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Food with Integrity: A Financial Analysis of Chipotle Mexican Grill

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FOOD WITH INTEGRITY: A FINANCIAL ANALYSIS OF CHIPOTLE MEXICAN GRILL

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ABSTRACT

For the accounting alternative thesis, we were to pick a publicly traded company domiciled in the U.S that we were interested in and research their financials, business, and industry. I chose Chipotle Mexican Grill due to their unique restaurant brand. Chipotle's Food with Integrity campaign makes up their main brand, but brings the issue of finding enough suppliers to meet their needs. If Chipotle has to use processed food to fulfill the lack of the natural, organic food then they will eventually lose their customer's trust. Chipotle has also expanded globally so there are always issues that appear when dealing with a new market.

The majority of the numerical values that relate directly to Chipotle's operations were found in their annual 10-K financial statements.

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Chapter 1: General Company Information

Business History

Chipotle was first opened by Steve Ells in 1993 in a former Dolly Madison ice cream location in Denver, Colorado. Steve graduated from the Culinary Institute of America in 1990 before moving to San Francisco where he worked as a sous-chef at Stars. He grew to like the taquerias in San Francisco where they foil wrapped their burritos and you could pick what you wanted on it. He wanted to open this similar “fast-casual” restaurant to generate some cash flow to open a full scale fine-dining restaurant. He moved back to Denver, Colorado to open this burrito shop with $80,000 that his dad had loaned him. The ice cream shop was on a corner near the University of Denver campus but it wasn’t a high traffic spot. Steve even mentions that some high profile fast food chains had looked at the property but had passed it up for better locations. It was affordable for him, though, so he took the spot. They used cheap materials (plywood, barn metal, and pipes) for the design of Chipotle, which unintentionally added to the atmosphere and brand that they were promoting. Steve planned on a profit of $24,000 for Chipotle’s first year, but they exceeded that number exponentially.

In 1995, Steve added the second and third locations. By 1996, they had opened five more Chipotle's in the Denver area. In 1999, the first restaurants opened outside of Colorado in Minneapolis, Minnesota and Columbus, Ohio. They opened 16 Chipotle's in five years. In 1998, Chipotle brings outside investors in, the biggest being McDonalds. McDonalds invested $350 million in the company in seven years, becoming majority stakeholder. They helped jump start Chipotle into becoming a major company, even though they have very different cultures. The first year alone, they invested $50 million. McDonalds knew they had to make a change to show Wall Street that they were diversified and growing. John Charlesworth former president of McDonald's Midwestern division said, "The benefits that being connected with McDonald's offered were capital, distribution systems, real-estate expertise, construction knowledge, some talent, organizational structures, and things like that." McDonalds and Chipotle parted ways in 2006 with McDonalds making more than $670 million on the deal, nearly double its original investment. Steve Ells said, "What we found at the end of the day was that culturally, we're very different. There are two big things that we do differently. One is the way we approach food, and the other is the way we approach our people's culture. It's the combination of those things that I think make us successful."

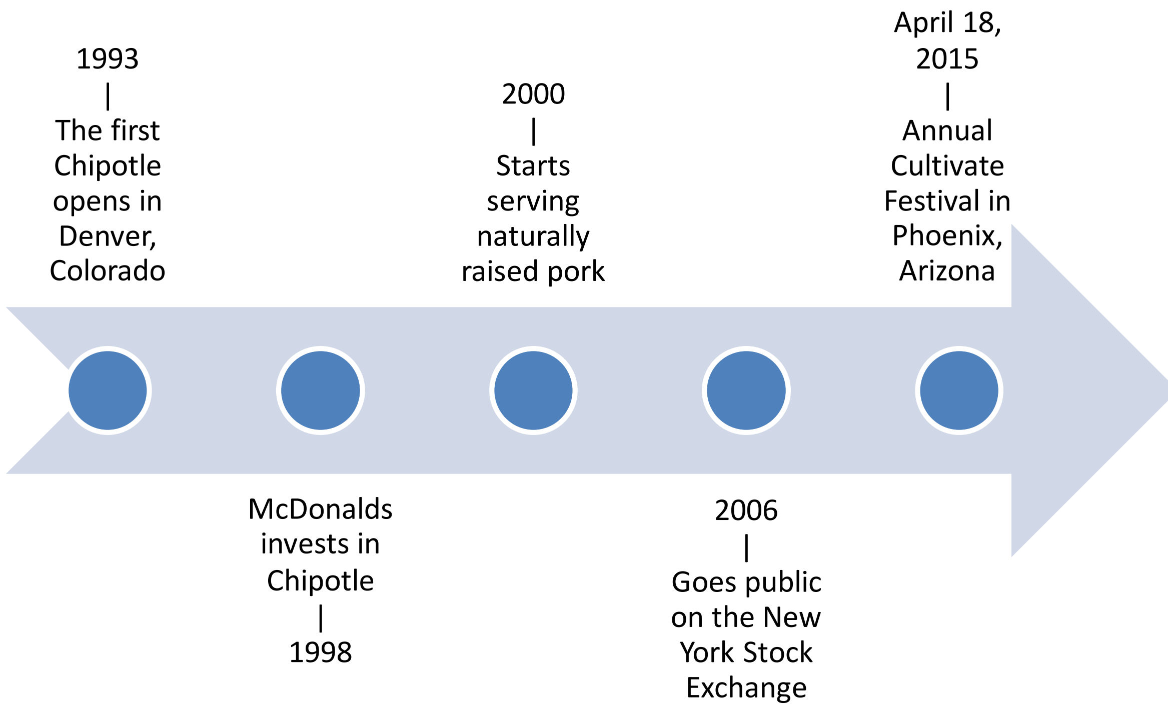
On January 26, 2006, Chipotle went public on the New York Stock Exchange with restaurants in over 500 locations. They were originally priced at

$22 per share but the stock couldn't open for over an hour. Once it did, shares were going for $44. This was the second best restaurant IPO of all time.Today the company is worth $12 billion as the stock has more than tripled in the past five years. In the documentary "Inside Chipotle," one person said that Chipotle was trading like an Internet stock but there was no reason that it should be. It was trading at 40 times earnings.

They wanted to reinvent the fast food culture with higher quality food but without the sit down service. Steve wanted to use fresh new ingredients prepared in the restaurant and to have it served in an interactive format letting the customers pick and choose exactly what they wanted. Nick Setyan (Wedbush Securities Analyst) said, "If anything, they created the fast casual category. I look at them as more of a trail blazer." Fast Casual is the fastest growing category in the restaurant business, boosting sales of 13 percent in the U.S. in 2012. Even with the financial crisis of 2008, Chipotle's sales have steadily increased.Their main menu has hardly changed since the beginning because they wanted to focus on a simple menu with quality food. However, since Chipotle started to open in airports– the first in Dulles - they now have to add breakfast items because of lease stipulations.

Then Chipotle started their campaign "Food with Integrity."Steve learned about the way that most pork is raised in the U.S. and decided that he wanted to change the way Chipotle ran things. In 2000, they started serving naturally raised pork from Niman Ranch, in 2002 naturally raised chicken, and in 2008 naturally raised beef. In 2009, Steve testified before Congress to try to eliminate the use of antibiotics in ranching.Chipotle wanted to brand itself as a company that you can relate with based on your values. They wanted to bring awareness about how animals are raised. They had started out buying fresh food and then realized maybe fresh isn't enough anymore.Chipotle buys more naturally raised meat than any other country in the world. All of this adds to their brand.

Chipotle markets quite differently than other large restaurants. They have only one national television ad that is a two minute animated film about a farmer letting his pigs out to roam free. The video first went viral and then to movie theatres before hitting television. Chipotle also hosts an annual Cultivate festival that involves cooking demos, eating, drinking, booths promoting agriculture, warnings about industrial farming, and bands. They've started a mini drama web series called Farmed and Dangerous and they've recently started selling organic hoodies, totes, and baby tees. According to Inside Chipotle, they spend one-third of sales on ingredients and very, very little on marketing.



Company Operations

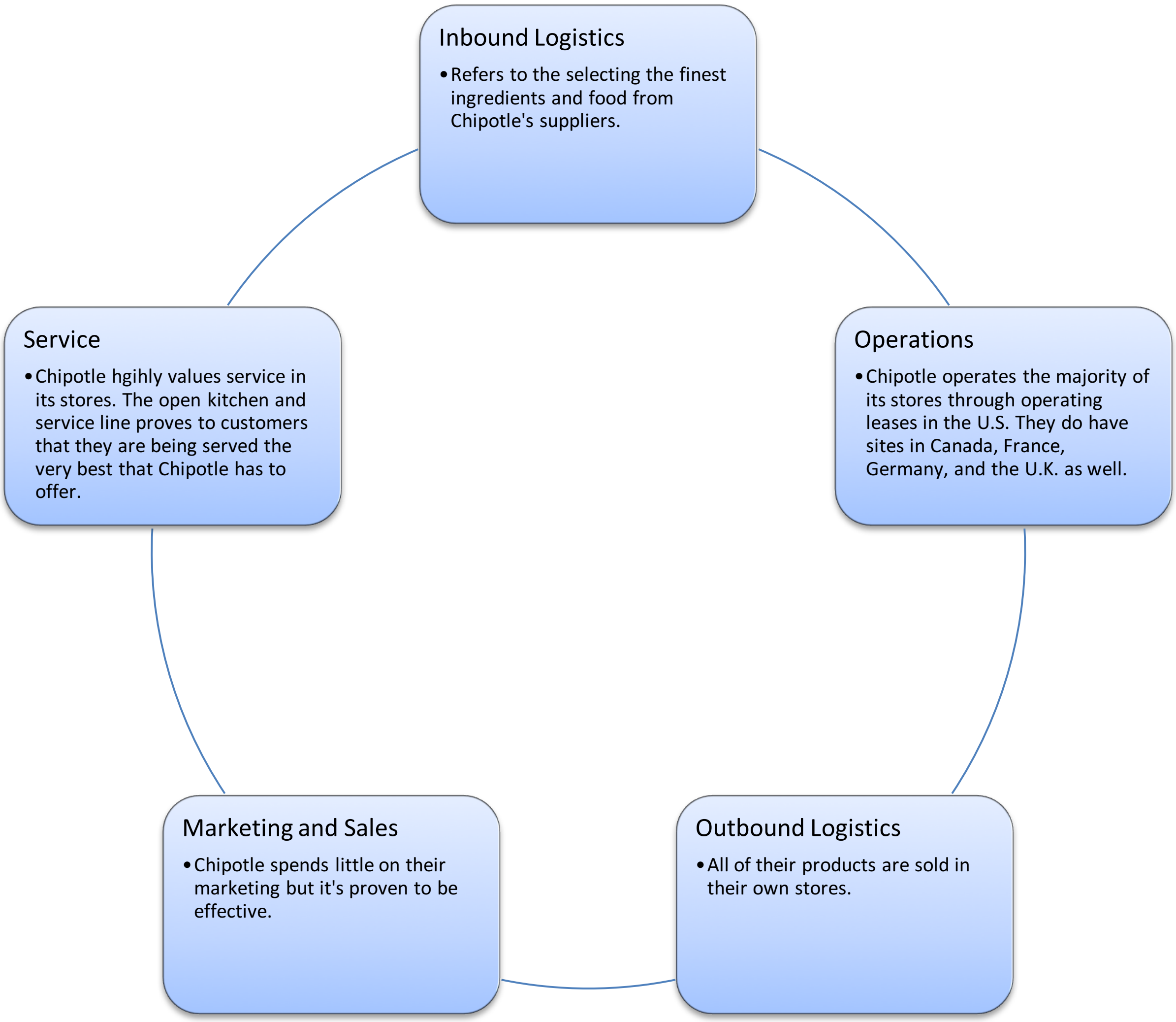
Chipotle operates fresh Mexican food restaurants serving burritos, tacos, burrito bowls and salads. As of December 31, 2014, they had 1,783 restaurants in operation, including 1,755 Chipotle restaurants throughout the United States, with an additional seven in Canada, six in England, three in France, and one in Germany.Their openings include nine ShopHouse Southeast Asian Kitchen restaurants, serving Asian-inspired cuisine, and they've invested in a consolidated entity that owns and operates two Pizzeria Locale restaurants, a fast casual pizza concept. Chipotle has also launched their catering service which has brought in 1.3 percent of revenue for 2014. Chipotle has 22 independently owned and operated regional distribution centers that purchase from various suppliers carefully selected based on quality and their understanding of Chipotle's mission. However, Chipotle's main office is in Denver, Colorado. They manage their operations and restaurants based on eight regions that aggregate into one reportable segment.

Their main operation is serving food through their stores. They buy the food from suppliers that fit in with the "Food with Integrity" campaign that Chipotle has. For example, Niman Ranch raises pigs naturally so Chipotle gets most of their pork from here. Once they have the produce in the store, they prepare it to put on the service line. Chipotle makes much of their food in small batches through the day so that they can serve you the freshest food possible. They begin early to marinate meats, chop produce, and prepare salsa and guacamole, right in the restaurant. Once on this "interactive line," customers can pick and choose what goes on their burritos or tacos. Another operation they have is catering. You can order this online or in the store. In April 2015, Chipotle started their new delivery service to test in certain locations. Chipotle has their kitchen open and directly behind the "line-up". The concept of the open kitchen allows the consumer to see the food being prepared and to see the fresh ingredients going into the food, just another way Chipotle has insured its customers they are receiving the best quality food.

Chipotle employees get culinary training, so they have an in-depth understanding of cooking, seasoning, knife skills and grilling techniques.Recently, Inside Chipotle, a Netflix documentary on Steve Ells and the Chipotle brand was released. A lot of the documentary described how Steve likes for his teams at Chipotle to be quality workers and to want to have an experience at Chipotle where they could possibly be promoted. They stressed that “the team” was important to the Chipotle brand. “We have an emphasis on identifying, hiring and empowering top performing employees. We are committed to creating a performance based culture that leads to the best restaurant experience possible for our employees and our customers. The foundation of that culture starts with hiring the best people in our restaurants.” However, in 2010, an audit found 450 undocumented workers at Chipotle. They provided more than 300,000 pages of documents to the government agencies and began using the Department of Homeland Security’s E-verify program which, as its name suggests, verifies the documents provided by potential employees.

