ 1,102	$ -	$ 1,102	$ 1,102	$ 1,102	$ -
Commercial paper	326	-	326	326	326	-
Certificates of deposit	65	-	65	65	65	-
Agency discount notes	423	-	423	423	423	-
Original maturity greater than 91 days:						
Certificates of deposit	35	-	35	35	-	35
Agency discount notes	779	3	782	782	-	782
	$ 2,730	$ 3	$ 2,733	$ 2,733	$ 1,916	$ 817

Restricted Cash

Restricted cash primarily represents cash that serves as collateral and other cash that is restricted from withdrawal for use. As of January 28, 2006, restricted cash represents the restriction of $55 million, all of which serves as collateral for our insurance obligations. As of January 29, 2005, restricted cash represented the restriction of $1.0 billion, of which $900 million served as collateral for our committed bank lines that backed our letter of credit agreements to finance our inventory purchases, and the remainder was primarily restricted for our insurance obligations. The $900 million of restricted cash that collateralized the prior letter of credit agreements was fully released in May 2005. See Note B.

Hedging Instruments

We apply Statement of Financial Accounting Standards No. ("SFAS") 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, which establishes the accounting and reporting standards for derivative instruments and hedging activities. We recognize all derivative instruments as either other current assets or accrued expenses and other current liabilities in our Consolidated Balance Sheets and measure those instruments at fair value.

Merchandise Inventory

Inventory is valued using the cost method, which values inventory at the lower of the actual cost or market. Cost is determined using the first-in, first-out ("FIFO") method. Market is determined based on the estimated net realizable value, which generally is the merchandise selling price. We review our inventory levels in order to identify slow-moving merchandise and broken assortments (items no longer in stock in a sufficient range of sizes) and use markdowns to clear merchandise. We estimate and accrue shortage for the period between the last physical count and the balance sheet date. Our shortage estimate can be affected by changes in merchandise mix and changes in actual shortage trends.

Property and Equipment

Property and equipment are stated at cost and consists of the following:

($ in millions)	January 28, 2006	January 29, 2005
Leasehold improvements	$ 2,742	$ 2,636
Furniture and equipment	2,532	2,847
Land and buildings	1,008	1,038
Software	596	417
Construction-in-progress	80	231
Property and equipment, gross	6,958	7,169
Less: Accumulated depreciation and amortization	(3,712)	(3,793)
Property and equipment, net	$ 3,246	$ 3,376

Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the related assets. Estimated useful lives are as follows:

Category	Term
Leasehold improvements	Shorter of lease term or economic life, ranging from 1 to 15 years
Furniture and equipment	Up to 10 years
Buildings	39 years
Software	3 to 7 years

The cost of assets sold or retired and the related accumulated depreciation or amortization are removed from the accounts with any resulting gain or loss included in net earnings. Maintenance and repairs are charged to expenses as incurred.

Interest costs related to assets under construction are capitalized during the construction period. Interest of $11 million, $10 million and $9 million was capitalized in fiscal 2005, 2004 and 2003, respectively.

Lease Rights and Key Money

Lease rights are costs incurred to acquire the right to lease a specific property. A majority of our lease rights are related to premiums paid to landlords. Lease rights are recorded at cost and are amortized over the corresponding lease term. The gross carrying value and accumulated amortization of lease rights was $108 million and $63 million, respectively, as of January 28, 2006, and $114 million and $68 million, respectively, as of January 29, 2005 and are included in other assets on the Consolidated Balance Sheets. The amortization expense associated with lease rights was $6 million, $9 million and $9 million in fiscal 2005, 2004 and 2003, respectively.

Key money is the amount of funds paid to a landlord or tenant to acquire the rights of tenancy under a commercial property lease for a property located in France. These rights can be subsequently sold by us to a new tenant or the amount of key money paid can be recovered from the landlord should the landlord refuse to allow the automatic right of renewal to be exercised. Prior to fiscal 2005, we considered key money an indefinite life intangible asset that was not amortized. In fiscal 2005, we determined that key money should more appropriately be amortized over the corresponding lease term and have recorded $50 million in cost of goods sold and occupancy expenses representing the cumulative impact of amortizing our key money balance from fiscal 1995 through the end of fiscal 2005. The gross carrying value and accumulated amortization of key money was $62 million and $50 million, respectively, as of January 28, 2006 and are included in other assets on the Consolidated Balance Sheets. This accounting change did not have a material impact on our results of operations or financial position for any of the comparable periods presented or prior periods.

Rent Expense

Minimum rental expenses are recognized over the term of the lease. We recognize minimum rent starting when possession of the property is taken from the landlord, which normally includes a construction period prior to store opening. When a lease contains a predetermined fixed escalation of the minimum rent, we recognize the related rent expense on a straight-line basis and record the difference between the recognized rental expense and the amounts payable under the lease as deferred rent liability. Deferred rent liability is included in lease incentives and other liabilities on the Consolidated Balance Sheets. We also receive tenant allowances, with the short-term portion included in accrued expenses and other current liabil-

ities and the long-term portion included in lease incentives and other liabilities on the Consolidated Balance Sheets. Tenant allowances are amortized as a reduction to rent expense in the Statements of Operations over the term of the lease.

Certain leases provide for contingent rents that are not measurable at inception. These contingent rents are primarily based on a percentage of sales that are in excess of a predetermined level. These amounts are excluded from minimum rent and are included in the determination of rent expense when it is probable that the expense has been incurred and the amount is reasonably estimable.

Long-lived Assets, Impairment and Excess Facilities

In accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," we review the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Events that result in an impairment review include decisions to close a store, headquarter facility or distribution center, or a significant decrease in the operating performance of the long-lived asset. For our store assets that are identified as potentially being impaired, if the undiscounted future cash flows of the long-lived assets are less than the carrying value, we recognize a loss equal to the difference between the carrying value and the asset's fair value. The fair value of the store's long-lived assets is estimated using the discounted future cash flows of the assets based upon a rate that approximates our weighted-average cost of capital. Our estimate of future cash flows is based upon our experience, knowledge and third-party advice or market data. However, these estimates can be affected by factors such as future store profitability, real estate demand and economic conditions that can be difficult to predict. We recorded a charge for the impairment of store assets of $3 million, $5 million and $23 million during fiscal 2005, 2004 and 2003, respectively.

The decision to close or sublease a store, distribution center or headquarter facility space can result in accelerated depreciation over the revised estimated useful life of the long-lived asset. In addition, we record a charge and corresponding sublease loss reserve for the net present value of the difference between the contract rent obligations and the rate at which we expect to be able to sublease the properties. We estimate the reserve based on the status of our efforts to lease vacant office space, including a review of real estate market conditions, our projections for sublease income and sublease commencement assumptions. Most store closures occur upon the lease expiration. See Note E.

Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consist of payroll and related benefits, deferred rent liability and other current liabilities. Accrued payroll and related benefits were $225 million at January 28, 2006 and $275 million at January 29, 2005.

Insurance/Self-Insurance

We use a combination of insurance and self-insurance for a number of risk management activities including workers' compensation, general liability, automobile liability and employee-related health care benefits, a portion of which is paid by our employees. Liabilities associated with these risks are estimated based on actuarially determined amounts, and accrued in part by considering historical claims experience, demographic factors, severity factors and other actuarial assumptions.

Comprehensive Earnings

Our comprehensive earnings is comprised of net earnings, adjusted for foreign currency translation and fluctuations in fair market value of financial instruments related to foreign currency hedging activities, net of tax.

Foreign Currency Translation

Our international subsidiaries use local currencies as the functional currency and translate their assets and liabilities at the current rate of exchange in effect at the balance sheet date. Revenue and expenses from these operations are translated using the monthly average exchange rates in effect for the period in which the items occur. The resulting gains and losses from translation are included as accumulated other comprehensive earnings in the Consolidated Statements of Shareholders' Equity. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the local functional currency are included in the Consolidated Statements of Operations and were a loss of approximately $13 million and $3 million in fiscal 2005 and 2003, respectively, and a gain of approximately $1 million in fiscal 2004. Cumulative currency translation adjustments in accumulated other comprehensive earnings were $54 million, $79 million and $50 million at January 28, 2006, January 29, 2005 and January 31, 2004, respectively.

Treasury Stock

We account for treasury stock under the cost method and include treasury stock as a component in the Consolidated Statements of Shareholders' Equity.

