

Krispy kreme essay sample



**ASSIGN
BUSTER**

This case considers the sudden and very large drop in the market value of equity for Krispy Kreme Doughnuts, Inc., associated with a series of announcements made in 2004. Those announcements caused investors to revise their expectations about the future growth of Krispy Kreme, which had been one of the most rapidly growing American corporations in the new millennium.

The task for the student is to evaluate the implications of those announcements and to assess the financial health of the company. This case is intended to be introductory as it can provide a first exercise in financial statement analysis and lay the foundation for two important financial themes: the concept of financial health, and the financial-economic definition of value and its determinants.

Suggested Questions for Advance Assignment to Students

1. What can the historical income statements (case Exhibit 1) and balance sheets (case Exhibit 2) tell you about the financial health and current condition of Krispy Kreme Doughnuts, Inc.?
2. How can financial ratios extend your understanding of financial statements? What questions do the time series of ratios in case Exhibit 7 raise? What questions do the ratios on peer firms in case Exhibits 8 and 9 raise?
3. Is Krispy Kreme financially healthy at year-end 2004?
4. In light of your answer to question 3, what accounts for the firm's recent share price decline?

5. What is the source of intrinsic investment value in this company? Does this source appear on the financial statements? Hypothetical Teaching Plan

This case could be used for the opening class in a sequence of finance and accounting cases in a short executive-education program. Students are expected to have studied an introductory reading on financial statements. Accordingly, this case seeks to exercise and build upon that rudimentary understanding so that students begin (1) to develop a sense of how capital markets consume financial statements and, (2) to explore some of the determinants of value.

The following outline pursues those objectives. With a more advanced group of students, the instructor could dispense with the first discussion question and launch directly into the exploration of financial health. In all cases, the instructor will need to exercise careful discipline over time: Although the case seems simple, it raises many issues and can trigger an extensive discussion.

1. What are the definition and purpose of an income statement, as shown in case Exhibit 1? What are the definition and purpose of a balance sheet as shown in case Exhibit 2? How are the two statements related? Are Krispy Kreme's financial statements exact? Does management have any discretion over how those accounts are estimated?

The goals of this opening are to survey the mechanics of financial statements and to explore how statements are derived. The insights obtained here become a crucial foundation for evaluating the impact of Krispy Kreme's accounting policies.

2. Is Krispy Kreme financially “ healthy”? What do the statements show?

What do the ratios show?

This segment of the discussion provides an opportunity to exercise statement and ratio analysis and to lay the foundation for the third question. The instructor should prod students to wring the most out of the comparative ratios, both against peers and against Krispy Kreme’s own performance over time.

3. Given your assessment of Krispy Kreme’s health, why did its stock price drop by 80% between 2003 and 2004?

This final segment of the discussion provides the bridge between accounting and finance that permits the students and the instructor to compare and contrast the two fields. The essence of this comparison must be that accounting is focused on explaining past events, whereas finance (through its attention to market value) is focused on future expectations.

Investors pay careful attention to financial statements not only for what they say about the past, but also for any clues they may give about future performance. The surprising revelations about the U. S. Securities and Exchange Commission’s (SEC) investigation into Krispy Kreme and the reports of aggressive accounting for franchises probably caused investors to revise downward their expectations about future cash flows. Thus, financial statements and the choice of accounting policies may be seen as containing signals about future performance.

The instructor could close the discussion with a review of events since the date of the case. The epilogue presented here summarizes the company's financial performance up to late 2005. Exhibits TN2 and TN3 (on financial statement analysis and financial health) may be distributed to students after the discussion or could be used by the instructor as a foundation for summary comments. See the company's Web site for updates on its financial information (<http://www.krispykreme.com>).

Case Analysis

Preparation and exactness of financial statements

The purpose and structure of a firm's financial statements are well documented in standard texts and will not be repeated here. Novices studying this case, however, may benefit from a slow review of the specific accounts, the choices that managers can make in estimating them, and the possible degree of exactitude. The case presents none of the footnotes to the accounts, which prevents a detailed discussion of accounting policy. Nevertheless, student discussion can highlight some of the following accounting choices and sources of variation in reported results.

Cash and cash equivalents: It is possible to derive a fairly exact estimate of cash. In contrast to some other balance sheet accounts, the cash balance could change dramatically from day to day because cash is fungible.

Accounts receivables: As long as the accountant or analyst agrees that the products have been sold, estimating gross receivables is relatively straightforward. The accounting for sales to "affiliates," or franchises, was a

significant issue for Krispy Kreme. Uncertainty about sales and bad debts can produce an uncertain figure for net receivables.

Inventories: Managerial choices about whether to use the first-in, first-out (FIFO) or last-in, first-out (LIFO) method of inventory valuation and how to treat obsolescence, spoilage, shrinkage, and even outright fraud, affect estimates of inventory values.

Property, plant, and equipment: Managers have choices about depreciation policies and investment basis (for example, property acquired through a purchase-method merger can be written up from its former book value).

Goodwill and other intangibles: The estimation of goodwill and other intangibles, such as the value assigned to recipes, trademarks, and trade names, is a matter of judgment. Reacquired franchise rights result from a company's acquisition of franchise markets from existing franchisees, and there is considerable room for discretion in how those assets are valued.

Revenues: When do we recognize a sale as revenue? This judgment call is a matter of choice. As indicated in the case, Krispy Kreme generates at least four major streams of incomes for which there are a number of potential revenue recognition choices. **Expenses:** Underlying the expense estimates are numerous decisions that involve the allocation of costs across different products and across time.

The instructor can develop an even more detailed list but, at the end of this segment of the discussion, may wish to ask students to speculate on the degree of variation in total assets or earnings that occurs as a result of

estimation error and managerial discretion in accounting policy. My experience in discussing this case with managers suggests possible variation from reported figures in the range of plus or minus 10% to 25%.