Value Chain

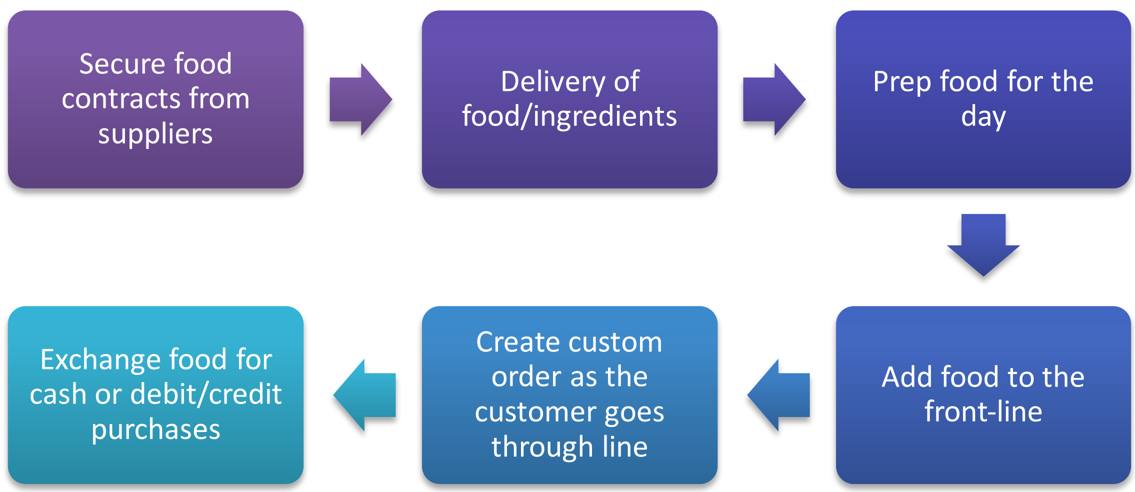
A value chain is a series of activities or processes that aim at creating and adding value to a product at every step during the production process. The more



value that a company can create, the more profitable they will be. Primary activities are directly related to the creation of a good or service while the secondary activities help enhance the efficiency and work to obtain a competitive advantage among peers. Some of the primary activities are listen in the chart above.

Secondary activities include infrastructure, human resource management, technology, and procurement. In regards to infrastructure, this includes departments like management, accounting, legal, etc. Chipotle owns every single restaurant since they don't use franchises and therefore can control what goes on. They have a single manager at each store to ensure quality food and service. The next secondary activity is human resource management. Chipotle has incentives for managers to have high sales. Efficient workers create better service and generally improve sales. Steve Ells mentions that employees on the front-line are very important to Chipotle's business. Another secondary activity, technology development, is important to adding value to Chipotle's operations. They recently opened a new Chipotle app where you can order your food for pick up, making it easier for customers to grab and go. This also generates extra revenue aside from in-restaurant sales. Finally, procurement involves finding the best suppliers to get the resources Chipotle needs to operate. Food with Integrity is huge to Chipotle's brand and they make sure to find the suppliers that entail the same values.In January 2015, they dropped one of their major pork suppliers because they were not treating the animals the way that Food with Integrity calls for. Chipotle showed its customers and shareholders that they are willing to sacrifice sales to keep in line with their values and brand.

Business Process Model:



Board of Directors

The board of directors consists of: Steve Ells, Montgomery Moran, Albert Baldocchi, John Charlesworth, Neil Flanzraich, Patrick Flynn, Darlene Friedman, and Kimbal Musk. The board is lacking in diversity with only one female represented however many different industries are represented.

Steve Ells: Chairman and co-Chief Executive Director: Steve founded Chipotle in 1993. He is Co-Chief Executive Officer and was appointed Chairman of the

Board in 2005. Before Chipotle, Steve graduated from the University of Colorado with a Bachelor of Arts degree in art history, and then graduated in 1990 from the Culinary Institute of America. Steve worked for two years at Stars restaurant in San Francisco. His vision “that food served fast doesn’t have to be low quality and that delicious food doesn’t have to be expensive” is the brand that Chipotle is based on. His culinary knowledge is vital to the board because good-tasting food brings customers back. He is also the largest individual shareholder of Chipotle.

Montgomery (Monty) Moran: Co-Chief Executive Officer: Monty became Co-Chief Executive Officer in 2009 after serving as President and Chief Operating Officer since 2005. He previously served as chief executive officer of Messner& Reeves, LLC law firm, where he was employed. Monty went to the University of Colorado and Pepperdine law school. He also went to high school with Steve Ells. His time at Messner& Reeves helps bring the legal aspect to the board of directors.

Albert Baldocchi: Director: He has been self-employed since 2000 as a financial consultant and strategic advisor for a variety of privately held companies, with a specialization in multi-unit restaurant companies. His extensive involvement with restaurant companies over a period of 17 years has given him an in-depth knowledge of restaurant company finance, operations and strategy. He also has considerable experience with high-growth companies in the restaurant industry and in other industries, and his experience as a senior investment banker at a number of prominent institutions, including Morgan Stanley, Solomon Brothers and Montgomery Securities has helped him develop tremendous capabilities in accounting and finance as well. He holds a Bachelor of Science degree in chemical engineering from the University of California at Berkeley and an MBA from Stanford University.

John Charlesworth: Director: John is currently the sole owner of Hunt Business Enterprises LLC and EZ Street LLC, which own commercial properties and own and operate car care facilities. Before retiring in 2000, John worked for McDonald's for 26 years. He served as a Senior Vice President in Southeast Asia from April 1995 to July 1997. His international experience included strategic planning and risk assessment for the growth and development of McDonald's across Southeast Asia, as well as serving as the McDonald's partner representative to seven Southeast Asian joint ventures. Most recently he served as President of the Midwest Division of McDonald's USA from July 1997 to December 2000. His experience with McDonald's included responsibility for managing a large and diverse employee workforce similar in many ways to Chipotle's, and also gave him a detailed knowledge of restaurant operations, site selection and related matters. He also has developed strong financial acumen through his experience at McDonald's, as well as running his own business interests. He holds a Bachelor of Science degree in business, majoring in economics, from Virginia Polytechnic Institute.

Neil Flanzraich: Lead Director: He has been a private investor since February 2006. He served as Vice Chairman and President of IVAX Corporation, an international pharmaceutical company from 1998 through 2006. From 1995 to 1998, he served as Chairman of the Life Sciences Legal Practice Group of Heller Ehrman LLP, a law firm, and from 1981 to 1994, served in various capacities at Syntex Corporation, a pharmaceutical company. Neil's past executive experience helped him develop outstanding skills in leading and managing strong teams of employees, and in oversight of the growth and financing of businesses in a rapidly-evolving market. His legal background is also valuable in the risk management area, and he brings extensive experience serving as an independent director of other companies. He is also a director of Continucare Corporation, Equity One Inc., Javelin Pharmaceuticals, Inc., and BELLUS Health Inc. He was a director of RAE Systems, Inc. until March 2009, a director of IVAX Diagnostics, Inc. until April 2006, and a director of IVAX Corporation until January 2006. Above all, he received an A.B. from Harvard College and a J.D. from Harvard Law School.

Patrick J. Flynn: Director: Patrick has been retired since January 2, 2001. Prior to retiring in 2001, he spent 39 years at McDonald's where he held a variety of executive and management positions, most recently as Executive Vice President responsible for strategic planning and acquisitions. From his background as a senior-level restaurant industry executive, Mr. Flynn developed strong capabilities in guiding corporate strategy, and tremendous knowledge of the operational aspects of the restaurant business as well. He also has past experience as a director of a publicly-held financial institution, and this experience, as well as his background in analyzing financial statements of businesses he has led and companies he has considered for acquisition, has given him strong financial analysis skills as well.

Darlene J. Friedman: Director: Prior to retiring in 1995, Darlene spent 19 years at Syntex Corporation where she held a variety of management positions, most recently as Senior Vice President of Human Resources. While at Syntex Corporation, she was a member of the corporate executive committee and the management committee, and was responsible for the analysis, recommendation and administration of the company's executive compensation programs and worked directly with the compensation committee of Syntex's board. This experience and her talent in these areas are invaluable in connection with her service as a director and as a member of the Compensation Committee. Finally, she holds a Bachelor of Arts degree in psychology from the University of California at Berkeley and an MBA from the University of Colorado.

Kimbal Musk: Director: Kimbal is an entrepreneur and restaurateur who has founded and advised several companies and non-profits including: The Kitchen, a restaurant company with restaurants in Boulder and Denver, CO, The Kitchen Community, Zip2 Corporation, PayPal, Inc., Everdream Corporation, Tesla Motors, Inc., Space Exploration Technologies Corp,OneRiot, and SolarCity Corporation. After success in the technology business, he decided to pursue his passion for food and cooking by attending the French Culinary Institute in New York City. His extensive experience with fast-growing and innovative companies as well as restaurants and other retail operations, and his experience on numerous boards of directors are an asset to this Board. He is also a member of the board of directors of Tesla Motors, Inc. as well as a number of privately-held companies and charitable organizations. He has served as an Adjunct Professor at New York University, and is a graduate of Queen's Business School in Canada and the French Culinary Institute.

Chapter 2: Industry and Geographical Analysis; Strategic Analyses

Business Mission and Strategy

Chipotle’s business mission is simple; Food with Integrity. Their mission statement, “our commitment to finding the very best ingredients raised with respect for the animals, the environment and the farmers” has reflected their Food with Integrity plan which began in 1999. Chipotle serves more naturally raised meat and local produce than any other restaurant company in the US. At Chipotle, they prefer working with farms that are family owned and operated. They like the idea of family farms and believe the foods they grow taste better. Whenever possible, Chipotle tries to use meat from animals raised without antibiotics, or added hormones. These antibiotics keep them from getting sick and enhance their growth. According to the Union of Concerned Scientists, American pork producers use over ten million pounds of antibiotics per year to keep their confinement-raised pigs from getting sick. That's more than three times the estimated amount used to treat all human illness.Feeding farm animals antibiotics over long periods of time can cause the bacteria living in those animals to become antibiotic resistant, forming what are commonly called super bugs. Humans that become infected and ill with a super bug may not be able to respond to antibiotic treatment. Chipotle also wants the animals to be raised in way that they can display their natural tendencies by socializing and interacting, not living in tight confining pens. The animals are also fed a vegetarian diet. Chipotle believes that naturally raised animals make the animals healthier which gives the food better taste.

Besides food, Chipotle dives in even farther to protect the environment. By using 100 percent recycled content in their napkins, they save over 22 million gallons of water per year. Working with sustainable family farms also not only helps the farmers, but it also positively affects local economies. Studies show that small pig farms spend almost 50 percent more at local businesses than large farms, who typically buy supplies outside of the local community. Plus, a 2006 United Nations report found that industrial factory farming produces more greenhouse gas emissions than the transportation sector worldwide. The burrito bowls are made from 93 percent recycled material--mostly recycled newspapers, and the aluminum lids are made of 95 percent recycled materials, including aluminum cans. The lids reduce energy consumption by 96 percent compared to using lids made of new materials.Chipotle teams at each of the locations project the amount of food that they cook and serve each day so food does not go to waste. Leftover food from any of the restaurants can be donated to the Harvest Program to help eliminate hunger in the US.

In 1999, Steve Ells took a tour of a sustainable pig farm in Iowa. This family farm raised pigs outdoors, fed them a vegetarian diet with no animal by-products and no antibiotics. Moved to learn more about pig farming practices, Steve also toured some industrial factory pig farms and witnessed the grim, inhumane treatment of the pigs and the dangerous environmental conditions these industrial farms created. These visits inspired Steve to start sourcing naturally raised meats. In 2009, Steve Ells spoke to congress in support of a bill designed to limit antibiotic use among farm animals.He told committee members, “I did not want Chipotle's success to be tied to this kind of exploitation."

Product differentiation is a marketing strategy that businesses use to distinguish a product from similar offerings on the market. This strategy is used when there are firms producing similar products so firms have to make their product more unique. Chipotle’s business mission of supplying food that comes from naturally raised meat and produce entails this strategy. This also creates loyalty from customers since you can’t get this kind of combination of food and atmosphere anywhere else. As long as Chipotle keeps their quality high, customers should continue returning. “Many of our competitors in the fast-casual and quick-service segments of the restaurant industry also emphasize lower-cost, “value meal” menu options, a strategy we do not currently pursue.”

Supply and Demand

Trying to supply healthy and naturally raised pork, chicken, beef, and produce can be challenging at times, but Chipotle believes that if they have the demand for these items that farmers will eventually be able to supply them 100 percent. These food items are considered normal goods and have a positive elasticity. However, naturally raised and organic food could be seen as a luxury item to some people. If income is lower, they might resort to cheaper, less healthy substitutes for chicken, beef, pork, etc.

Less than five percent of the US pork supply is naturally raised but Chipotle has been using 100 percent naturally raised pork since 2001. They began trying to find naturally raised beef in 1999 and have been successful in that, however, there can be beef shortages at times. They make sure to let people know when this happens. They believe that if they increase the demand for naturally raised beef that eventually the supply will increase also. Chipotle tries to serve cheese and sour cream from pasture-raised cows which means they're allowed to openly graze and they are fed a vegetarian, plant-based diet. Recombinant bovine growth hormone, or rBGH, is used by commercial dairy farms to increase milk productivity which Chipotle tries to avoid. This is used to shorten a dairy cow's lifespan and cause it maladies such as ulcers, arthritis, and kidney and heart abnormalities. According to U.S. law, all chicken today must be raised without added growth hormones, but Chipotle wants to purchase chicken that's been raised without antibiotics as well. Just like beef shortages though, naturally raised chicken does go through shortages at times. They notify customers when this occurs. A portion of their beans are organically grown, which has a number of benefits including a reduction in chemical pesticide usage. They've been increasing the use of organically grown beans over the last few years. Chipotle's local produce is grown on farms within 350 miles of the restaurant. They also exceeded their goal in 2010 of serving five million pounds of locally grown produce.

In January 2015, one of Chipotle's major pork suppliers was discovered to not be raising pork up to Chipotle's standards. Pork was removed from almost one-third of Chipotle's stores in the U.S. hurting sales and eventually stock price. By April of the same year, Chipotle announced that they had found another supplier and that pork should be back in all stores by the fall.

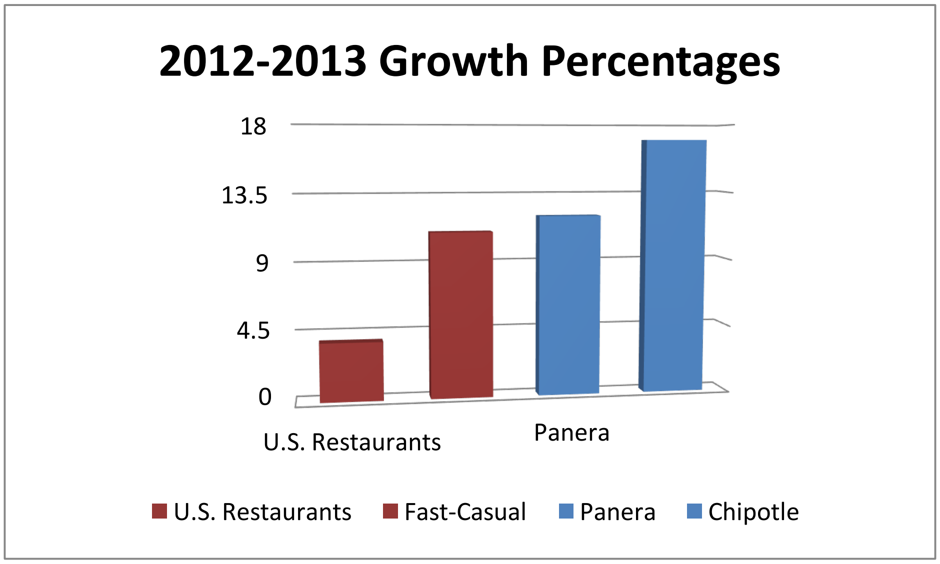
Competitors

Chipotle's "fast-casual" dining experience can be found similar to some other restaurants as well. This dining experience is highly competitive in respect to taste, price, food quality and presentation, service, location and the ambience and condition of each restaurant. Some of these include Qdoba Mexican Grill, Panera Bread, and Panda Express.