Revenue Recognition

We recognize revenue and the related cost of goods sold (including shipping costs) at the time the products are received by the customers in accordance with the provisions of Staff Accounting Bulletin No. ("SAB") 101, "Revenue Recognition in Financial Statements" as amended by SAB 104, "Revenue Recognition." Revenue is recognized for store sales at the point at which the customer receives and pays for the merchandise at the register with either cash or credit card. For online sales, revenue is recognized at the time we estimate the customer receives the product. We estimate and defer revenue and the related product costs for shipments that are in-transit to the customer. Customers typically receive goods within a few days of shipment. Such amounts were immaterial as of January 28, 2006, January 29, 2005, and January 31, 2004. Amounts related to shipping and handling that are billed to customers are reflected in net sales and the related costs are reflected in cost of goods sold and occupancy expenses.

Allowances for estimated returns are recorded based on estimated gross profit using our historical return patterns. A summary of activity in the sales return allowance account is as follows:

($ in millions)	January 28, 2006	January 29, 2005	January 31, 2004
Balance at beginning of year	$ 19	$ 19	$ 15
Additions	704	714	633
Returns	(705)	(714)	(629)
Balance at end of year	$ 18	$ 19	$ 19

Upon the purchase of a gift card or issuance of a gift certificate, a liability is established for the cash value of the gift card or gift certificate. The liability is relieved and income is recorded as net sales upon redemption or as other income, which is a component of operating expenses, after sixty months, whichever is earlier. It is our historical experience that the likelihood of redemption after sixty months is remote. The liability for gift cards and gift certificates is recorded in accounts payable on the Consolidated Balance Sheets and was $356 million at January 28, 2006 and $363 million at January 29, 2005.

Cost of Goods Sold and Occupancy Expenses

Cost of goods sold and occupancy expenses include the cost of merchandise, inventory shortage and valuation adjustments, freight charges, costs associated with our sourcing operations, production costs, insurance costs related to merchandise and occupancy, rent, common area maintenance, real estate taxes, utilities, and depreciation for our stores and distribution centers.

Operating Expenses

Operating expenses include payroll and related benefits (for our store operations, field management, distribution centers, and corporate functions), advertising, and general and administrative expenses. Also included are costs to design and develop our products, merchandise handling and receiving in distribution centers and stores, distribution center general and administrative expenses, and rent, occupancy and depreciation for headquarter facilities.

Advertising

Costs associated with the production of advertising, such as writing, copy, printing and other costs, are expensed as incurred. Costs associated with communicating advertising that has been produced, such as television and magazine, are expensed when the advertising event takes place. Advertising costs were $513 million, $528 million and $509 million in fiscal 2005, 2004 and 2003, respectively.

Income Taxes

Income taxes are accounted for using the asset and liability method in accordance with SFAS 109 "Accounting for Income Taxes." Under this method, deferred income taxes arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the Consolidated Financial Statements. A valuation allowance is established against deferred tax assets when it is more likely than not that some portion or all of the deferred tax assets will not be realized.

We record reserves for estimates of probable settlements of foreign and domestic tax audits. At any point in time, many tax years are subject to or in the process of audit by various taxing authorities. To the extent that our estimates of probable settlements change or the final tax outcome of these matters is different than the amounts recorded, such differences will impact the income tax provision in the period in which such determinations are made.

Stock-based Awards

During fiscal 2005, 2004, and 2003, we accounted for stock-based awards to employees and directors using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. ("APB") 25, "Accounting for Stock Issued to Employees." Under the intrinsic value method, when the exercise price of the employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized in the Consolidated Statements of Operations. Performance units and discounted stock option awards, which are granted at less than fair market value, are amortized to operating expenses over the vesting period of the stock award. We amortize deferred compensation for each vesting layer of a stock award using the straight-line method.

SFAS 148, "Accounting for Stock-Based Compensation—Transition and Disclosure—an Amendment of FASB Statement No. 123" and SFAS 123, "Accounting for Stock-Based Compensation," require the disclosure of pro forma net earnings per share as if we had adopted the fair value method. Under SFAS 123, the fair value of stock-based compensation is calculated through the use of option pricing models. These models require subjective assumptions, including future stock price volatility and expected life, which affect the calculated values. The following table illustrates the effect on net earnings and earnings per share had we applied the fair value recognition provisions of SFAS 123:

($ in millions)	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Net earnings, as reported	$ 1,113	$ 1,150	$ 1,031
Add: Stock-based employee compensation expense included in reported net earnings, net of related tax effects	13	3	1
Less: Total stock-based employee compensation expense determined under fair-value based method for all awards, net of related tax effects (a)	(93)	(80)	(53)
Pro forma net earnings	$ 1,033	$ 1,073	$ 979

(a) Included in the $93 million stock-based compensation expense in fiscal 2005 is $33 million, net of related tax effects, pertaining to our January 26, 2006 acceleration of certain stock options. See Note G.

Earnings per share:			
As reported–basic	$ 1.26	$ 1.29	$ 1.15
Pro forma–basic	1.17	1.20	1.10
As reported–diluted	1.24	1.21	1.09
Pro forma–diluted	1.15	1.13	1.03

The value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	January 28, 2006	January 29, 2005	January 31, 2004
Dividend yield	0.88%	0.40%	0.53%
Risk-free interest rate	4.07%	3.16%	2.39%
Volatility	36%	49%	50%
Expected life (in years)	4	4	4

Under the Black-Scholes option pricing model, the weighted-average fair value of the stock options granted during fiscal 2005, 2004 and 2003 was $7.20, $8.33 and $5.36, respectively.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4." SFAS 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material and requires that these items be recognized as current period charges. SFAS 151 applies only to inventory costs incurred during periods beginning after the effective date and also requires that the allocation of fixed production overhead to conversion costs be based on the normal capacity of the production facilities. SFAS 151 is effective for fiscal 2006. We do not believe the adoption of SFAS 151 will have a material impact on our financial position, cash flows, or results of operations.

In December 2004, the FASB issued SFAS 123(R) which is effective for us at the beginning of fiscal 2006. SFAS 123(R) requires an entity to recognize compensation expense in an amount equal to the fair value of share-based payments granted to employees. We will apply the standard using the modified prospective method, which requires compensation expense to be recorded for new and modified awards. For any unvested portion of previously issued and outstanding awards compensation expense is required to be recorded based on the previously disclosed SFAS 123 methodology and amounts. Prior periods presented are not required to be restated. We estimate the impact on our fiscal 2006 results of operations upon the adoption of SFAS 123(R) to be about $45 million before tax. Because this estimate is based on assumptions including anticipated levels of new awards to be granted, changes in stock price, forfeitures of awards and employee exercise behaviors, the actual impact of earnings may differ from this estimate.

In March 2005, the SEC issued Staff Accounting Bulletin ("SAB") 107, "Share-Based Payment." SAB 107 provides guidance regarding the interaction between SFAS 123(R) and certain SEC rules and regulations, including guidance related to valuation methods, the classification of compensation expense, non-GAAP financial measures, the accounting for income tax effects of share-based payment arrangements, disclosures in Management's Discussion and Analysis subsequent to adoption of SFAS 123(R), and modifications of options prior to the adoption of SFAS 123(R). We are currently assessing the guidance in SAB 107 as part of our evaluation of the adoption of SFAS 123(R).

In March 2005, the FASB issued FASB Interpretation No. ("FIN") 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143." This Interpretation clarifies that the term conditional asset retirement obligation refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. This Interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. We adopted FIN 47 in the fourth quarter of fiscal 2005 and this adoption did not have a material effect on our financial position, cash flows or results of operations.

In May 2005, the FASB issued SFAS 154, "Accounting Changes and Error Corrections - a Replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, voluntary changes in accounting principles were generally required to be recognized by way of a cumulative effect adjustment within net earnings during the period of the change. SFAS 154 requires retrospective application to prior period financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements. We do not believe the adoption of SFAS 154 will have a material effect on our financial position, cash flows or results of operations.

In June 2005, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 05-06, "Determining the Amortization Period for Leasehold Improvements." EITF 05-06 provides guidance for determining the amortization period used for leasehold improvements acquired in a business combination or purchased after the inception of a lease, collectively referred to as subsequently acquired leasehold improvements. EITF 05-06 provides that the amortization period used for the subsequently acquired leasehold improvements to be the lesser of (a) the subsequently acquired leasehold improvements' useful lives, or (b) a period that reflects renewals that are reasonably assured upon the acquisition or the purchase. EITF 05-06 is effective on a prospective basis for subsequently acquired leasehold improvements purchased or acquired in periods beginning after the date of the FASB's ratification, which was on June 29, 2005. We adopted EITF 05-06 in the third quarter of fiscal 2005 and this adoption did not have a material effect on our financial position, cash flows or results of operations.