Although Panera is not a Mexican or “burrito” style restaurant, they do resemble the high quality food in a casual setting style similar to Chipotle. They all utilize the “open kitchen” theme and have their interactive service lines set up just like Chipotle. Qdoba also offer queso as an option for burritos or with their chips, whereas Chipotle does not. Panera is known for their freshly cooked bread and they serve soups, sandwiches, and salads. Panda Express has a variety of Asian options like fried rice and noodles that you can pick from the line. The prices for these restaurants are also very similar, usually ranging between seven to twelve dollars for a meal. Qdoba, Panera, and Panda Express offer more menu items than Chipotle does. However, this is an advantage for Chipotle because the food they have is the best quality and customers get their food faster. IBISWorld estimates Qdoba will earn system-wide sales of $615 million in 2014, representing annualized growth of 7.2 percent over the previous five years. IBISWorld also states that over the five years prior to 2014, Chipotle's US-specific revenue was expected to increase at an average annual rate of 19.4 percent to $3.7 billion. This rapid growth at more than four times the industry rate has been due to a combination of a change in consumer preferences, the rise in healthier eating and value-conscious consumers.

Chipotle's annual report mentions competition from outside the fast-casual restaurant segment. "Competitive pressures can come from deli sections and in-store cafés of several major grocery store chains, including those targeted at customers who want higher-quality food, as well as from convenience stores and casual dining outlets. These competitors may have, among other things, a more diverse menu, lower operating costs, better locations, better facilities, better management, more effective marketing and more efficient operations than we have."

So what gives Chipotle the competitive advantage? According to the Simmons Report for adults in 2009, those who look for organic or natural foods when shopping are more likely to eat at Chipotle than Panera Bread and Qdoba. Those who are more likely to purchase a product from a company that is environmentally friendly are more likely to go to Chipotle than they are to Panera and Qdoba as well. Plus, as stated in their annual report, many of their competitors grow by franchising. Chipotle does not. Chipotle also believes they can continue growing by increasing awareness among consumers about the type of food they are eating and how it is prepared in different types of eating establishments. Food with Integrity sets Chipotle apart from any other restaurant in the United States which is why Chipotle has had such success among its competitors. Their advertising and marketing is unlike any other company as well, with only a few ads and the Cultivate festival they put on every year setting them apart. They spend less on their marketing and ads which give them more room to buy the healthy and higher quality food.



Foreign Risks and Rewards

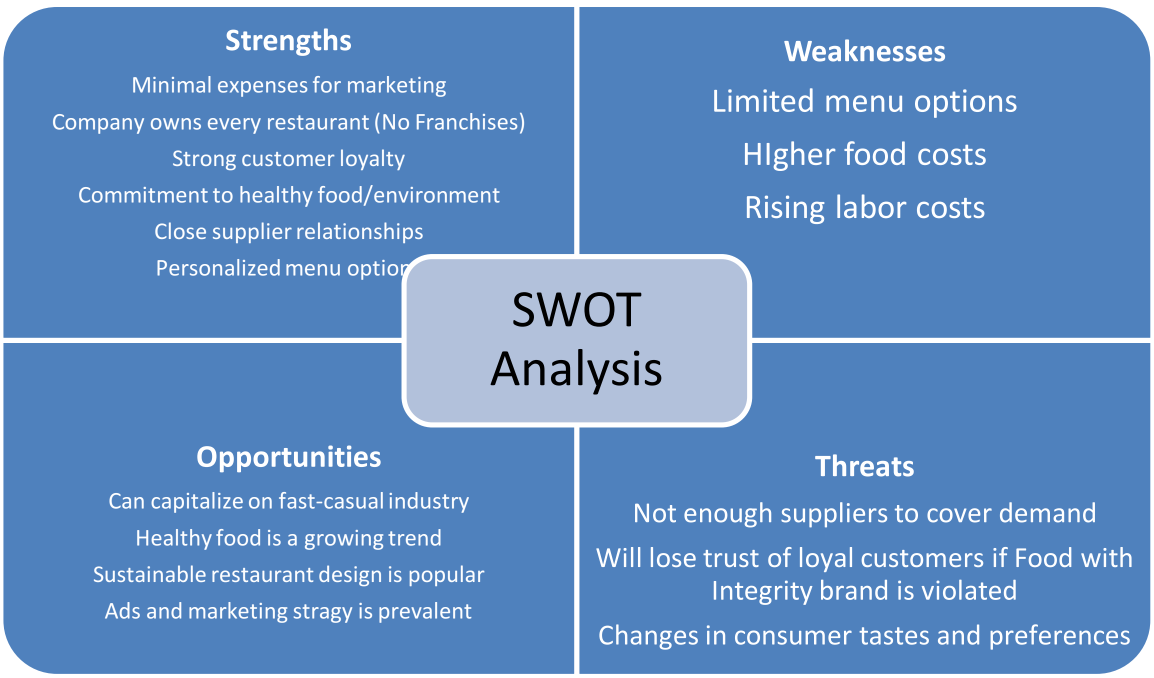
In 2008, Chipotle opened their first international restaurant in Toronto, Canada. According to Chipotle's 2015 10-K, there are seven locations in Canada, three in France, one in Germany, and six in the United Kingdom. Due to spending less time in these countries, Chipotle has lower brand awareness, lower sales, and less operating experience in these markets. The markets outside the United States have different competitive conditions, consumer tastes and spending patterns than in the U.S. markets.

- "Specifically, due to lower consumer familiarity with the Chipotle brand, differences in customer tastes or spending patterns, or for other reasons, sales at restaurants opened outside the U.S. may take longer to ramp up and reach expected sales and profit levels, and may never do so, thereby affecting our overall growth and profitability."

- "To build brand awareness in international markets, we may need to make greater investments in advertising and promotional activity than we originally planned, which could negatively impact the profitability of our operations in those markets."
- "We may also find it more difficult in international markets to hire, motivate and keep qualified employees who can project our vision, passion and culture, and labor costs may be higher in international markets due to increased regulation or local market conditions."

Restaurants in other countries also have higher construction, occupancy and food costs than in the United States. Chipotle would likewisehave to find suppliers that match their needs with the Food with integrity mission. "Our overall results may also be negatively affected by currency risk on the transactions in other currencies and translation adjustments resulting from the conversion of our international financial results into the U.S. dollar. "

Porter's Five Competitive Forces



There are five factors to Michael Porter's model of competition.

1. Supplier Power: There are few suppliers that raise animals naturally with a vegetarian diet. Their product is unique to that, since so few restaurants actually use that type of animal/produce anymore. This uniqueness and limited availability give the suppliers for Chipotle a lot of power as far as the prices they are willing to sell to Chipotle.

2. Buyer Power: Chipotle has over 1500 locations over the U.S. and 17 locations abroad. There are thousands of buyers every day. Therefore, the buyers do not have much power over the prices Chipotle sells their food at.
3. Competitive Rivalry: Here, there are a few restaurants that serve the same type of quality healthy food in such a casual setting. However, if Chipotle was to increase their prices too drastically, buyers could leave to eat elsewhere. The Food with Integrity model is unique though. I would say Chipotle has stable/equal strength to competitors in this model.
4. Threat of Substitution: Consumers could eat and make burritos at home, but would probably not have the benefit of getting food straight from these family farms. A farmers market would be the closest supplier. This type of food is not so readily available, so the threat of substitution might not be very high, but it is still leering.
5. Threat of New Entry: Opening a new restaurant requires a big investment, but the “fast-casual” segment of restaurants has been growing exponentially. Healthy food has also become popular as more people begin to watch what they are eating and where they are from. Therefore, the threat to new entry for Chipotle is relevant.

Chapter 3: Financial Statement Analysis Part 1

Asset Composition

Current Assets

Cash and Cash Equivalents: According the Chipotle's most recent 10-K, "The Company considers all highly liquid investment instruments purchased with an initial maturity of three months or less to be cash equivalents." The amount of cash and its equivalent for 2014 was $419,465,000, which was an increase of $96,262,000 from the previous annual year. 2014's cash was an increase from 2011 of 4.54 percent. Cash is the largest of the current assets at 48 percent.

Accounts Receivable: This account consists of receivables from "third party gift card distributors, tenant improvement receivables, payroll-related tax receivables, vendor rebates, and receivables arising from the normal course of business." The net account receivable amount for 2014 was $34,839,000. The allowance for doubtful accounts is based off of estimates that the company makes on how probable losses are on existing accounts receivable amounts. The balance is written off when they believe they will not be collecting any more on an account.

Inventory: For Chipotle, inventory mostly consists of supplies, drinks, and the food that they purchase. The food (beef, pork, chicken, beans, rice, sour cream, cheese, tortillas) is purchased from a small number of suppliers. Chipotle uses the first-in, first-out valuation method. The value for inventory for 2014 is $15,332,000.

Current Deferred Tax: The Company recognizes deferred tax assets at enacted income tax rates for the temporary differences between the financial reporting bases and the tax bases of its assets and liabilities. Deferred U.S. income taxes have not been recorded for temporary differences related to investments in certain foreign subsidiaries. These temporary differences consisted primarily of undistributed earnings considered permanently invested in operations outside the U.S.

Prepaid Expenses: Prepaid expenses for the year were $34,795,000,- which was a decrease of $658,000 from the previous year.

Income Tax Receivable: “The Company’s policy is to recognize interest to be paid on an underpayment of income taxes in interest expense and any related statutory penalties in the provision for income taxes in the consolidated statement of income and comprehensive income."

Investments: The investments consist of "U.S. treasury notes and certificates of deposit placed through an account registry service with maturities up to approximately two years and classified as held-to-maturity." The securities are measured using fair value costs. The 2014 value for investments are $338,592,000. Long term investments are valued at $496,106,000.

Chipotle does not have significant working capital because customers generally pay using cash or credit and debit cards. They also do not require significant receivables or inventories due to the use of their fresh ingredients. "In addition, we generally have the right to pay for the purchase of food, beverage and supplies sometime after the receipt of those items, generally within ten days, thereby reducing the need for incremental working capital to support our growth." Investments is the second largest current asset making up 39 percent of total current assets.

Long Term Assets

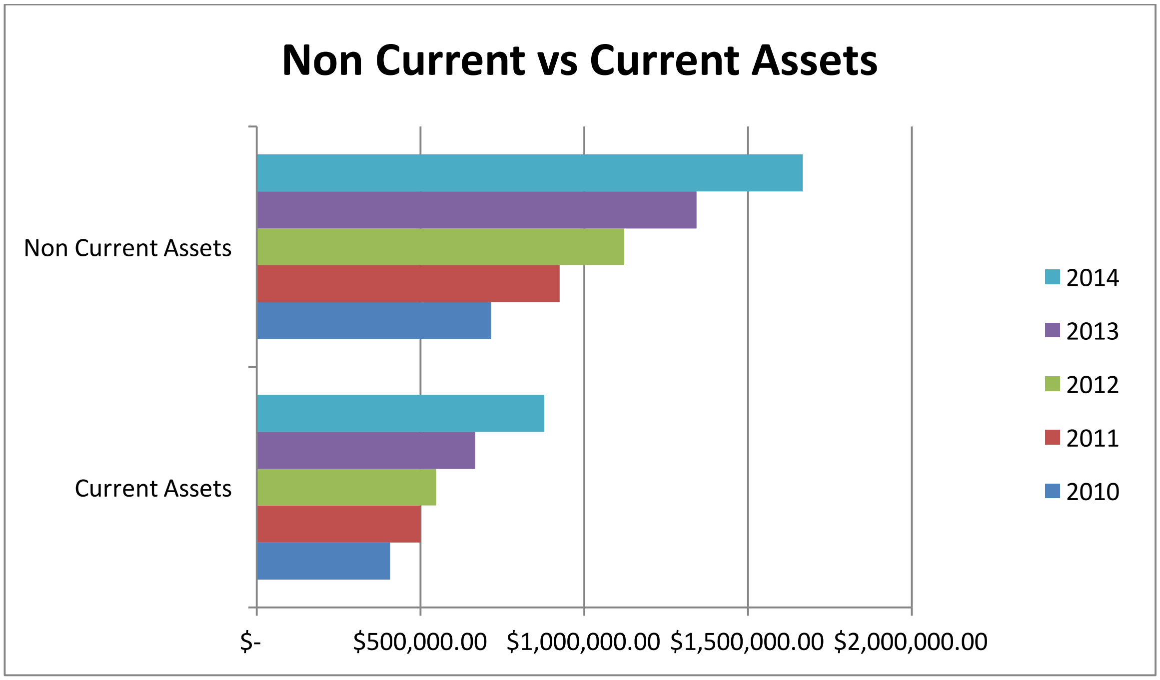
Long lived assets are impaired whenever the carrying value of the asset is not recoverable. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized as the amount by which the carrying amount of the asset exceeds the fair value of the asset. There was an impairment charge in 2013 of $1,220,000 and was recognized as a loss on disposal of assets. The impairment charges resulted primarily from restaurant relocations.

Leasehold improvements:This is the largest asset that Chipotle has at 43 percent of total assets. This is similar to Panera Bread as well, except that their leasehold improvements make up 57 percent of their total assets. This account is recorded at cost. “Expenditures for major renewals and improvements are capitalized while expenditures for minor replacements, maintenance and repairs are expensed as incurred.” They use the straight line method for depreciation and the improvements are amortized over the lease term. “Upon retirement or disposal of assets, the accounts are relieved of cost and accumulated depreciation and the related gain or loss, if any, is reflected in loss on disposal of assets in the consolidated statement of income and comprehensive income.” Annually, Chipotle evaluates and adjusts the useful lives when needed. Currently the estimated useful lives are:

	Estimated Useful Lives
Leasehold Improvements and Buildings	3-20 Years
Furniture and Fixtures	4-7 Years
Equipment	3-10 Years

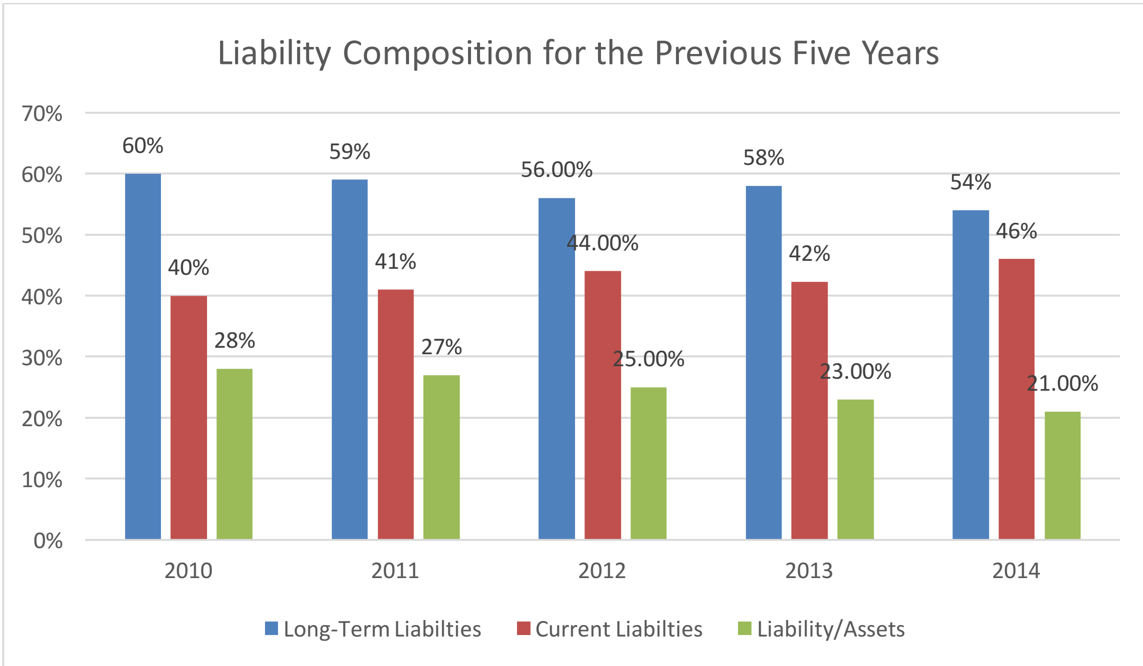
Other Assets:This account consists mostly of restricted cash assets of “a rabbi trust, transferable liquor licenses which are carried at the lower of fair value or cost, and rental deposits related to leased properties. Restricted cash assets are primarily insurance related restricted trust assets.” The 2014 value was $42,777,000.

Goodwill:Goodwill is known as an intangible asset and is the excess of cost over fair value of net assets of the business acquired. It is not amortized but it is subject to impairment at least once a year. Impairment is measured as the excess of the carrying value over the fair value of the goodwill. There were no impairment charges for 2014 and the value of goodwill was $21,939,000.



Source of Financing

Steve Ells used both debt and equity financing when starting Chipotle. He started the first restaurant when he borrowed over $80,000 from his father. Chipotle then initially received equity financing when McDonalds invested in them but also when they went public in 2006. They show a zero percent debt to equity ratio. This could be that this type of fast- casual restaurant runs mostly on cash so they do not require any long-term debt.



For 2014, Chipotle's total liabilities divided by total assets equaled 20.97 percent. Their current liabilities are about 46 percent of the total liabilities and long term is about 54 percent. This probably does not make them very flexible financially meaning the company might be heading on a more risky path. Overtime, their liabilities compared to their assets have been slowly decreasing which is a good measure.

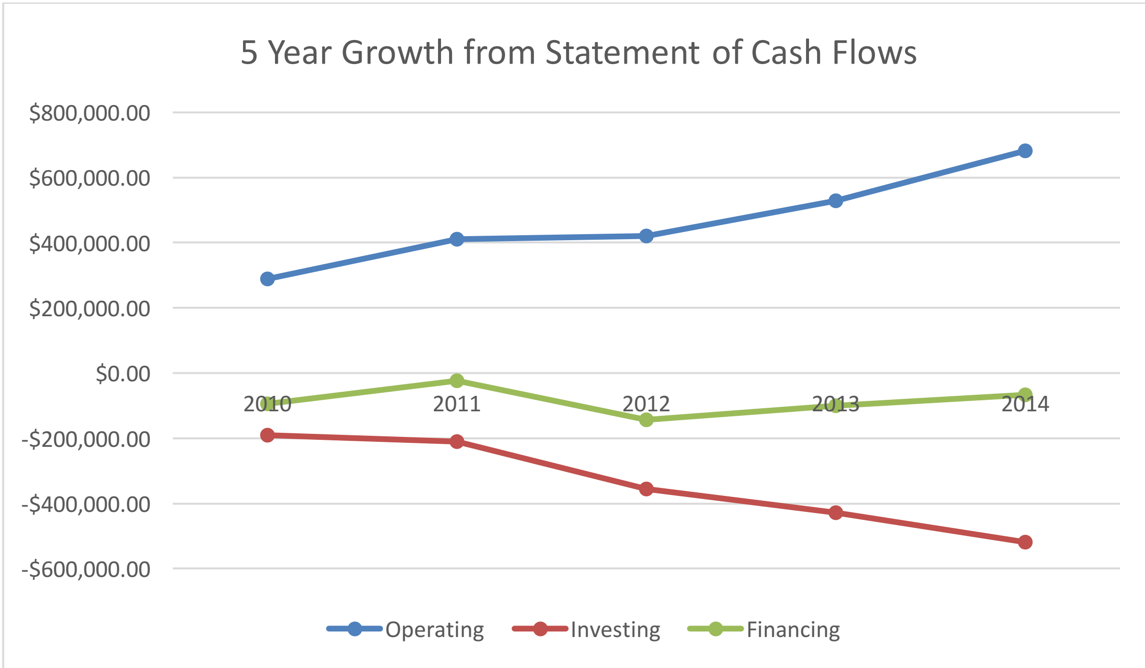
Cash Flows

The operating section measures the amount of cash spent on normal day to day activities so an increase in the cash in this section is a good sign. On the Statement of Cash Flows for 2012-2014, this section has had all positive increases meaning they are probably finding better ways to generate cash. In 2014, net cash provided by operating activities equaled $682,087,000.

The investing section measures the cash used or provided by the sale of income producing assets. This section has been increasing negatively since 2012 and the total net cash from investing for 2014 is negative $518,844,000. This does not seem to be a good number since it is negative, but it could be from purchasing more long-term investments.

The financing section measures the cash flow between the company and its owners and creditors. This section has been increasing positively since 2012; however, they are still in the negative numbers. The net cash used for financing activities in 2014 was negative $66,737,000. The total net cash change from the year 2013 was $96,262,000.

Comparing cash provided from operating, investing, and financing, it can be concluded that Chipotle is in the maturity stage of the life cycle. Their growth and sales should start leveling out based on this assumption unless they can innovate new ideas to generate increases in sales.



Liquidity and Solvency

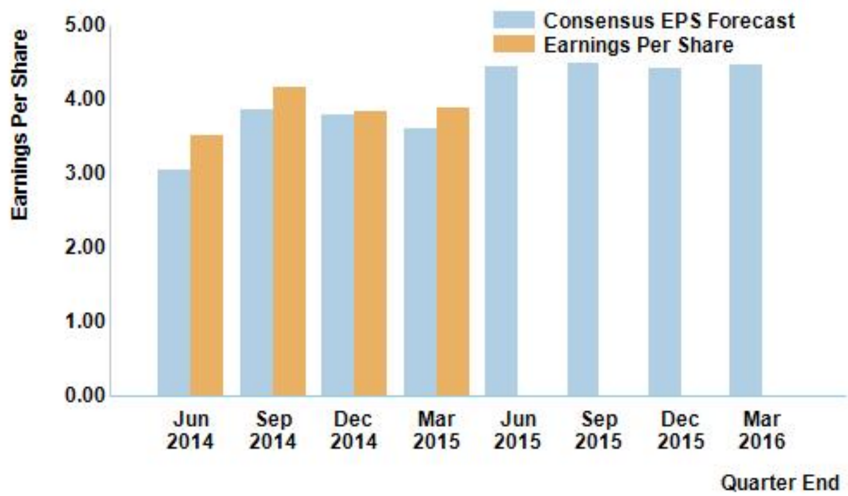
The liquidity ratios help measure how quickly a company can pay off its short-term debt obligations. The more liquid assets there are (assets that can easily be converted to cash) the better they can cover their short-term liabilities. Chipotle's current ratio in 2014 was 3.58 which had increased since the previous year. This compares the current assets to the current liabilities. The higher the liquidity is the better, so this is a positive change (although there can be a limit to this.) This also means they have a little more financial flexibility than previous years. The quick ratio for 2014 is 3.23 which is also an increase from previous years. The quick ratio compares cash, short term investments, and accounts receivable to current liabilities. The quick ratio is a more conservative measure of liquidity than the current ratio as it takes out inventory from the current assets used in the ratio's formula. By excluding inventory, the quick ratio focuses on the more-liquid assets of a company. Since both of these ratios are a positive change causing higher liquidity, the company seems to be becoming less risky.

Liquidity Ratios	2014	2013	2012	2011	2010
Current	3.58	3.34	2.93	3.18	3.3
Quick	3.23	3.02	2.62	2.95	2.89

Earnings per Share

EPS	**2014**	**2013**	**2012**	**2011**	**2010**
Basic	$14.35	$10.58	$8.82	$6.89	$5.73
Diluted	$14.13	$10.47	$8.75	$6.76	$5.64

Basic earnings per share are calculated by dividing net income by the weighted-average number of shares of common stock outstanding. Diluted earnings per share are calculated using net income divided by diluted weighted-average shares of common stock outstanding during each period. This table



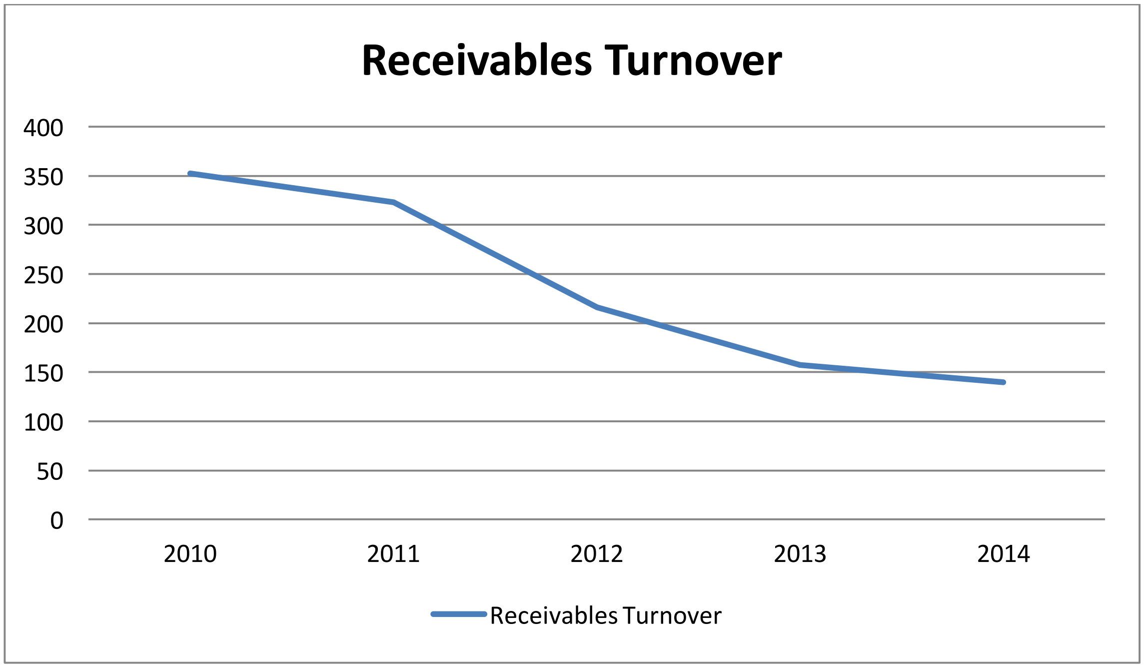
shows the increase in earnings per share for the past five years. Thus, the earning power of Chipotle has improved along with Chipotle consistently beating their targets. In Chipotle's most recent 10-K, they stated that they did not pay dividends which means that they put the cash back into the business for more potential growth. "We intend to continue to retain earnings for use in the operation and expansion of our business and therefore do not anticipate paying any cash dividends on our common stock in the foreseeable future."

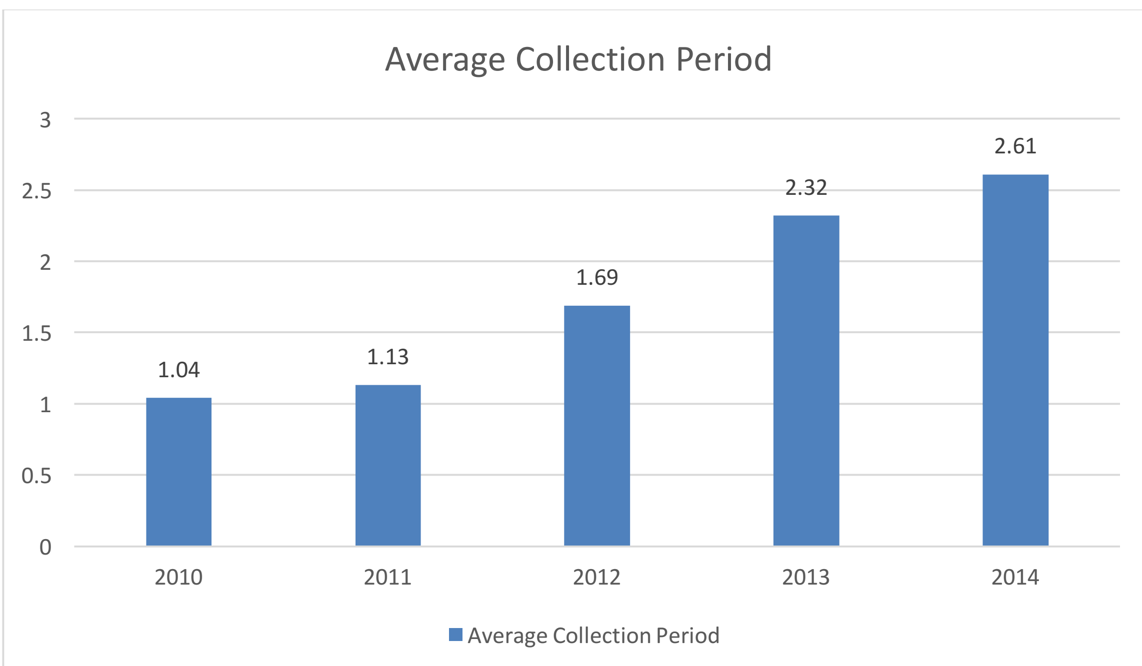
Chapter 4: Financial Statement Analysis Part 2

Receivables

The accounts receivable account primarily consists of receivables from third party gift card distributors, tenant improvement receivables, payroll-related tax receivables, vendor rebates, and receivables arising from the normal course of business. For the current year, the net accounts receivable account totaled $34,839,000.

The customers of Chipotle have to use cash or credit/debit card so receivables are not highly existent in operations. “We haven’t required significant working capital because customers generally pay using cash or credit and debit cards and because our operations do not require significant receivables….”


Receivables Turnover
400
350
300
250
200
150
100
50
0
2010
2011
2012
2013
2014
Receivables Turnover


Average Collection Period
3
2.5
2
1.5
1
0.5
0
1.04
1.13
1.69
2.32
2.61
2010
2011
2012
2013
2014
Average Collection Period

The receivables is a high ratio meaning that Chipotle is collecting its receivables sooner and are able to pay their bills or other items with this cash. This ratio however used revenue since credit and cash sales are not reported separately. The average collection ratio has increased over the past five years. This shows that customer payments are slowing down which could lead to reduced sales in the future.

“The allowance for doubtful accounts is the company’s best estimate of the amount of probable credit losses in the company’s existing accounts receivable based on a specific review of account balances. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recoverability is considered remote.” The carrying value of the company’s accounts receivable approximate fair value because of their short-term nature and the allowance method is used to account for the bad debt. Bad debt is recorded as an expense on the Income Statement, therefore decreasing net income.