In October 2005, the FASB issued FASB Staff Position ("FSP") 13-1, "Accounting for Rental Costs Incurred During a Construction Period," to clarify the proper accounting for rental costs incurred on building or ground operating leases during a construction period. The FSP requires that rental costs incurred during a construction period be expensed, not capitalized. The statement is effective for the first reporting period beginning after December 15, 2005. We do not believe adoption of FSP 13-1 will have a material effect on our financial position, cash flows or results of operations.

NOTE B: DEBT, SENIOR CONVERTIBLE NOTES AND OTHER CREDIT ARRANGEMENTS

On May 6, 2005, we entered into four separate $125 million 3-year letter of credit agreements and four separate $100 million 364-day letter of credit agreements for a total aggregate availability of $900 million, which collectively replaced our prior letter of credit agreements. Unlike the previous letter of credit agreements, the current letter of credit agreements are unsecured. Consequently, the $900 million of restricted cash that collateralized the prior letter of credit agreements was fully released in May 2005.

On August 30, 2004, we terminated all commitments under our $750 million three-year secured revolving credit facility scheduled to expire in June 2006 (the "Old Facility") and replaced the Old Facility with a new $750 million five-year unsecured revolving credit facility scheduled to expire in August 2009 (the "New Facility"). The New Facility is available for general corporate purposes, including commercial paper backstop, working capital, trade letters of credit and standby letters of credit. The facility usage fees and fees related to the New Facility fluctuate based on our long-term senior unsecured credit ratings and our leverage ratio.

The New Facility and letter of credit agreements contain financial and other covenants, including, but not limited to, limitations on liens and subsidiary debt as well as the maintenance of two financial ratios – a fixed charge coverage ratio and a leverage ratio. A violation of these covenants could result in a default under the New Facility and new letter of credit agreements, which would permit the participating banks to terminate our ability to access the New Facility for letters of credit and advances, terminate our ability to request letters of credit under the letter of credit agreements, require the immediate repayment of any outstanding advances under the New Facility, and require the immediate posting of cash collateral in support of any outstanding letters of credit under the letter of credit agreements. In addition, such a default could, under certain circumstance, permit the holders of our outstanding unsecured debt to accelerate payment of such obligations.

Letters of credit represent a payment undertaking guaranteed by a bank on our behalf to pay the vendor a given amount of money upon presentation of specific documents demonstrating that merchandise has shipped. Vendor payables are recorded in the Consolidated Balance Sheets at the time of merchandise title transfer, although the letters of credit are generally issued prior to this. As of January 28, 2006, we had $306 million in trade letters of credit issued under our letter of credit agreements totaling $900 million and there were no borrowings under our $750 million revolving credit facility.

A summary of our long-term debt and senior convertible notes is as follows:

	January 28, 2006		January 29, 2005	
($ in millions)	Carrying Amount in U.S. Dollars	Fair Value (a)	Carrying Amount in U.S. Dollars	Fair Value (a)
$500 million notes payable, 6.90%, interest due semi-annually, due September 2007	$ 325	$ 329	$ 325	$ 348
$500 million notes payable, 8.80% (9.55%), interest due semi-annually, due December 2008 (b)	138	153	138	167
$50 million notes payable, 6.25%, interest due semi-annually, due March 2009	50	51	50	53
Total long-term debt	513	533	513	568
$1.38 billion senior convertible notes payable, 5.75%, interest due semi-annually, due March 2009	-	-	1,373	1,833
Total long-term debt and senior convertible notes	$ 513	$ 533	$ 1,886	$ 2,401

(a) Based on the face amount multiplied by the market price of the note as of January 27, 2006.

(b) The interest rate payable on these notes is subject to increase (decrease) by 0.25 percent for each rating downgrade (upgrade) by the rating agencies. The rate in parentheses reflects the rate at January 28, 2006. In no event will the interest rate be reduced below the original interest rate on the note.

On March 11, 2005, we called for the full redemption of our outstanding $1.4 billion aggregate in principal of our 5.75 percent senior convertible notes (the "Notes") due March 15, 2009. The redemption was complete by March 31, 2005. Note holders had the option to receive cash at a redemption price equal to 102.46 percent of the principal amount of the Notes, plus accrued interest excluding the redemption date, for a total of approximately $1,027 per $1,000 principal amount of Notes. Alternatively, note holders could elect to convert their Notes into approximately 62.03 shares of Gap, Inc. common stock per $1,000 principal amount. As of March 31, 2005, $1.4 billion of principal was converted into 85,143,950 shares of Gap Inc. common stock and approximately $0.5 million was paid in cash redemption.

In line with our fiscal 2004 objective of reducing long-term debt, we repaid $871 million in debt in fiscal 2004. This included early extinguishment of $596 million of our domestic debt and the maturity of €227 million 5-year euro bond ($275 million). We repurchased and extinguished early an aggregate of $180 million in principal amount of our notes due 2005, $91 million in principal amount of our notes due 2007 and $325 million in principal amount of our notes due 2008. We performed a net present value analysis on our outstanding debt and determined that it would be beneficial to repurchase the debt earlier even though we incurred $105 million in loss on early retirement of debt due to premiums paid and the write-off of debt issuance costs.

Our 8.80 percent note payable, due December 2008 ("2008 Notes"), has an interest rate that is subject to adjustment if our credit rating is upgraded or downgraded by the credit rating agencies. As a result of upgrades to our long-term credit ratings in fiscal 2004, the interest rate on the 2008 Notes decreased from 10.55 percent as of year-end fiscal 2003 to 10.05 percent as of year-end fiscal 2004. As a result of subsequent upgrades to our long-term credit ratings in fiscal 2005, the interest payable by us on the 2008 Notes decreased a total of 50 basis points to 9.55 percent per annum as of June 15, 2005 and remains at this rate as of January 28, 2006.

NOTE C: INCOME TAXES

The provision for income taxes consisted of the following:

($ in millions)	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Current			
Federal	$ 657	$ 589	$ 473
State	63	73	79
Foreign	45	114	117
Total current	765	776	669
Deferred			
Federal	(44)	(38)	(5)
State	4	(19)	(18)
Foreign	(45)	3	7
Total deferred	(85)	(54)	(16)
Total provision	$ 680	$ 722	$ 653

The foreign component of pretax earnings before elimination of intercompany transactions in fiscal 2005, 2004 and 2003 was approximately $273 million, $534 million and $431 million, respectively. Except where required by U.S. tax law, no provision was made for U.S. income taxes on the undistributed earnings of the foreign subsidiaries as we intend to utilize those earnings in the foreign operations for an indefinite period of time or repatriate such earnings only when tax-effective to do so. That portion of accumulated undistributed earnings of foreign subsidiaries at fiscal year-end 2005 and 2004 was approximately $700 million and $604 million, respectively. If the undistributed earnings were repatriated, the unrecorded deferred tax liability in fiscal 2005 and 2004 would be approximately $80 million and $24 million, respectively.

In October 2004, Congress enacted, and the President signed into law, the American Jobs Creation Act of 2004. Among its numerous changes in the tax law, this Act included a tax relief provision allowing corporate taxpayers a reduced tax rate on dividends received from controlled foreign corporations if certain conditions are satisfied. We have reviewed the provisions of the new law and concluded we will not benefit from these changes; therefore, there is no effect on income tax expense (or benefit) for the periods presented as a result of the American Jobs Creation Act's repatriation provisions.

The difference between the effective income tax rate and the U.S. federal income tax rate is summarized as follows:

	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Federal tax rate	35.0%	35.0%	35.0%
State income taxes, less federal benefit	3.5	2.7	2.1
Tax impact of foreign operations	2.3	2.0	2.2
Other (a)	(2.9)	(1.1)	(0.5)
Effective tax rate	37.9%	38.6%	38.8%

(a) The increase from fiscal 2004 in other is primarily driven by the impact of a favorable tax settlement related to the U.S.–Japan Income Tax Treaty.

Deferred tax assets (liabilities) consisted of the following:

($ in millions)	January 28, 2006	January 29, 2005
Compensation and benefits accruals	$ 44	$ 44
Scheduled rent	117	120
Nondeductible accruals	77	120
Fair value of financial instruments included in accumulated other comprehensive earnings	1	19
Other	62	72
State and foreign NOL	67	33
Gross deferred tax assets	368	408
NOL valuation allowance	(18)	(10)
Depreciation	(17)	(53)
Other	(17)	(12)
Inventory capitalization and other adjustments	(3)	(48)
Gross deferred tax liabilities	(37)	(113)
Net deferred tax assets	$ 313	$ 285
Current portion (included in other current assets)	$ 109	$ 149
Non-current portion (included in other assets)	204	136
Total	$ 313	$ 285

At January 28, 2006, we had $388 million of state and foreign net operating loss carryovers that could be utilized to reduce the tax liabilities of future years. A portion of the state and foreign net operating loss carryovers was reduced by a valuation allowance. The losses begin to expire in fiscal 2006 with some loss carryovers having indefinite carryforward periods.

NOTE D: LEASES

We lease most of our store premises and some of our headquarter facilities and distribution centers. These operating leases expire at various dates through 2033. Most store leases are for a five year base period and include options that allow us to extend the lease term beyond the initial base period, subject to terms agreed to at lease inception. Some leases also include early termination options, which can be exercised under specific conditions.

For leases that contain predetermined fixed escalations of the minimum rentals, we recognize the related rental expense on a straight-line basis and record the difference between the recognized rental expense and amounts payable under the leases as deferred rent liability. Deferred rent liability is recorded in lease incentives and other liabilities on the Consolidated Balance Sheets and was approximately $342 million at January 28, 2006 and $361 million at January 29, 2005.

Lease payments that depend on factors that are not measurable at the inception of the lease, such as future sales volume, are contingent rentals and are excluded from minimum lease payments and included in the determination of total rental expense when it is probable that the expense has been incurred and the amount is reasonably estimable. Future payments for maintenance, insurance and taxes to which the Company is obligated are excluded from minimum lease payments.

Tenant allowances received upon entering into certain store leases are recognized on a straight-line basis as a reduction to rent expense over the lease term. At January 28, 2006 and January 29, 2005, the short-term portion of the deferred credit was approximately $70 million and $82 million, respectively, and is included in accrued expenses and other current liabilities on the Consolidated Balance Sheets. At January 28, 2006 and January 29, 2005,

the long-term portion of the deferred credit was approximately $525 million and $496 million, respectively, and is included in lease incentives and other liabilities on the Consolidated Balance Sheets.

The aggregate minimum non-cancelable annual lease payments under leases in effect on January 28, 2006, are as follows:

Fiscal Year	($ in millions)
2006	$ 974
2007	873
2008	786
2009	678
2010	537
Thereafter	1,660
Total minimum lease commitment	$ 5,508

Rental expense, net of sublease income, for all operating leases was as follows:

($ in millions)	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Minimum rentals	$ 866	$ 819	$ 808
Contingent rentals	139	148	146
Total	$ 1,005	$ 967	$ 954

NOTE E: SUBLEASE LOSS RESERVE AND OTHER LIABILITIES

As a result of our 2001 decision to consolidate and downsize corporate facilities in our San Francisco and San Bruno campuses, we have approximately 217,000 square feet of excess facility space as of January 28, 2006. We record a sublease loss reserve for the net present value of the difference between the contract rent obligations and the rate at which we expect to be able to sublease the properties. These estimates and assumptions are monitored on at least a quarterly basis for changes in circumstances. We estimate the reserve based on the status of our efforts to lease vacant office space, including a review of real estate market conditions, our projections for sublease income and sublease commencement assumptions.

In fiscal 2005, we released a net amount of $61 million of sublease loss reserve, and recorded net sublease loss charges of $15 million and $10 million in fiscal 2004 and 2003, respectively. During the second fiscal quarter of 2005 we completed our assessment of available space and future office facility needs and decided that we would occupy one of our vacant leased properties in San Francisco. As a result, in the same quarter the sublease loss reserve of $58 million associated with this space at April 30, 2005 was reversed and planning efforts to design and construct leasehold improvements for occupation in 2006 began. The remaining reduction in the provision was related to our decision to occupy certain other office space. In addition, we also recorded $6 million related to corporate severance and outplacement expenses. Sublease loss charges are reflected in operating expenses in our Consolidated Statements of Operations.

Remaining cash expenditures associated with the headquarter facilities sublease loss reserve are expected to be paid over the various remaining lease terms through 2012. Based on our current assumptions as of January 28, 2006, we expect our lease payments, net of sublease income, to result in a total net cash outlay of approximately $20 million for future rent. Our accrued liability related to the domestic headquarter sublease loss charges of $14 million at January 28, 2006 was net of approximately $6 million of estimated sublease income to be generated from sublease contracts, which have not yet been identified.

Distribution facility changes in fiscal 2003 include costs associated with the cost of lease terminations, facilities restoration, severance and equipment removal.

The reserve balances and activities are as follows:

($ in millions)	Sublease Loss Reserve	Severance and Outplacement	Distribution Facilities Charges	Total
Balance at February 1, 2003	$ 115	$ -	$ 4	$ 119
Additional provision (reversals), net	10	-	(1)	9
Cash payments	(23)	-	(3)	(26)
Balance at January 31, 2004	102	-	-	102
Additional provision, net	15	2	-	17
Cash payments	(23)	-	-	(23)
Balance at January 29, 2005	94	2	-	96
Additional provision (reversals), net	(61)	6	-	(55)
Cash payments	(19)	(6)	-	(25)
Balance at January 28, 2006	$ 14	$ 2	$ -	$ 16

In January 2004, we signed an agreement to sell our Gap stores and exit the market in Germany, effective August 1, 2004. Gap brand operations in Germany represented our smallest international retail business, and with only 10 store locations, accounted for less than 1 percent of total Company sales. This decision represented a strategic move toward re-allocating our international resources to optimize growth in our other existing markets and focusing our attention on more attractive, longer-term growth opportunities in new markets. As a result of our decision, we recognized an operating expense charge of $14 million to write down the assets to their fair value in fiscal 2003, which was estimated based upon the expected net selling price. In August 2004, we completed the sale of our Gap stores in Germany. The actual net selling price approximated our initial estimate.

NOTE F: DERIVATIVE FINANCIAL INSTRUMENTS

We operate in foreign countries, which exposes us to market risk associated with foreign currency exchange rate fluctuations. Our risk management policy is to hedge substantially all forecasted merchandise purchases for foreign operations and intercompany obligations that bear foreign exchange risk using foreign exchange forward contracts. The principal currencies hedged during fiscal 2005 were the Euro, British pound, Japanese yen, and Canadian dollar. We do not enter into derivative financial contracts for trading purposes.

Forward contracts used to hedge forecasted merchandise purchases are designated as cash-flow hedges. Our derivative financial instruments are recorded on the Consolidated Balance Sheets at fair value and are determined using quoted market rates. These forward contracts are used to hedge forecasted merchandise purchases over approximately 12 months. Changes in the fair value of forward contracts designated as cash-flow hedges are recorded as a component of accumulated other comprehensive earnings within shareholders' equity, and are recognized in cost of goods sold and occupancy expenses in the period which approximates the time the hedged merchandise inventory is sold. An unrealized loss of approximately $3 million, net of tax, has been recorded in accumulated other comprehensive earnings at January 28, 2006, and will be recognized in cost of goods sold over the next 12 months. The majority of the critical terms of the forward contracts and the forecasted foreign merchandise purchases are the same. As a result, there were no material amounts reflected in fiscal 2005, fiscal 2004 or fiscal 2003 earnings resulting from hedge ineffectiveness. At January 28, 2006 and January 29, 2005, the fair value of these forward contracts was approximately $14 million and $2 million, respectively, in other current assets and $18 million and $52 million, respectively, in accrued expenses and other liabilities on the Consolidated Balance Sheets.

We also use forward contracts to hedge our market risk exposure associated with foreign currency exchange rate fluctuations for certain intercompany loans and balances denominated in currencies other than the functional currency of the entity holding or issuing the loan and intercompany balance. Forward contracts used to hedge intercompany transactions are designated as fair value hedges. At January 28, 2006 and January 29, 2005, the fair value of these forward contracts was approximately $1 million and $8 million, respectively, in other current assets and $6 million and $28 million, respectively, in accrued expenses and other liabilities on the Consolidated Balance Sheets. Changes in the fair value of these foreign currency contracts, as well as the underlying intercompany loans and balances, are recognized in operating expenses in the same period and generally offset, thus resulting in no material amounts of ineffectiveness.

Periodically, we hedge the net assets of certain international subsidiaries to offset the foreign currency translation and economic exposures related to our investments in these subsidiaries. We have designated such hedges as net investment hedges. The changes in fair value of the hedging instruments are reported in accumulated other comprehensive earnings within shareholders' equity to offset the foreign currency translation adjustments on the investments. At January 28, 2006 and January 29, 2005, we used a non-derivative financial instrument, an intercompany loan, to hedge the net

investment of one of our subsidiaries. The net amount of the gain resulting from the fair value change of the hedging instrument included in accumulated other comprehensive earnings during fiscal 2005 and fiscal 2004 was $9 million and $5 million, respectively.