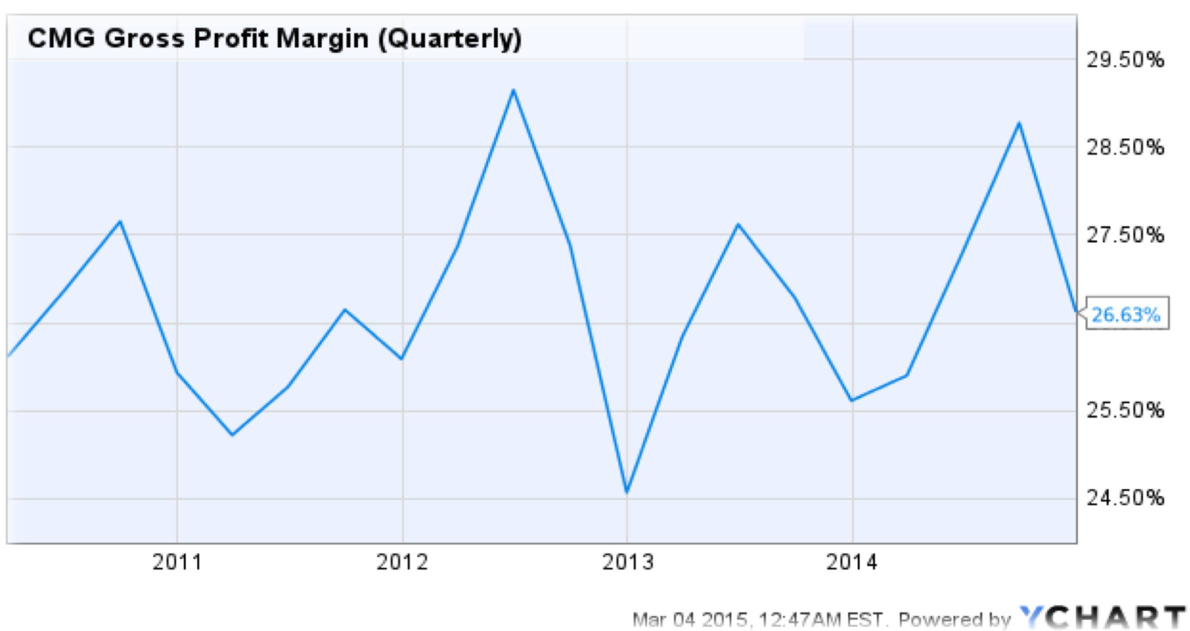
	12/31/14	12/31/13	12/31/12	12/31/11	12/31/10
Allowance for doubtful accounts (in thousands)	$1,199	$1,190	$1,187	$208	$102
Allowance for doubtful accounts %	3.44%	4.96%	7.07%	2.48%	1.8%

Between the years of 2011 and 2012, there was a sharp increase in the allowance for doubtful account. Chipotle could have under estimated the bad debt for the previous year so they over compensated for 2012. Since 2012, the increase in the allowance account has been miniscule. They've also recently started catering which also probably increased the receivables.

Accounts receivable and allowance for doubtful accounts are in the discretion of management since these numbers are just estimates. They can have low estimates on the allowance for doubtful accounts which would show higher accounts receivable numbers depending on if management wants to increase or decrease their earnings. Chipotle can also sell their receivables so that they would not have to deal with them anymore.

Inventories

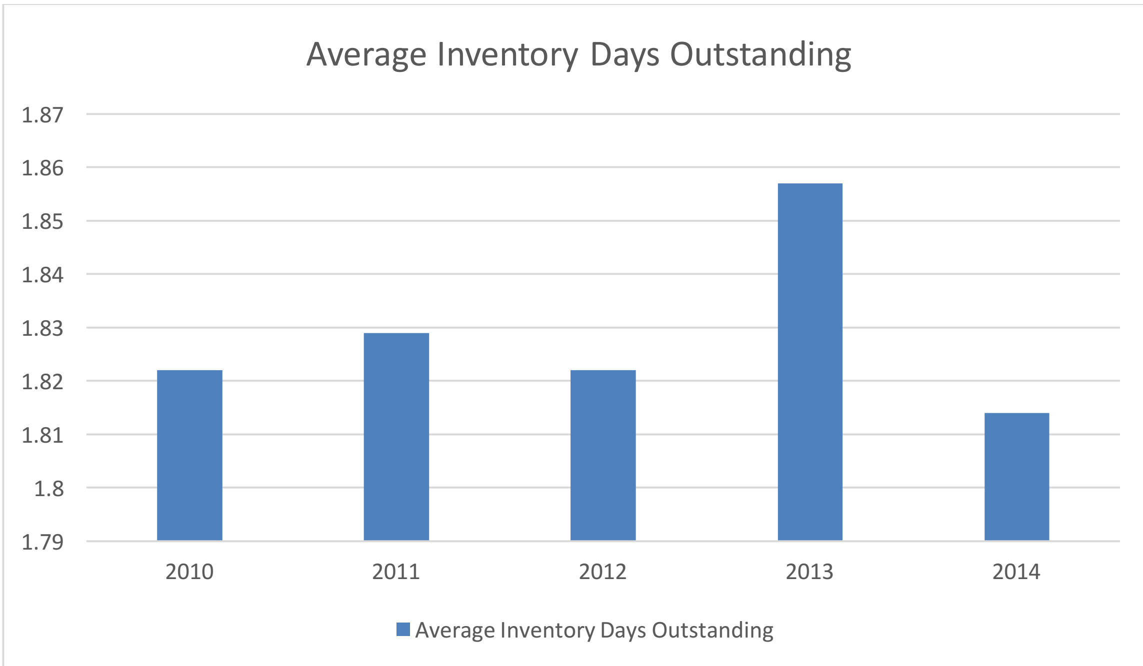
The inventory account consists principally of food, beverages, and supplies, and is valued at first-in, first-out lower of cost or market. Certain key ingredients including beef, pork, chicken, beans, rice, sour cream, cheese, and tortillas are purchased from a small number of suppliers. “We haven’t required significant working capital because customers generally pay using cash or credit and debit cards and because our operations do not require significant receivables, nor do they require significant inventories due, in part, to our use of various fresh ingredients.”



The gross profit margin is a good indicator of financial health for a company and should be stable. It's a profitability ratio that shows what amount of dollars is left after paying for cost of goods sold. Chipotle's does not seem to fluctuate much only ranging between 24.57 percent at its lowest and 26.09 percent at its highest for the previous five years. The gross profit margin as shown on the graph above shows the margin for this most recent year at 26.63 percent. The previous four years are as follows:

	Gross Profit Margin
2010	25.94%
2011	26.09%
2012	24.57%
2013	25.62%

Inventory turnover shows how many times Chipotle sells their inventory in any given period. It's good to have quick turnover so that you don't have old inventory sitting around building up costs.



Inventory days outstanding measure the average number of days a company holds inventory before selling it. For Chipotle, this seems to be a pretty stable number at an average of 1.8288 days. Due to the use of fresh ingredients, their turnover is very quick and shows that Chipotle moves fast. This also shows that their inventory is very liquid which gives them good cash flows.

Overstating inventory value will lead to an understated of cost of goods sold, and therefore an artificially higher net income, assuming actual inventory and sales levels remain constant.

Property Plant and Equipment

	December 31	
	2014	**2013**
Land	$ 11,062	$ 11,062
Leasehold improvements and buildings	1,267,108	1,121,260
Furniture and fixtures	127,260	113,751
Equipment	315,230	244,562
	1,720,660	1,490,635
Accumulated depreciation	(613,676)	(527,397)
	$ 1,106,984	$ 963,238

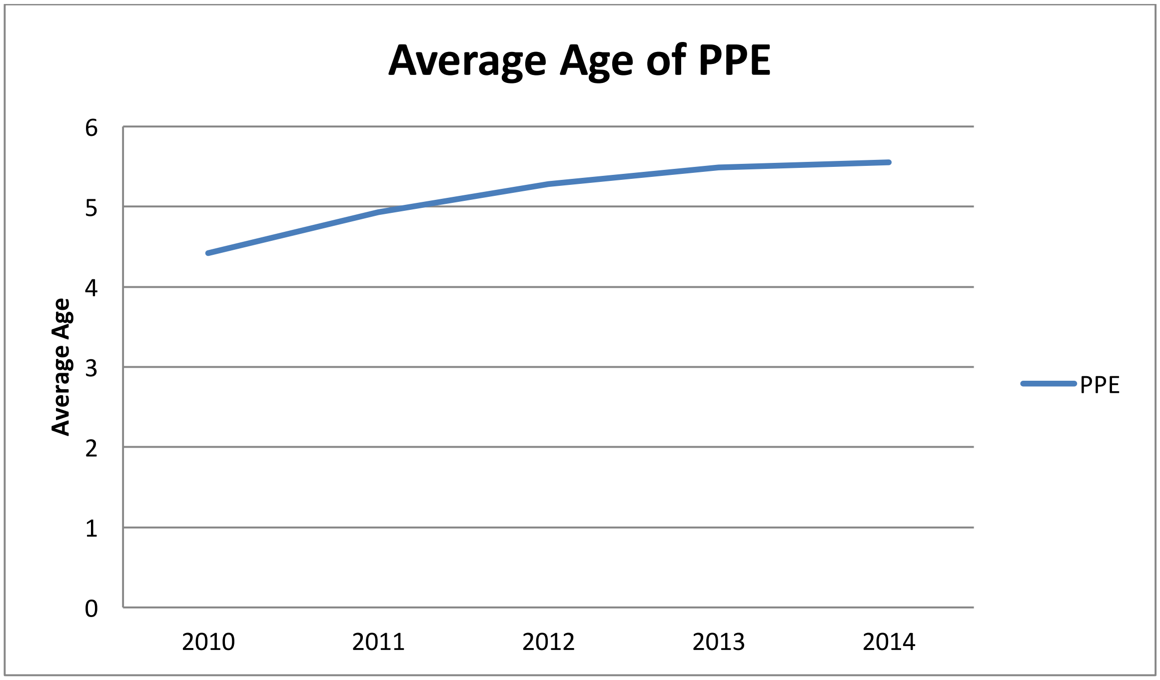
Chipotle calculates their depreciation using the straight-line method over the estimated useful lives of the assets. They evaluate and adjust the useful lives annually. Property and equipment are also recorded at cost, not fair value. “As a percentage of revenue, depreciation and amortization decreased in 2014 and 2013 as a result of the benefit of higher average restaurant sales on a partially fixed-cost base.” Pre-opening costs like rent, wages, benefits and travel for the training and opening teams, food and other restaurant operating costs, are expensed as incurred prior to a restaurant opening for business.

Chipotle opened 192 restaurants in 2014, bringing their total to 1,783 restaurants in operation. Their future plans entail increasing the number of restaurants significantly in the next three years by opening between 190 and 205 new restaurants in 2015.

For the purpose of reviewing Chipotle's restaurant assets to be held and used for potential impairment, the assets are grouped together at the market level, or in the case of a potential relocation or closure, at the restaurant level. Chipotle manages its restaurants as a group with significant common costs and promotional activities; as such, an individual restaurant's cash flows are not generally independent of the cash flows of others in a market. "Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized as the amount by which the carrying amount of the asset exceeds the fair value of the asset." For 2014 and 2012, there was a zero dollar impairment charge. For 2013, an aggregate impairment charge of $1,220,000 was recognized in loss on disposal of assets in the consolidated statement of income and comprehensive income. The impairment charges resulted primarily from restaurant relocations. Fair value of the restaurants was determined using inputs based on a discounted cash flows method through the estimated date of closure.

	2014	2013	2012	2011	2010
Fixed Asset Turnover Ratio	3.97	3.51	3.37	3.18	2.8

This ratio is a rough measure of the productivity of a company's PP&E with respect to generating sales and is designed to reflect a company's efficiency in managing these significant assets. For most companies, their investment in fixed assets represents the single largest component of their total assets which is the case here as Chipotle's PPE holds 43 percent of their total assets.Since the turnover ratio show in the table above is growing higher every year, this is a sign of positive growth and efficiency for Chipotle.



Deteriorating property, plant, and equipment can be detected by computing the average age. This is estimated by dividing accumulated depreciation by depreciation expense. If the average age increases over time this indicates that the company is letting their asset base deteriorate. Chipotle's PPE has slightly increased as shown in the graph above.

Companies can boost earnings by delaying investment in PPE. Depreciation expense is lower since the older assets likely had a lower historical cost than newer replacement assets. Depreciation is subject to numerous choices made by management like the method of depreciation they choose, the estimates of useful life, the estimates of salvage value, and impairments of PPE. A lot of these estimates are made by management and can be increased or decreased to meet analyst’s forecasts. Capital additions versus repairs and whether or not they lease their buildings versus owning them are also other ways management can boost their earnings. These manipulations will be discussed further in future chapters.

Chapter 5: Financial Statement Analysis Part 3

Intercorporate Investments

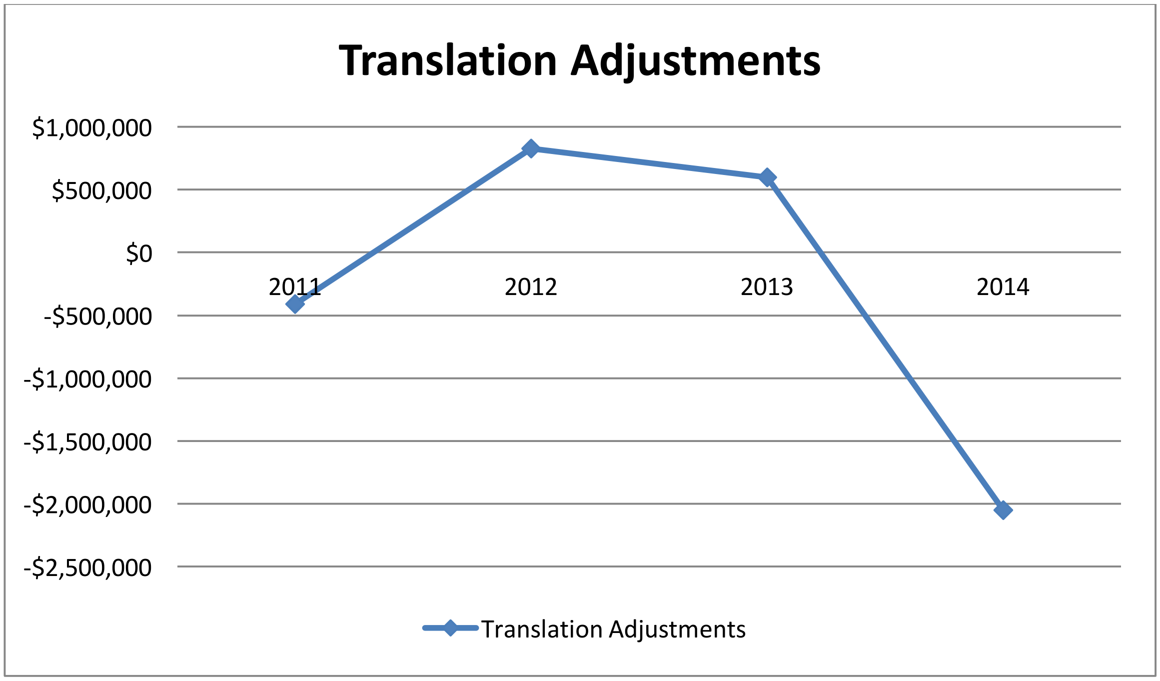
Intercorporate investments occur when companies invest in the equity or debt of other firms. Some of the benefits to this include gaining access to another market, gaining a competitive market, increasing your asset base, increasing profitability through the other company, and earning a favorable return on idle cash.These investments affect income with interest revenue, unrealized and realized holding gains and losses, and goodwill impairments.The investments are usually categorized depending on the percentage of ownership or voting control the investor undertakes in the firm. The categories are investments in financial assets, investments in associates, or business combinations which usually give a rise to goodwill.Chipotle's goodwill account has been $21,939,000 for the previous five years, showing no impairments for those years. Along with other research, it is clear that Chipotle does not hold any intercorporate investments at this time and grows their business organically.