In addition, we use cross-currency interest rate swaps to swap the interest and principal payable of $50 million debt securities of our Japanese subsidiary, Gap (Japan) KK, from a fixed interest rate of 6.25 percent, payable in U.S. dollars, to 6.1 billion Japanese yen with a fixed interest rate of 2.43 percent. At January 28, 2006 and January 29, 2005, the fair market value loss of the swaps was $2 million and $9 million, respectively, and is included in accrued expenses and other liabilities on the Consolidated Balance Sheets. We have designated such swaps as cash flow hedges to hedge the total variability in functional currency – cash flows of the interest and principal.

NOTE G: SHAREHOLDERS' EQUITY AND STOCK COMPENSATION PLANS

Common and Preferred Stock

The Board of Directors is authorized to issue 60,000,000 shares of Class B common stock, which is convertible into shares of common stock on a share-for-share basis. Transfer of the shares is restricted. In addition, the holders of the Class B common stock have six votes per share on most matters and are entitled to a lower cash dividend. No Class B shares have been issued.

The Board of Directors is authorized to issue 30,000,000 shares of one or more series of preferred stock, par value of $0.05 per share, and to establish at the time of issuance the issue price, dividend rate, redemption price, liquidation value, conversion features and such other terms and conditions of each series (including voting rights) as the Board of Directors deems appropriate, without further action on the part of the shareholders. No preferred shares have been issued.

Stock Repurchase Program

During fiscal 2005, we announced share repurchase authorizations totaling $2.0 billion, which we completed by the end of the fiscal year. We repurchased approximately 99 million shares of our common stock at a total cost of approximately $2.0 billion, at an average price per share of $20.29 including commissions. On February 23, 2006, we announced the authorization of a new $500 million share repurchase program. Under this program, shares may be repurchased over 24 months.

During fiscal 2004, we repurchased approximately 48 million shares for approximately $1.0 billion, including commissions, at an average price per share of $20.92.

Dividends

During fiscal 2005, we increased our annual cash dividends, which had been $0.09 per share to $0.18 per share. The increase in annual dividends reflects the declaration and payment schedule of our fiscal 2005 dividends at the increased $0.045 per share per quarter. This annual dividend of $0.18 per share does not include the fourth quarter 2004 dividend of $0.0222 per share declared in the fourth quarter of fiscal 2004 but paid in the first quarter of fiscal 2005. We have revised our dividend schedule in 2005 such that all dividends are declared and paid in the same fiscal quarter.

In February 2006, we announced our intent to increase the annual dividend per share from $0.18 to $0.32 for fiscal 2006. The dividend is expected to be paid quarterly in April, July, October and January.

Stock Compensation Plans

The 1996 Stock Option and Award Plan (the "1996 Plan") was established on March 26, 1996, and amended and restated on January 28, 2003. Subject to the approval of shareholders on May 9, 2006, the 1996 Plan was most recently amended and restated on January 24, 2006 and renamed the 2006 Long-Term Incentive Plan (the "2006 Plan"). The Board authorized 123,341,342 shares for issuance under the 1996 Plan, which includes shares available under the Management Incentive Restricted Stock Plan and an earlier stock option plan established in 1981, both of which were superseded by the 1996 Plan. Following May 9, 2006, the number of shares available for grant under the 2006 Plan will increase by the sum of (a) the number of shares that remain available for grant under the 2002 Plan as of January 24, 2006, the date of board approval of the 2006 Plan, and (b) any shares that otherwise would have been returned to the 2002 Plan after January 24, 2006, on account of the expiration, cancellation, or forfeiture of awards granted thereunder. The 2006 Plan empowers the Compensation and Management Development Committee of the Board of Directors (the "Committee") to award compensation primarily in the form of nonqualified stock options, restricted stock, or performance units to key employees. The 2002 Stock Option Plan (the "2002 Plan"), formerly known as Stock Up on Success, was established on January 1, 1999. The Board originally authorized 52,500,000 shares for issuance under the 2002 Plan, which includes shares available under an earlier stock option plan established in 1999 that was merged with the 2002 Plan. Subject to the approval of shareholders on May 9, 2006, the 2002 Plan will be discontinued

and only those shares then outstanding would continue to be subject to the terms of the 2002 Plan under which they were granted. The 2002 Plan empowered the Committee to award nonqualified stock options to non-officer employees. The stock options generally expired 10 years from the grant date, three months after termination, or one year after the date of retirement or death, if earlier. In addition, the stock options generally vested over a four-year period, with shares becoming exercisable in equal annual installments of 25 percent.

Beginning in fiscal 2005, the Compensation and Management Development Committee of the Board of Directors (the "Committee") began granting stock awards in the form of performance units under our 1996 Stock Option and Award Plan. One share of common stock is issued for each performance unit upon time-based vesting of the awards. During the year ended January 28, 2006, we awarded approximately 2 million performance units (net of cancellations) subject to time-based vesting. We recognize compensation expense for these performance units based on the fair market value of the underlying common stock on the date of grant. The award is presented as an increase to shareholders' equity as it is amortized over the vesting period of the performance unit. During fiscal 2005, $18 million of compensation expense related to these performance units was recognized.

In December 2005, we finalized our Tender Offer (the "Offer") to provide eligible employees, including certain executives, a voluntary opportunity to exchange outstanding, eligible options for new options and, if applicable, cash payments. Each eligible option granted had been granted with a per share exercise price that was below the fair market value on that option's original date of grant. Due to Section 409A of the Internal Revenue Code and recently proposed regulations under Section 409A, neither of which were in effect or anticipated at the time these options were granted, these options likely would have resulted in income recognition by the optionee prior to exercise, an additional twenty percent (20%) income tax, and potential interest charges if they had remained outstanding. The Offer was instituted to allow employees holding eligible options the opportunity to avoid these unfavorable tax consequences by exchanging them for new options and preserve as closely as practicable the economic characteristics that were contemplated when the grants were originally made. In total, eligible options to purchase 1,968,525 shares of common stock were exchanged for new options with exercise prices greater than or equal to the original exercise price and with similar vesting periods. Compensation expense of $4 million was recognized in fiscal 2005 representing the incremental intrinsic value of the new award and, for certain new options, the cash consideration. Compensation expense for those stock options issued at less than fair market value under the 1996 Plan, the 2002 Plan, and the Deferred Compensation Plan (no options were granted in fiscal 2005) for non-employee members of the Board of Directors was approximately $4 million, $5 million and $1 million in fiscal 2005, 2004 and 2003, respectively, representing the original intrinsic value of these discounted stock options.

On January 26, 2006, we accelerated the vesting of all stock options with an exercise price equal to or greater than $21 per share except options held by non-employee directors and performance-based options to purchase 1,000,000 shares granted to our Chief Executive Officer. Options to purchase approximately 15 million shares of common stock that were scheduled to vest from fiscal 2006 to 2009 were impacted by this action. Although these options became immediately exercisable, the exercise price did not change. The primary purpose of the accelerated vesting was to enable the Company to reduce compensation expense by approximately $45 million associated with these options on our Consolidated Statements of Operations for future periods upon the adoption of SFAS 123(R), "Share-Based Payment," in the first quarter of fiscal 2006. There was no impact to our Consolidated Statement of Operations in fiscal 2005.

Under our stock option plans, nonqualified options to purchase common stock are granted to officers, directors, eligible employees and consultants at exercise prices equal to the fair market value of the stock at the date of grant or as determined by the Compensation and Management Development Committee of the Board of Directors.

The following table summarizes stock option activity for all employee stock option plans:

	Shares	Weighted-Average Exercise Price
Balance at February 1, 2003	80,492,169	$ 20.12
Granted	26,782,766	14.13
Exercised	(8,229,703)	11.24
Canceled	(16,354,458)	22.04
Balance at January 31, 2004	82,690,774	18.68
Granted	23,757,358	21.10
Exercised	(9,275,770)	13.77
Canceled	(10,017,064)	21.63
Balance at January 29, 2005	87,155,298	19.53
Granted	10,644,588	20.28
Exercised	(8,115,351)	13.61
Canceled	(13,702,035)	20.83
Balance at January 28, 2006	75,982,500	$ 20.03

Outstanding options at January 28, 2006 have expiration dates ranging from January 2006 to January 2016.

At January 28, 2006, we reserved 156,465,588 shares of our common stock, including 339,370 treasury shares, for the exercise of stock options. There were 80,952,385, 80,007,291, and 94,246,540 shares available for granting of options at January 28, 2006, January 29, 2005, and January 31, 2004, respectively. Options for 57,346,127, 39,764,741, and 37,292,786 shares were exercisable as of January 28, 2006, January 29, 2005, and January 31, 2004, respectively, and had a weighted-average exercise price of $21.27, $22.06, and $22.53, respectively, at those dates.

The following table summarizes additional information about stock options outstanding and exercisable at January 28, 2006:

	Options Outstanding				Options Exercisable	
	Range of Exercise Prices	Number of Shares at January 28, 2006	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number of Shares at January 28, 2006	Weighted-Average Exercise Price
$	2.85 – $5.92	1,056,350	6.08	$ 5.72	1,056,350	$ 5.72
	6.56 – 12.87	15,461,188	6.04	12.00	7,529,932	11.45
	12.95 – 17.75	15,059,980	6.26	14.96	11,491,531	14.64
	17.79 – 20.94	10,850,105	6.57	20.01	5,407,339	20.02
	20.95 – 29.41	27,030,795	7.26	22.60	25,336,893	22.65
	30.13 – 49.53	6,524,082	3.89	42.46	6,524,082	42.46
$	2.85 – $49.53	75,982,500	6.41	$ 20.03	57,346,127	$ 21.27

Employee Stock Purchase Plan

We have an Employee Stock Purchase Plan under which eligible U.S. employees may purchase our common stock at 85 percent of the lower of the closing price on the New York Stock Exchange on the first or last day of the six-month purchase period. Employees pay for their stock purchases through payroll deductions at a rate equal to any whole percentage from 1 percent to 15 percent. There were 1,700,466, 1,422,059, and 1,626,393 shares issued under the plan during fiscal 2005, 2004 and 2003, respectively. All shares were issued from treasury stock. At January 28, 2006, there were 6,901,958 shares reserved for future issuances.

During fiscal 2000, we established an Employee Stock Purchase Plan for employees in the United Kingdom. Under the plan, all eligible employees may purchase our common stock at the lower of the closing price on the New York Stock Exchange on the first or last day of the six-month purchase period. We provide a match of one share for every seven shares purchased. Employees pay for their stock purchases through payroll deductions from £10 to £125 per month, not to exceed the lesser of either £750 per each six-month purchase period or 10 percent of gross annual base salary per tax year. At January 28, 2006, £1 was equivalent to $1.77. There were 14,136, 16,597, and 23,371 shares issued under the plan during fiscal 2005, 2004 and 2003, respectively. All shares were issued from treasury stock. At January 28, 2006, there were 891,120 shares reserved for future issuances.

NOTE H: EMPLOYEE BENEFIT PLANS

We have a qualified defined contribution retirement plan, called GapShare, which is available to employees who meet certain age and service requirements. This plan permits employees to make contributions up to the maximum limits allowable under the Internal Revenue Code. Under the plan, we match in cash all or a portion of employees' contributions under a predetermined formula. Our contributions vest immediately. Our contributions to the retirement plan in fiscal 2005, 2004 and 2003 were approximately $33 million, $31 million and $28 million, respectively.

A nonqualified Executive Deferred Compensation Plan (the "Plan") established on January 1, 1999, allows eligible employees to defer compensation up to a maximum amount. We do not match any employees' contributions under this plan. As of January 28, 2006, the asset and liability relating to the Plan was approximately $24 million and $30 million, respectively. The asset is classified in other assets and the liability is classified in lease incentives and other liabilities in the Consolidated Balance Sheets. This plan was frozen for additional contributions effective December 31, 2005.

A nonqualified Supplemental Deferred Compensation Plan established on January 1, 2006, replaced the Plan and allows eligible employees and non-employee members of the Board of Directors to defer compensation up to a maximum amount. We match in cash all or a portion of employees' contributions under a predetermined formula. We do not match non-employee members of the Board of Directors contributions under the current plan.

NOTE I: EARNINGS PER SHARE

Basic earnings per share is computed using the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share includes the additional dilutive effect of our potentially dilutive securities, which includes certain stock options and unvested shares of restricted stock, calculated using the treasury stock method, and convertible notes which are potentially dilutive at certain earnings levels calculated using the if-converted method. The following summarizes the incremental shares from the potentially dilutive securities:

	52 Weeks Ended January 28, 2006	52 Weeks Ended January 29, 2005	52 Weeks Ended January 31, 2004
Earnings–basic ($ in millions)	$ 1,113	$ 1,150	$ 1,031
Add: Interest on convertible notes, net of tax	8	49	48
Earnings–diluted ($ in millions)	$ 1,121	$ 1,199	$ 1,079
Weighted-average number of shares-basic	881,057,753	893,356,815	892,554,538
Incremental shares from:			
Stock options	8,037,041	12,244,267	10,015,477
Restricted stock	202,871	-	-
Convertible note	13,008,026	85,520,491	85,607,813
Weighted-average number of shares-diluted	902,305,691	991,121,573	988,177,828
Earnings per share–basic	$ 1.26	$ 1.29	$ 1.15
Earnings per share–diluted	1.24	1.21	1.09

Excluded from the above computations of weighted-average shares for diluted earnings per share were options to purchase 44,499,102, 32,943,414, and 30,788,277 shares of common stock for fiscal 2005, 2004 and 2003, respectively, because the exercise price was greater than the average market price of the Company's common stock during the period and, therefore, the effect is antidilutive.

NOTE J: COMMITMENTS AND CONTINGENCIES

In January 2006, we entered into a non-exclusive services agreement with International Business Machines Corporation ("IBM"). Under the services agreement, IBM will operate certain aspects of our information technology infrastructure that are currently operated by us. The services agreement has an initial term of ten years, and we have the right to renew it for up to three additional years. We have various options to terminate the agreement, and we will pay IBM under a combination of fixed and variable charges, with the variable charges fluctuating based on our actual consumption of services. Based on the currently projected service needs, we expect to pay approximately $1.1 billion to IBM ratably over the initial 10-year term.

The services agreement has performance levels that IBM must meet or exceed. If these service levels are not met, we would in certain circumstances receive a credit against the charges otherwise due, have the right to other interim remedies, or as to material breaches have the right to terminate the services agreement. In addition, the services agreement provides us certain pricing protections, and we have the right to terminate the agreement both for cause and for convenience (subject, in the case of termination for convenience, to our payment of a termination fee). IBM also has certain termination rights in the event of our material breach of the agreement and failure to cure.

We have applied the measurement and disclosure provisions of FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others," to our agreements that contain guarantee and certain indemnification clauses. FIN 45 requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under the guarantee. The initial recognition and measurement provisions of FIN 45 are effective for guarantees issued or modified after December 31, 2002. As of January 28, 2006, we did not have any material guarantees that were issued or modified subsequent to December 31, 2002.

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 financial condition or results of operations.

As party to a reinsurance pool for workers' compensation, general liability and automobile liability, we have guarantees with a maximum exposure of $76 million as of January 28, 2006, of which $10 million has already been cash collateralized.

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. Actions filed against us include commercial, intellectual property, customer, labor and employment related claims, including class action lawsuits in which plaintiffs allege that we violated federal and state wage and hour and other laws. 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. If the outcome of an action is expected to result in a loss that is considered probable and reasonably estimable, we will record a liability for the estimated loss.

We cannot predict with assurance the outcome of Actions brought against us. Accordingly, adverse developments, settlements or resolutions may occur and negatively impact earnings 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 adverse effect on our results of operations, liquidity or financial position taken as a whole.

NOTE K: RELATED PARTY TRANSACTIONS

We generally use a competitive bidding process for construction of new stores, expansions, relocations and major remodels (major store projects). In addition, we utilize a construction industry standard stipulated sum, non-exclusive agreement with our general contractors. During fiscal 2005, we had 41 general contractors qualified to competitively bid in North America. Fisher Development, Inc. ("FDI"), a company that is wholly owned by the brother of Donald G. Fisher, Founder and Chairman Emeritus, and the brother's immediate family, is one of our qualified general contractors. The stipulated sum agreement sets forth the terms under which our general contractors, including FDI, may act in connection with our construction activities. We paid to FDI approximately $21 million, $8 million, and $4 million in fiscal 2005, 2004, and 2003, respectively. At January 28, 2006 and January 29, 2005, amounts due to FDI were approximately $1 million and $2 million, respectively, on our Consolidated Balance Sheets. The Audit and Finance Committee of the Board reviews this relationship annually.