Restructuring

Restructuring costs are charges that must be paid when a company reorganizes. Restructuring may occur when a company is experiencing significant problems and need to reorganize to improve business and recover financially. Financial statement analysts pay close attention to restructuring charges since they show previous or ongoing problems within the company. No restructuring charges were found for the previous five years for Chipotle.

Foreign Currency

As of December 31, 2014, Chipotle has locations not only in the United States but seven in Canada, three in France, one in Germany, and six in the United Kingdom. "A portion of our operations consist of activities outside of the U.S. and we have currency risk on the transactions in other currencies and translation adjustments resulting from the conversion of our international financial results into the U.S. dollar. However, a substantial majority of our operations and investment activities are transacted in the U.S. and therefore our foreign currency risk is limited at this date." Chipotle's international operations generally use the local currency as the functional currency. Assets and liabilities are translated at exchange rates in effect as of the balance sheet date. Income and expense accounts are translated at the average monthly exchange rates during the year. Resulting translation adjustments are recorded as a separate component of accumulated other comprehensive income in the consolidated statement of shareholders' equity.



The change in 2014 was a substantial decrease which would affect profitability negatively. 2011, 2012, and 2013 were small changes and probably did not have a huge impact on profitability. The current exchange rates for March 13, 2015 are as follows:

Country	Exchange Rate
United States	1
Canada	1.27887
Euro	0.95431

Share Repurchases, Stock Dividends, and Stock Splits

“In accordance with stock repurchases authorized by our Board of Directors, we purchased shares of our common stock with an aggregate total repurchase price of $88.0 million during 2014. As of December 31, 2014, $102.2 million was available to be repurchased under the current repurchase authorizations announced on February 5, 2013 and April 17, 2014.” On February 3, 2015 Chipotle also announced that the Board of Directors authorized the expenditure of up to an additional $100 million to repurchase shares of common stock.The shares of common stock repurchased under authorized programs were 154, 336 and 686 for a total cost of $87,996, $109,987 and $206,394 during 2014, 2013 and 2012. As of December 31, 2014, $102,210 was available to be repurchased under the authorized programs. The shares repurchased are being held in treasury until such time as they are reissued or retired, at the discretion of the Board of Directors.

“We are not required to pay any dividends and have not declared or paid any cash dividends on our common stock. We intend to continue to retain earnings for use in the operation and expansion of our business and therefore do not anticipate paying any cash dividends on our common stock in the foreseeable future.”

After looking through Chipotle’s most recent 10-K, annual report, and news articles, it is shown that Chipotle has never split their stock.

Pensions

Chipotle does not have a pension, but instead a 401(k). The biggest difference between a 401(k) plan and a pension plan is the “distinction between a defined benefit plan and a defined contribution plan.” According to Investopedia, defined benefit plans, like pensions, guarantee a given amount of monthly income in retirement and place the investment risk on the plan provider. Defined contribution plans, such as 401(k) s, allow individual employees to choose their own retirement investments with no guaranteed minimum or maximum benefits which place the risk on the employees.

Chipotle matches 100 percent of the first three percent of pay contributed by each eligible employee and 50 percent on the next two percent of pay contributed. Employees become eligible to receive matching contributions after one year of service. For the years ended December 31, 2014, 2013, and 2012, matching contributions totaled (in thousands) approximately $3,881, $2,644 and $2,431, respectively.

In 2012, the Company began offering an employee stock purchase plan. Under the plan, 250 shares of common stock have been authorized and reserved for issuances to eligible employees, of which 248 represent shares that were authorized for issuance but not issued at December 31, 2014. Employees become eligible to contribute after one year of service and may contribute up to 15 percent of their base earnings toward the monthly purchase of the company's common stock. For each of the years ended December 31, 2014, 2013, and 2012, the number of shares issued under the ESPP were less than one.

Chipotle also has a Supplemental Deferred Investment Plan. This is a non-qualified plan that allows participants to make tax-deferred contributions that cannot be made under the 401(k) Plan because of Internal Revenue Service limitations. Participants' earnings on contributions made to the Deferred Plan fluctuate with the actual earnings and losses of a variety of available investment choices selected by the participant. Total liabilities under the Deferred Plan as of December 31, 2014 and 2013 were $16,147 and $13,397, respectively, and are included in other long-term liabilities in the consolidated balance sheet. For the years ended December 31, 2014, 2013, and 2012, the company made deferred compensation matches of $536, $201 and $213 respectively, to the Deferred Plan. Chipotle funds its deferred compensation obligations through a rabbi trust. The rabbi trust is subject to creditor claims in the event of insolvency, but the assets held in the rabbi trust are not available for general corporate purposes. Amounts in the rabbi trust are invested in mutual funds, as selected by participants, who are designated as trading securities and carried at fair value, and are included in other assets in the consolidated balance sheet. According to fool.com, Chipotle’s 401(k) plan ranks lower than Starbucks and Whole Foods.

Chapter 6: Financial Statement Analysis Part 4

Operating versus Non-Operating

Below are the operating and non-operating items that are listed on the income statement and balance sheet. These numbers will be used to compute different ratios for analytical reasons.

Operating	
Income Statement	**2014**
Revenue	$4,108,269
Food, beverage, and packaging costs	$1,420,994
Labor costs	$904,407
Occupancy costs	$230,868
Other operating costs	$434,244
General and administrative expenses	$273,897
Depreciation and amortization	$110,474
Pre-opening costs	$15,609
Loss on disposal of assets	$6,976
Total operating expenses	$3,397,469
Income from operations	$710,800
Provision for income taxes	($268,929)

Balance Sheet	
Current Assets:	
Accounts receivables (net of allowance for doubtful accounts)	$34,839
Inventory	$15,332
Current deferred tax asset	$18,968
Prepaid expenses	$34,795
Income Tax Receivable	$16,488
Non-Current Assets:	
Leasehold improvements	$1,106,984
Other assets	$42,777
Goodwill	$21,939
Current Liabilities:	
Accounts payable	$69,613
Accrued Liabilities	$102,203
Accrued payroll and benefits	$73,894
Non-Current Liabilities	
Deferred income tax liability	$40,529
Other liabilities	$28,263

Non-Operating

Income Statement	**2014**
Interest and other income, net	$3,503
Other Comprehensive Income	
Foreign currency adjustment	($2,049)

Balance Sheet	
Current Assets	
Cash and cash equivalents	$419,465
Investments	$338,592
Non-Current Assets	
Long term investments	$496,106
Current Liabilities	
Current deemed landlord financing	$0
Income tax payable	$0
Non-Current Liabilities	
Deferred rent	$219,414
Deemed landlord financing	$0
Shareholders' Equity	
Preferred stock	$0
Common stock	$354
Additional paid-in-capital	$1,038,932
Treasury stock	($748,759)
Accumulated other comprehensive income	($429)
Retained earnings	$1,722,271

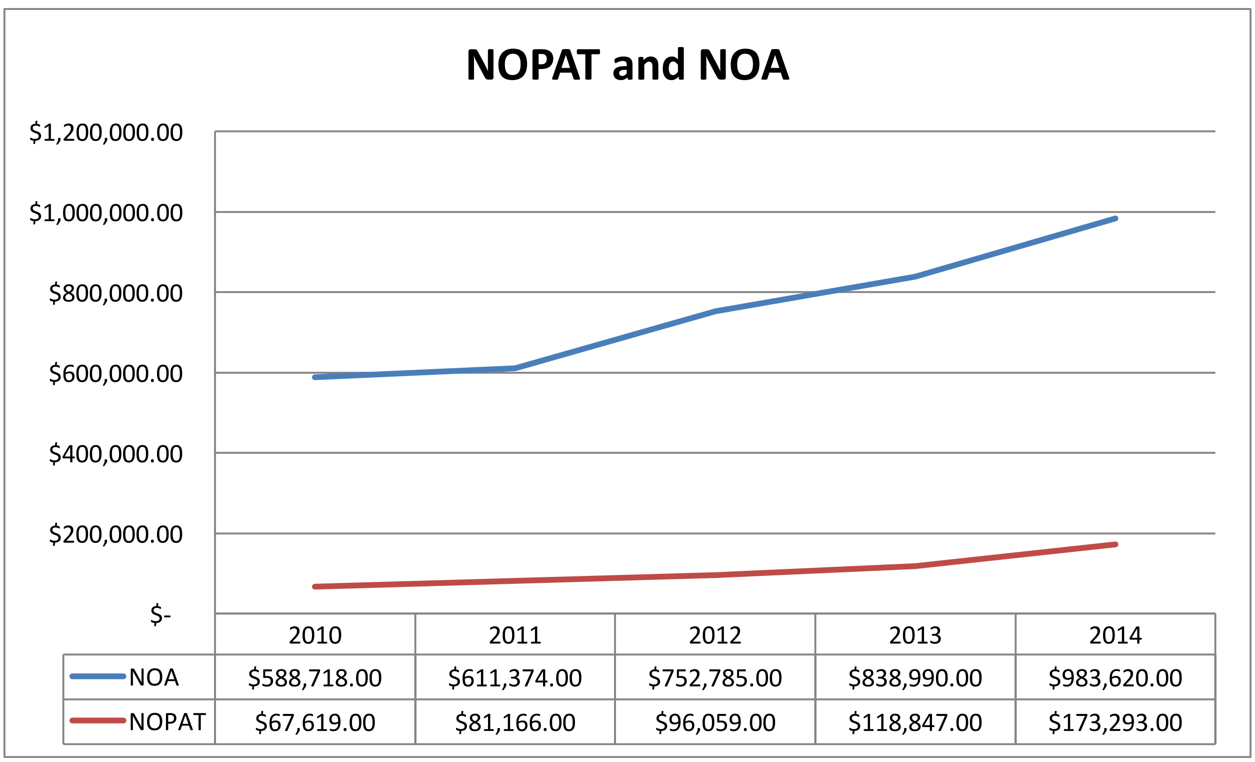
	2014	2013	2012	2011	2010
Statutory U.S. federal income tax rate	35%	35%	35%	35%	35%
State income tax, net of related federal income tax benefit	3.7%	4.2%	4.1%	4.1%	3.5%
Other	(1.1%)	(0.5%)	0.2%	(0.6%)	(0.4%)
Effective income tax rates	37.6%	38.7%	39.3%	38.5%	38.1%

Chipotle estimates that the 2015 annual effective tax rate will be 39.0 percent, increasing from 2014 due to the expiration of certain federal tax credits.

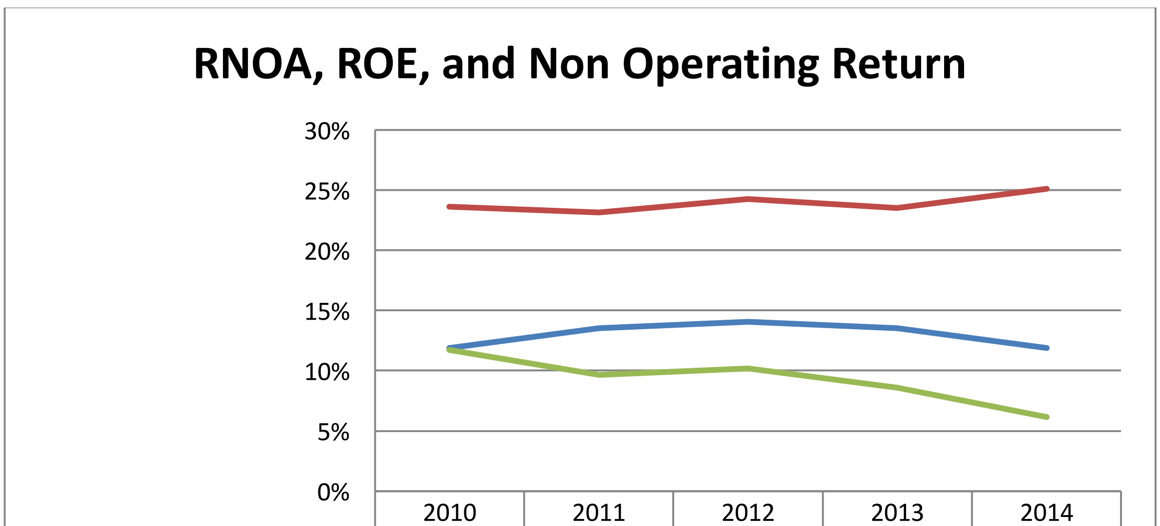
NOPAT is a more accurate look at operating efficiency. Simply, it looks at how well a company's core operations did, net of taxes. Accordingly, NOPAT is also used to calculate Economic Value Added (EVA). It is important to note that some industries fundamentally have higher costs than others which is why comparing NOPATs is generally most meaningful among companies within the same industry. This figure increased for Chipotle for the previous five years. They are more efficient in gaining net profit after tax.

Net Operating Profit Before Tax (NOPBT) - 2014		710,800	
Less Tax on Operating Profit			
Tax Expense	268,929		
Tax Shield	(714,303x37.6%)	-537,507.00	
Net Operating Profit After Tax (NOPAT)		173,293	

Net Operating Assets (NOA) is calculated taking total operating assets and subtracting operating liabilities. This figure has also increased in the past five years for Chipotle indicating that they are increasing their assets and decreasing their liabilities.



Operating Return (RNOA) is calculated by taking NOPAT and dividing NOA. The higher the return, the better the profit performance for the company. Chipotle's return is pretty low averaging at 13.2 percent for the previous five years. It increased between 2010 and 2011 but then leveled off until decreasing in 2014.