In October 2001, the Audit and Finance Committee of the Board reviewed and approved the terms of agreements to lease to Doris F. Fisher, Director, and Donald G. Fisher a total of approximately 26,000 square feet of space in our One Harrison and Two Folsom headquarter San Francisco locations to display portions of their personal art collection. The agreements provide for base rent ranging from $30.00 to $42.35 per square foot per year over a 15-year term. Our Consolidated Statements of Operations includes rental income from this leased space of approximately $0.9 million for each of the fiscal years 2005, 2004 and 2003. We believe that these rental rates were at least competitive when the agreements were entered into. The agreements also provide us and our employees significant benefits, including use of the space on a regular basis for corporate functions at no charge. In addition, Mr. and Mrs. Fisher allow employees to visit the galleries at no charge.

NOTE L: SEGMENT INFORMATION

We are primarily engaged in selling retail apparel through stores in North America, Europe and Asia. We identify our operating segments based on management responsibility that include Gap North America, Banana Republic North America, Old Navy North America, International, Forth & Towne, Outlet and Direct. Our stores sell merchandise under the Gap, Old Navy, Banana Republic, and Forth & Towne brand names. We consider our operating segments to be similar in terms of economic characteristics, production processes, and operations, and have aggregated them into a single reporting segment. We do not report Direct or Forth & Towne separately as they do not meet the quantitative threshold requirements of SFAS 131 "Disclosure about Segments of an Enterprise and Related Information."

Net Sales by Brand and Region

Net Sales ($ in millions)	Gap	Old Navy	Banana Republic	Other (3)	Total	Percentage of Net Sales
52 Weeks Ended January 28, 2006						
North America (1)	$ 5,409	$ 6,856	$ 2,287	$ 8	$ 14,560	91%
Europe	825	-	-	-	825	5%
Asia	603	-	14	-	617	4%
Other (2)	-	-	-	21	21	0%
Total Company	$ 6,837	$ 6,856	$ 2,301	$ 29	$ 16,023	100%
52 Weeks Ended January 29, 2005						
North America (1)	$ 5,746	$ 6,747	$ 2,269	$ -	$ 14,762	91%
Europe	879	-	-	-	879	5%
Asia	591	-	-	-	591	4%
Other (2)	24	-	-	11	35	0%
Total Company	$ 7,240	$ 6,747	$ 2,269	$ 11	$ 16,267	100%
52 Weeks Ended January 31, 2004						
North America (1)	$ 5,777	$ 6,456	$ 2,090	$ -	$ 14,323	90%
Europe	861	-	-	-	861	5%
Asia	610	-	-	-	610	4%
Other (2)	57	-	-	3	60	0%
Total Company	$ 7,305	$ 6,456	$ 2,090	$ 3	$ 15,854	100%

(1) North America includes the United States, Canada and Puerto Rico.
(2) Other includes our International Sales Program and Germany. In August 2004, we sold our stores and exited the market in Germany.
(3) Other includes Forth & Towne, Business Direct and International Sales Program.

Revenue from international retail operations, including Canada, was $2.4 billion, $2.4 billion, and $2.3 billion, and represented 14.9 percent, 14.6 percent and 14.8 percent of our revenues for fiscal 2005, 2004 and 2003, respectively. Long-lived assets of our international operations, including Canada, were $601 million and $646 million, and represented 17 percent of our long-lived assets for both fiscal 2005 and fiscal 2004.

NOTE M: QUARTERLY INFORMATION (UNAUDITED)

The following quarterly data are derived from the Consolidated Statements of Operations of Gap, Inc.

Financial Data

Fiscal 2005

($ in millions except per share amounts)	13 Weeks Ended April 30, 2005	13 Weeks Ended July 30, 2005 (a)	13 Weeks Ended Oct. 29, 2005 (b)	13 Weeks Ended Jan. 28, 2006 (c)	52 Weeks Ended Jan. 28, 2006 (a), (b), (c)
Net sales	$ 3,626	$ 3,716	$ 3,860	$ 4,821	$ 16,023
Gross profit (b)	1,481	1,385	1,363	1,640	5,869
Net earnings	291	272	212	338	1,113
Earnings per share–basic	0.33	0.30	0.24	0.39	1.26
Earnings per share–diluted	0.31	0.30	0.24	0.39	1.24

Fiscal 2004

($ in millions except per share amounts)	13 Weeks Ended May 1, 2004	13 Weeks Ended July 31, 2004	13 Weeks Ended Oct. 30, 2004	13 Weeks Ended Jan. 29, 2005	52 Weeks Ended Jan. 29, 2005
Net sales	$ 3,668	$ 3,721	$ 3,980	$ 4,898	$ 16,267
Gross profit	1,580	1,432	1,566	1,803	6,381
Net earnings	312	195	265	378	1,150
Earnings per share–basic	0.35	0.22	0.29	0.43	1.29
Earnings per share–diluted	0.33	0.21	0.28	0.40	1.21

(a) During the second quarter of fiscal 2005, we reversed $58 million of our sublease loss reserve due to our decision to occupy one of our vacant leased properties in San Francisco. See Note E.

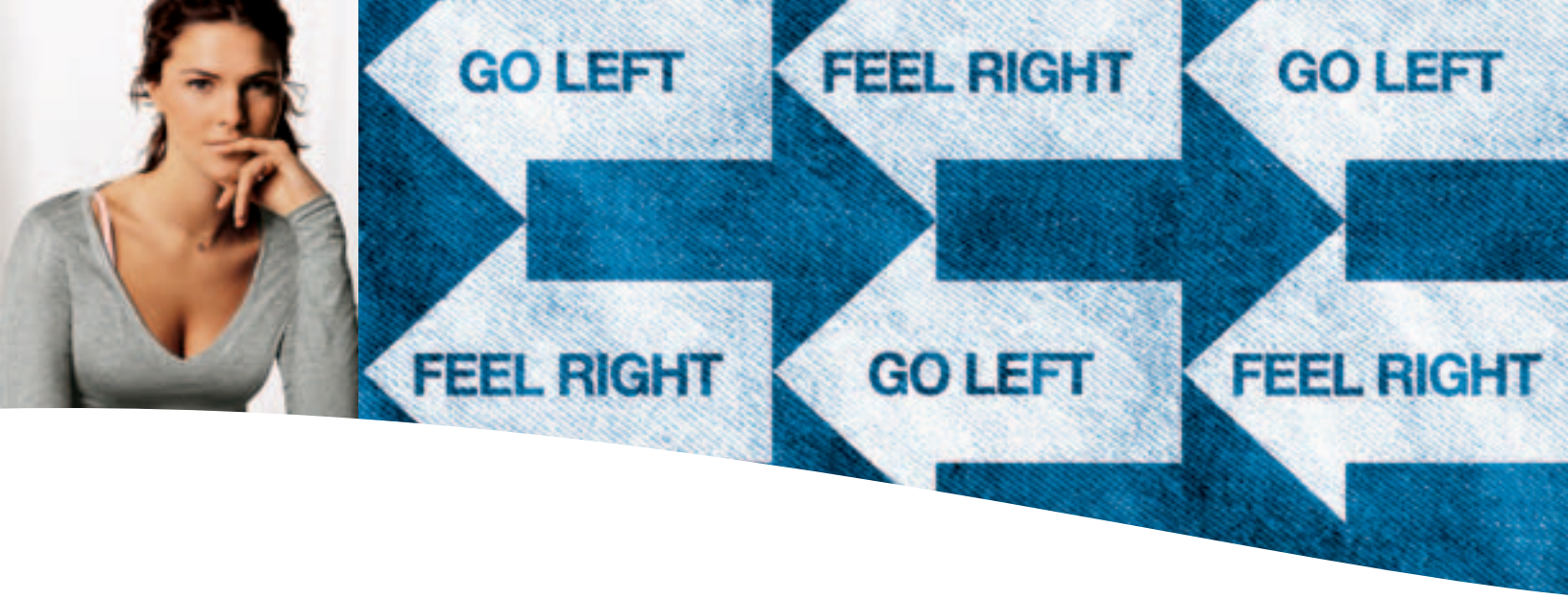
(b) During the third quarter of fiscal 2005, we reclassified $30 million of certain year to date sourcing expenses from operating expenses to cost of goods sold and occupancy expenses. These sourcing expenses were primarily comprised of payroll and benefit expenses for our wholly owned agent offices. Fiscal 2005 impact of this reclassification was $42 million. This reclassification had no impact on net earnings.

(c) During the fourth quarter of fiscal 2005, we recorded $50 million in cost of goods sold and occupancy expenses representing the cumulative impact of amortizing our key money balance from fiscal 1995 through the end of fiscal 2005. See Note A.

Per Share Data

	Market Prices				Dividends Paid	
Fiscal	2005		2004		2005 (a)	2004
	High	Low	High	Low		
1st Quarter	$ 22.70	$ 20.41	$ 23.39	$ 18.75	$ 0.045	$ 0.0222
2nd Quarter	21.88	19.52	25.72	21.13	0.045	0.0222
3rd Quarter	22.19	15.90	22.76	18.12	0.045	0.0222
4th Quarter	18.75	16.71	23.75	19.90	0.045	0.0222
Year					$ 0.180	$ 0.0888

(a) Dividends of $0.0222 declared in the fourth quarter of fiscal 2004 but paid in the first quarter of fiscal 2005 are presented in this table as if paid in the fourth quarter of fiscal 2004.



executive leadership

MARKA HANSEN
President
Banana Republic

CYNTHIA HARRISS
President
Gap North America

TOBY LENK
President
Gap Inc. Direct

JENNY MING
President
Old Navy

GARY MUTO
President
Forth & Towne

DIANE NEAL
President
Outlet

ART PECK
Executive Vice President
Corporate Strategy
and Business Development
Gap Inc.

BYRON POLLITT
Executive Vice President,
Chief Financial Officer
Gap Inc.

PAUL PRESSLER
President
Chief Executive Officer
Gap Inc.

EVA SAGE-GAVIN
Executive Vice President
Human Resources
Gap Inc.

LAURI SHANAHAN
Executive Vice President,
Chief Compliance Officer,
General Counsel and
Corporate Secretary
Gap Inc.

STEPHEN SUNNUCKS
President
Europe

MICHAEL TASOOJI
Executive Vice President,
Chief Information Officer
Gap Inc.

Executive Officer Note:
Founder Donald G. Fisher and Executive Leadership Team members Harriss, Ming, Pollitt, Pressler, Sage-Gavin and Shanahan are the executive officers of the company under Rule 3b-7 and Section 16 of the Securities Exchange Act of 1934, as amended.

board of directors

HOWARD P. BEHAR, *61 †‡*
Director since 2003. Former Starbucks Corporation executive. Director of Shurgard Storage Centers, Inc. and Starbucks Corporation.

ADRIAN D. P. BELLAMY, *64 †‡*
Director since 1995. Executive Chairman of The Body Shop International plc, a personal care retailer. Chairman of Reckitt Benckiser plc. Director of Williams-Sonoma, Inc.

DOMENICO DE SOLE, *62 **
Director since 2004. Former executive of Gucci Group NV. Director of Bausch & Lomb Incorporated, Delta Airlines, Inc. and Telecom Italia.

DONALD G. FISHER, *77*
Founder and Chairman Emeritus. Director since 1969. Director of The Charles Schwab Corporation. (Donald G. Fisher and Doris F. Fisher are husband and wife.)

DORIS F. FISHER, *74*
Director since 1969. Former merchandiser of the company. (Donald G. Fisher and Doris F. Fisher are husband and wife.)

ROBERT J. FISHER, *51*
Chairman since 2004. Director since 1990. Former executive of the Company. Director of Sun Microsystems, Inc. (Robert J. Fisher is the son of Doris F. and Donald G. Fisher.)

PENELOPE L. HUGHES, *46 **
Director since 2002. Former Coca-Cola Company executive. Director of Reuters Group, plc, Skandinaviska Enskilda Banken AB., and Vodafone plc.

BOB L. MARTIN, *57 †‡*
Lead Independent Director. Director since 2002. Chief Executive Officer (part-time) of Mcon Management Services, Ltd., a consulting company; former Wal-Mart executive. Director of Conn's, Inc., FurnitureBrands International, Inc., Guitar Center, Inc., and Sabre Holdings Corporation.

JORGE P. MONTOYA, *59 †‡*
Director since 2004. Former executive of The Procter & Gamble Company. Director of Rohm & Haas Company.

PAUL S. PRESSLER, *49*
Director since 2002. President and Chief Executive Officer of Gap Inc. Director of Avon Products, Inc.

JAMES M. SCHNEIDER, *53 *‡*
Director since 2003. Senior Vice President and Chief Financial Officer of Dell Inc., a computer manufacturer. Director of General Communication Inc. and Lockheed Martin Corporation.

MAYO A. SHATTUCK III, *51 *‡*
Director since 2002. Chairman, President and Chief Executive Officer of Constellation Energy Group, an energy company. Director of Capital One Financial Corporation.

MARGARET C. WHITMAN, *49 ‡*
Director since 2003. President and CEO of eBay, Inc., an online marketplace and payment company. Director of eBay, Inc., Dreamworks Animation SKG, Inc. and The Procter & Gamble Company. Not standing for re-election in 2006.

* Audit and Finance Committee
† Compensation and Management Development Committee
‡ Governance, Nominating and Social Responsibility Committee

Gap Inc. was founded in 1969 on the principle of conducting our business in a responsible, honest and ethical manner. In an effort to provide open communication, we invite shareholders to contact our Board of Directors directly via email to board@gap.com. These emails are received by our Chairman and our Lead Independent Director as well as our Corporate Governance department.

Corporate and Shareholder Information

Gap Inc. Corporate Offices
Two Folsom Street
San Francisco, CA 94105
650-952-4400

Investor Relations
Two Folsom Street, San Francisco, CA 94105
Investor_relations@gap.com, 800-GAP-NEWS

Gap Inc.'s common stock is listed for trading on the
New York Stock Exchange and the Pacific Exchange, ticker symbol "GPS"

Annual Meeting
May 9, 2006, 10:00 a.m.
Gap Inc. headquarters
Two Folsom Street
San Francisco, CA 94105

Registrar and Transfer Agent (for registered shareholders)
Wells Fargo Back, N.A.
Shareowner Services
161 North Concord Exchange Street South
St. Paul, MN 55075-1139
877-262-8250 (toll-free); fax: 651-450-4033
wellsfargo.com/shareownerservices

Beneficial Shareholders (shares held by your broker in the name of the brokerage house) should direct questions to their broker.

Independent Auditors
Deloitte & Touche LLP
San Francisco, CA

CEO and CFO Certifications
The certifications by the Chief Executive Officer and the Chief Financial Officer of The Gap, Inc., required under Section 302 of the Sarbanes-Oxley Act of 2002, have been filed as exhibits to The Gap, Inc.'s 2005 Annual Report on Form 10-K. The Annual CEO Certification of The Gap, Inc. pursuant to NYSE Corporate Governance Standards Section 303A.12(a) that the CEO was not aware of any violation by The Gap, Inc. of the NYSE's Corporate Governance listing standards was submitted to the NYSE on May 31, 2005.

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The GAP employed an environmentally "sustainable" printer for the production of this Annual Report that has a zero landfill, 100% recycling policy for all hazardous and non-hazardous production waste by-products, generates all its own electrical and thermal power, and is the only AQMD certified "totally enclosed" commercial print facility in the nation which results in virtually zero volatile organic compound (VOC) emissions from its production operations being released to the atmosphere.

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Shareholder Communications

Annual Report on Form 10-K

A copy of our Annual Report to the Securities and Exchange Commission (Form 10-K) for our most recent fiscal year will be available to shareholders without charge (except exhibits which are available for a nominal charge) by March 29, 2006, by visiting our Web site at gapinc.com, by calling 800-GAP-NEWS, or by making a written request to Investor Relations at our corporate offices.

Investor Relations Hotline

Our Investor Relations Hotline provides recorded highlights from the most recent quarter and month. The toll-free line is accessible from within the U.S. at 800-GAP-NEWS. International callers can access the Hotline by dialing 706-634-4421.

Web Sites

www.gapinc.com offers information about Gap Inc., including online versions of our Annual Report, Securities and Exchange Commission reports, quarterly earnings results and monthly sales reports. You can also read about employment opportunities, our ethical sourcing efforts, corporate governance matters and our environmental and community relation programs. Product information is available through our brand Web sites at gap.com, bananarepublic.com and oldnavy.com.

The financial section of this Annual Report is printed on New Leaf West Coast Opaque Text which is manufactured from 100% "FSC Certified" post-consumer-waste (PCW) derived fiber. The Forest Stewardship Council promotes environmentally appropriate, socially beneficial and economically viable management of the world's forests. FSC "Chain of Custody" certificates for the paper mill, merchant and printer are as follows: Grays Harbor Paper, SW-COC-1557, New Leaf Paper, SCS-COC-00565, and Anderson Lithograph, SCS-COC-00533.

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