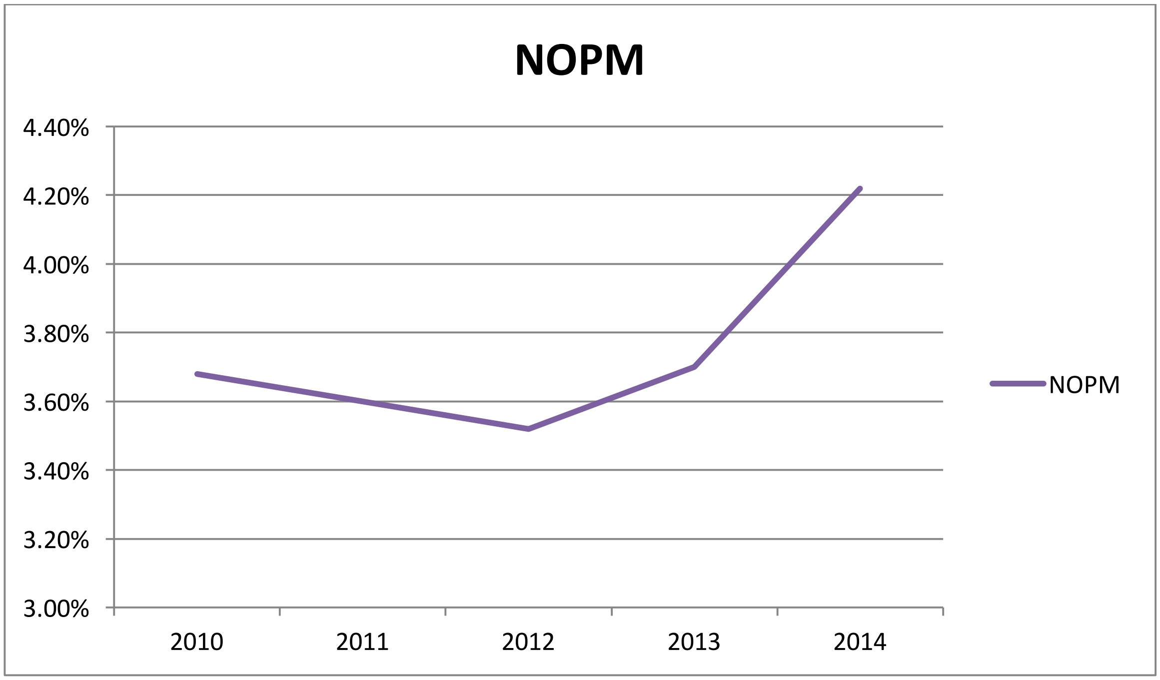
	2010	2011	2012	2013	2014
RNOA	12%	14%	14%	14%	12%
ROE	24%	23%	24%	24%	25%
Non Operating Return	12%	10%	10%	9%	6%

Return on Equity (ROE) is net income divided by average stockholder's equity. ROE is a good ratio to find; Warren Buffet uses it for investment criteria. It can also be calculated as Operating Return plus Non-Operating Return. ROE has been slightly increasing for Chipotle which is a good measure.

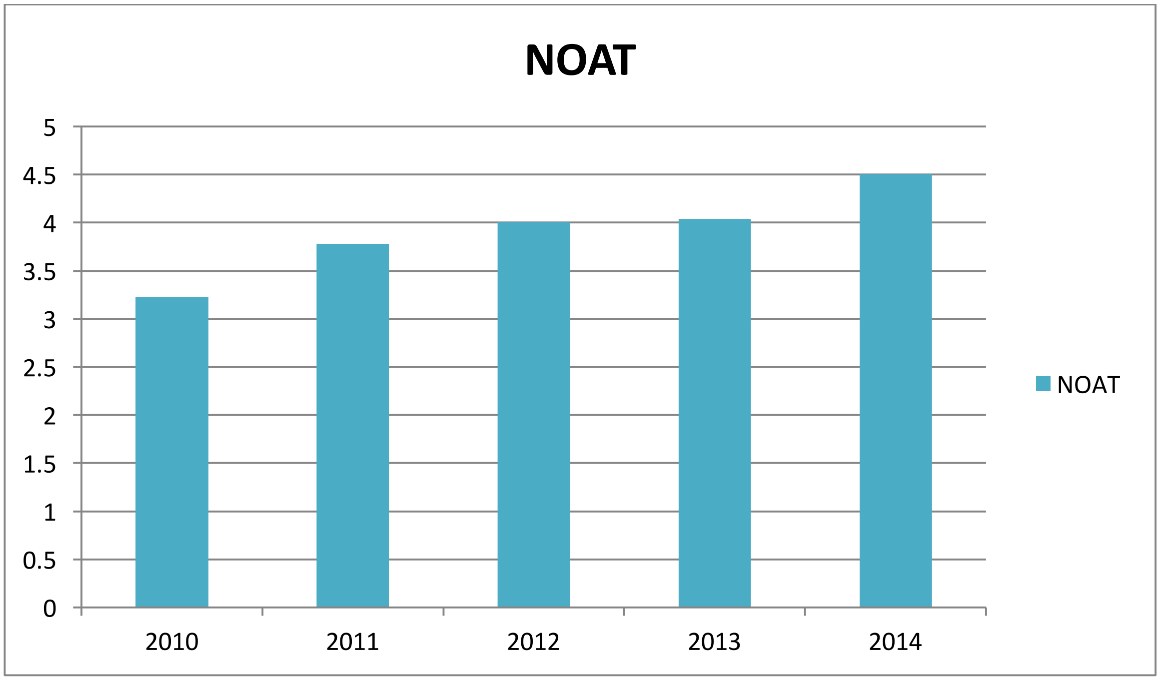
Chipotle's Non-Operating Return has been slightly decreasing since 2010. This means they are returning less on their non-operating items which probably means a greater return on their operating items.

RNOA =	NOPAT =	NOPAT	x	Sales	
	Average NOA	Sales		Average NOA	

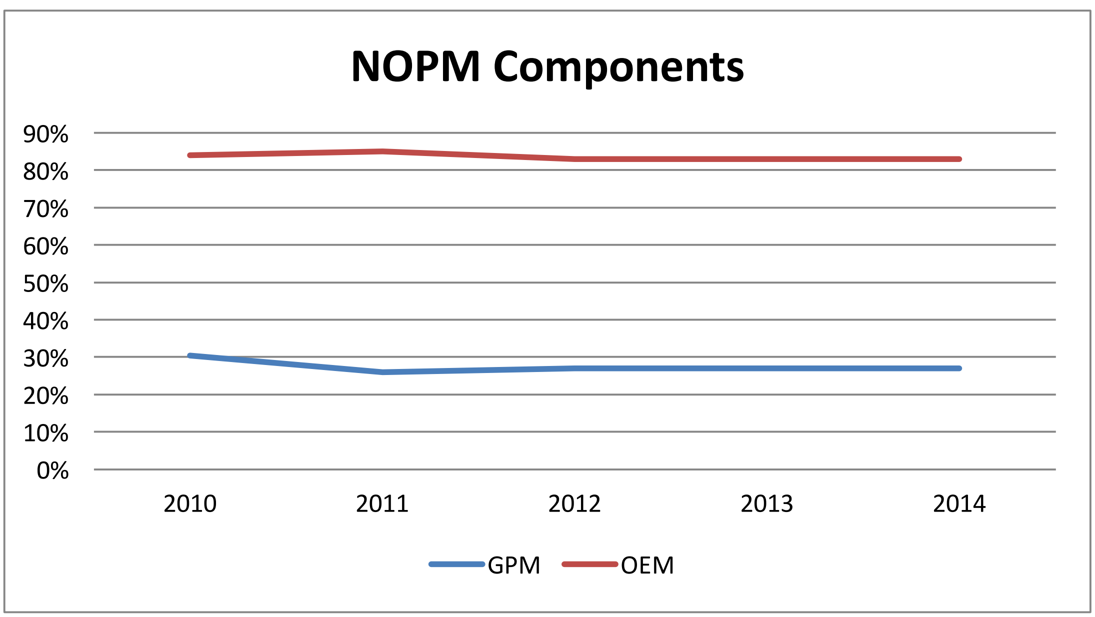
Operating Return can be separated into Net Operating Profit Margin (NOPM = NOPAT/Sales) and Net Operating Asset Turnover (NOAT = Sales/AvgNOA).The net operating profit margin shows how much operating profit the company earns from every dollar of sales. It's affected by gross profit, operating expenses, level of competition, and the company's willingness and ability to control costs. It is equal to the net operating profit after tax divided by sales. Chipotle's NOPM is below the median of other publicly traded firms.



The net operating asset turnover shows the productivity of the company’s net operating assets. It shows how much the company realizes in sales from each dollar invested in the net operating assets. Chipotle’s NOAT is higher than the median of $1.4 for publicly traded companies and continues to increase.

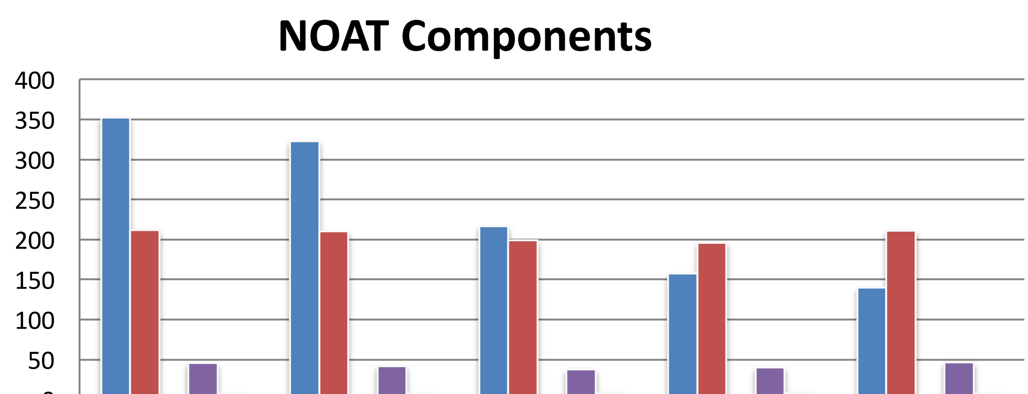


To further disaggregate, Gross Profit Margin (GPM) and Operating Expense Margin (OEM) are part of NOPM.



Gross Profit Margin is gross profit divided by sales. A company's GPM should be stable and should not fluctuate much from one period to another. Chipotle's GPM decreased from 2010 to 2011 but then remained stable for the years after. Operating Expense Margin is operating expenses divided by sales. This compares the amount of operating expenses compared to sales. This is a high percentage but has remained steady in the past five years.

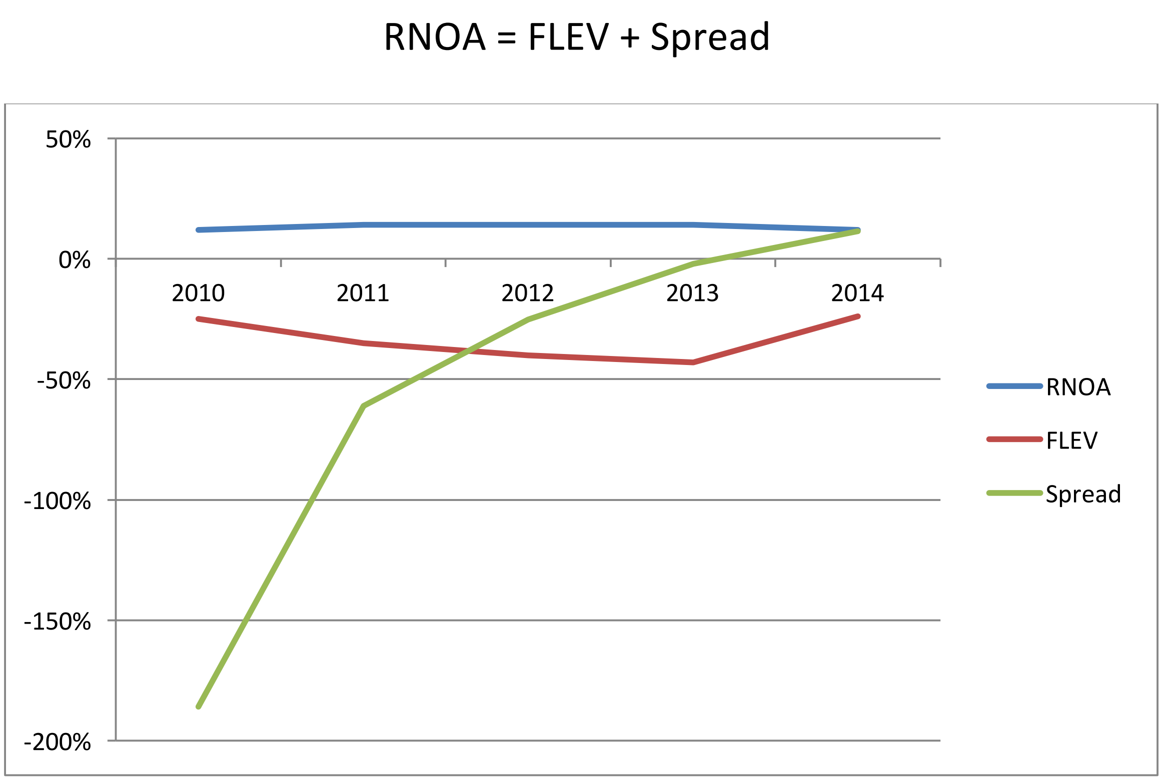
There are also several components to NOAT.



	2010	2011	2012	2013	2014
ART	352.3166	323.1133	216.8499	157.5162	139.6041
INVT	211.85	209.883	198.989	195.511	210.778
LTOAT	2.66184	3.00352	3.16284	3.27969	3.73342
APT	45.6942	41.9619	37.892	40.0914	46.4967
NOWCT	7.674	7.24	7.765	7.776	7.471

Accounts Receivable Turnover (ART) has dramatically decreased since 2010. This means they are collecting their receivables less now than they did in previous years.Inventory turnover (INVT) has stayed relatively stable the past five years. Long-Term Operating Assets Turnover (LTOAT) has also stayed stable and measures how often Chipotle collects on their long-term operating assets. Accounts Payable Turnover (APT) means that for 2014 they're paying off their accounts payable about eight times a year (365/46.5). The last component, Net Operating Working Capital Turnover (NOWCT), stayed close to seven all five years.

Non-Operating Return: FLEV and Spread



Spread multiplied by FLEV gives you RNOA. All three of these ratios together all make ROE. These can also make more accurate predictions of long-term future growth. The ratios listed in this chapter all affirm the product differentiation strategy that was discussed in future chapters. Chipotle’s NOA is increasing which exhibits them creating more ideas and assets

Ratio Limitations

Financial statements reflect what can be reliably measured. Some of the accounts are estimated (A/R minus Allowance for Doubtful Accounts) therefore some of the numbers may not be accurate until we find the correct value in the future. Management has a lot of leeway in over or underestimating many accounts. Some assets are also left out if they cannot be reliably measured like the value of the brand Food with Integrity. The costs that are expensed related to the assets mentioned above are also not included in the financial statements. Therefore, the ratios involving expenses may not be as accurate. Likewise, most accounts are recorded at historical cost and not fair market value and increases in the value are not recorded until realized.

Chapter 7: Accounting Quality

Macroeconomic Trends

Gross Domestic Product is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. GDP is equal to consumer and government spending, investments, and net exports (C + G + I + NX). If consumers spending increase (increasing GDP), we can assume more people are going out to eat and spending money at places like Chipotle (and same vice versa). This is a very general statement considering the number of factors that contribute to GDP. Since 2011, GDP has slightly increased. Assuming this trend continues, Chipotle should have increasing traffic

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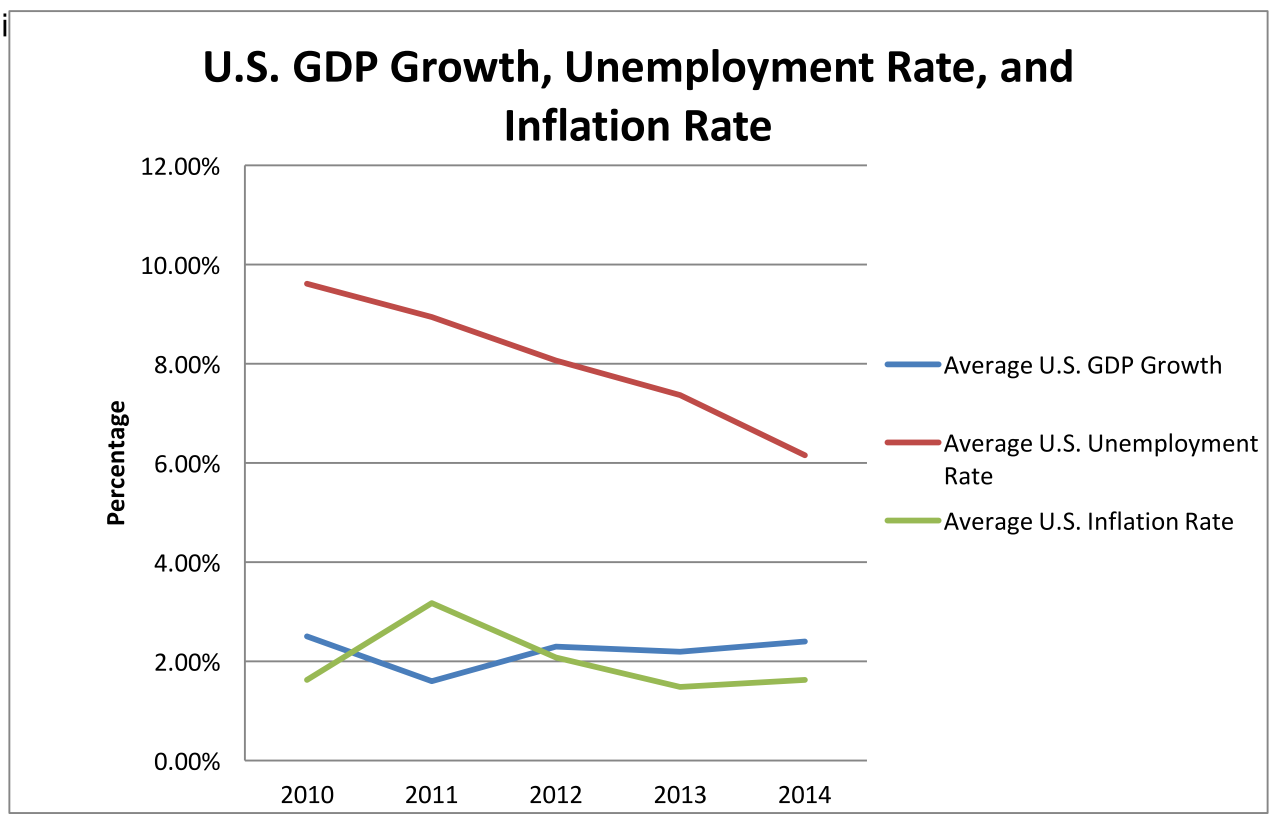
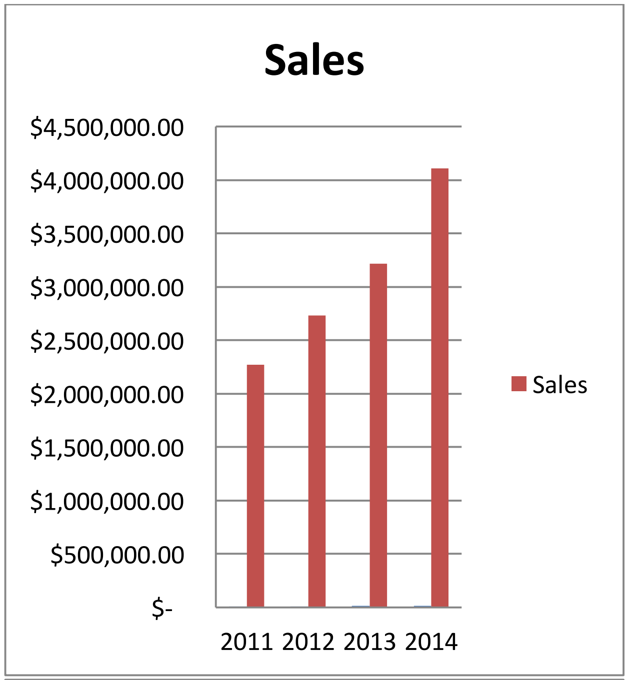


The unemployment rate has an inverse relationship with GDP. GDP measures how much a company is producing which requires labor. Therefore, if GDP is increasing, the unemployment rate should be decreasing. The higher the unemployment rate, the lower the amount that people spend. In the past five years the unemployment rate has been decreasing, so we can assume if the trend continues that people should continue spending more.

Another factor to keep in mind that relates to GDP is income. A simple way to describe the relationship is that if people are spending more, then firms will produce more. They then have to have more workers or people working more hours which leads to an increase in income for households. For that reason, if GDP increases, then income should also increase, allowing people to eat out more. This increases Chipotle's revenues.

As seen on the graph above, inflation rates affect GDP. Inflation is the rate at which the general level of prices for goods and services is rising and purchasing power is falling. It can be measured by the core Consumer Price Index (CPI), which is the standard measurement of inflation used in the U.S. financial markets. "The primary areas of our operations affected by inflation are food, healthcare costs, labor, fuel, utility costs, materials used in the construction of our restaurants, and insurance.”

Two last macroeconomic indicators are inventory levels and sales. Strong retail sales affect GDP positively because companies will have more money to hire more workers and be more productive. High inventory levels show that either the demand for inventory should be increasing in the future or that there is a current lack of demand.Seeing the graphs below, inventory and sales are both increasing at decent levels. Therefore, it can be determined that there is a demand for inventory to increase in the future which in turn is leading to higher sales.


Sales
$4,500,000.00
$4,000,000.00
$3,500,000.00
$3,000,000.00
$2,500,000.00
$2,000,000.00
$1,500,000.00
$1,000,000.00
$500,000.00
$-
2011 2012 2013 2014
Sales


Inventory
$18,000.00
$16,000.00
$14,000.00
$12,000.00
$10,000.00
$8,000.00
$6,000.00
$4,000.00
$2,000.00
$-
2011 2012 2013 2014
Inventory

Revenue Recognition

The current revenue recognition principle is to recognize revenue when it is realized or realizable and when it is earned. It is recognized for a sale of a product, for services rendered, or for letting others use an asset. There are different rules for recognition at delivery, before delivery, and after delivery. Revenue recognition is one of the most problematic areas facing the accounting profession and is the most prevalent reason for restatements. It is difficult to develop guidelines applicable to all situations. It's known as a top fraud risk and the risk of errors and inaccuracies are significant. For Chipotle, "revenue from restaurant sales is recognized when food and beverage products are sold." For the time being, this recognition is appropriate; however, it will change with the new recognition standard.

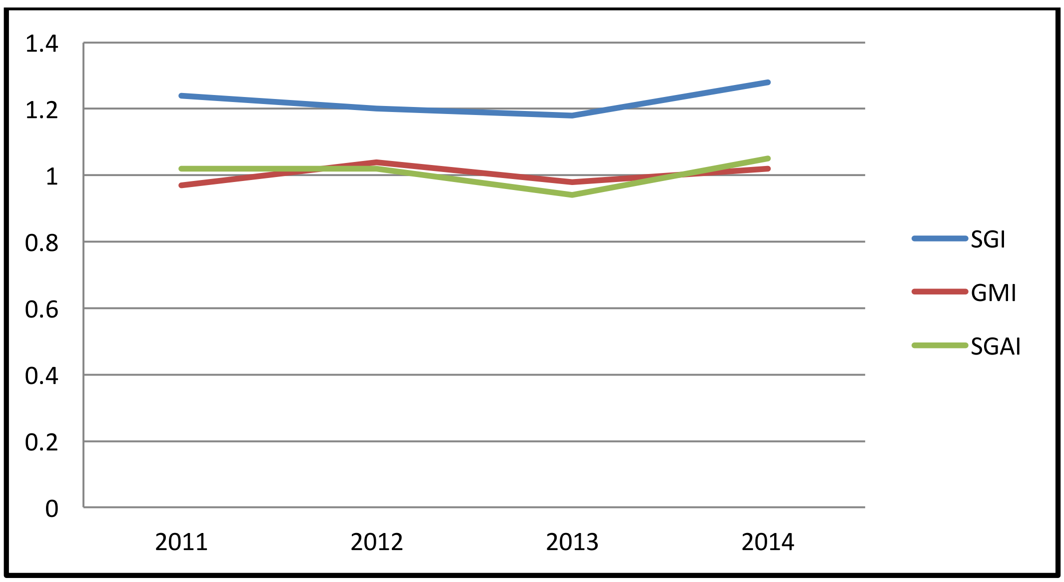
FASB and the IASB issued a converged standard in 2014 called "Revenue from Contracts with Customers" that becomes effective December 15, 2016. Under the new standard, companies under contract to provide goods or services to a customer will be required to follow a five-step process to recognize revenue:

1. Identify the contract with customers.
2. Identify the separate performance obligations in the contract.
3. Determine the contract price.
4. Allocate the transaction price to the separate performance obligations.
5. Recognize revenue when each performance obligation is satisfied.

Some ways that companies can skew their revenues to report higher earnings are channel stuffing, gross versus net, barter transactions, and bill and hold transactions. Channel stuffing is artificially inflating current sales and earnings by shipping more goods than would normally be ordered. The company sells more of its product to distributors than the distributors can sell to customers. This temporarily boosts the company's accounts receivables and makes them look healthier than they are in reality. Some companies report their gross revenue instead of net, which would be more appropriate. Reporting it at gross allows for it to be higher than it actually is.

Bartering is an exchange of goods or services that have equal value; cash may or may not be added to the exchange to even out the trade. The Ormita Commerce Network estimates that approximately 70 percent of all Fortune 500 companies barter on a regular basis, totaling billions in official non-cash exchanges each year. The Internal Revenue Service has ruled that companies and individuals must include the fair market value of all received goods and services exchanged for all provided goods and services. The way that some companies can inflate their revenue is by trading these assets with another company back and forth but never actually selling assets to customers. They trade back and forth and keep accumulating revenue. A bill and hold transaction is one in which the seller does not ship goods to the buyer, but still records the related revenue. This does not align with the revenue recognition principle as cost of goods sold is not recognized, yet sales is.

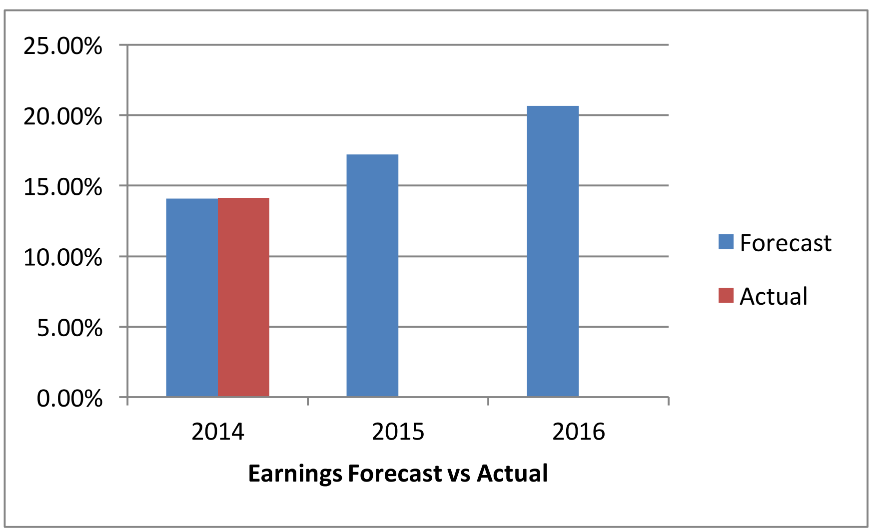
There are some ratios that serve as red flag indicators. The sales growth index shows how fast sales figures are increasing. The gross margin index is measured as the ratio of gross margin versus prior year. The sales, general and administrative expense index is the ratio of SG&A expenses compared to the prior year.



For SGI, rapidly increasing sales could reflect manipulation of revenue recognition and cash accruals. As you can see in the graph above, SGI does have an increase between 2013 and 2014 but it is slight. Moving forward, we may want to keep an eye on it if it increases dramatically. When GMI is greater than one, the company's gross margins have deteriorated. Gross margin deterioration is a negative signal about firms' prospects and firms with poorer prospects have been shown to be more likely to engage in earnings manipulation. In 2012 and 2014, GMI was slightly greater than one. These are probably yellow flags and we should keep an eye on these numbers also. SGAI is more than one for all four years. These could be overstated revenues.

Earnings Targets

Based on 247wallst.com, for the full year, the company reported EPS of $14.13 on revenues of $4.11 billion, compared with EPS of $10.47 and revenues of $3.21 billion in the 2013 fourth quarter. Analysts were looking for EPS of $14.07 on revenues of $4.11 billion so Chipotle barely beat the analysts' forecasts.



According to finance.yahoo.com, the goal for this year is $17.22 and the goal for next year is $20.64. If analysts keep forecasting higher EPS each year, Chipotle managers may feel the pressure to keep meeting those needs by using earnings management.

Earnings Management

According to Investopedia, earnings management is “the use of accounting techniques to produce financial reports that may paint an overly positive picture of a company's business activities and financial position.” Sometimes management feels pressure to manipulate their earnings to satisfy expectations.

Some managers at Chipotle may feel the need to increase their earnings to show a healthy and strong restaurant, which in turn could result in a bonus. “Our best general managers, who run great restaurants and develop strong, empowered restaurant teams, are promoted to Restaurateur and in that role can earn bonuses for developing people.” To increase their earnings, managers could offer incentives to customers to accelerate sales. Any account that deals with estimates could also be manipulated. To calculate depreciation, you must estimate useful lives and salvage values. To calculate net accounts receivable, you have to estimate what amount you will be collecting and what amount you must write off. Managers can use optimistic estimates to decrease these accounts and increase their earnings.

Other managers might want to decrease their earnings. If future earnings are forecasted to be poor but current earnings are good, they'll want to decrease now so they can increase them in the future. They want to have a smooth earnings profile. Managers can also manipulate their estimates to shift earnings downward. Big Bath in accounting is an earnings management technique whereby a one-time charge is taken against income in order to reduce assets, which results in lower expenses in the future. The write-off removes or reduces the asset from the financial books and results in lower net income for that year. The objective is to 'take one big bath' in a single year so future years will show increased net income. "Cookie jar accounting" is used by a company to smooth out volatility in its financial results, thus giving investors the misleading impression that it is consistently meeting earnings targets. One time charges can be considered cookie jar accounting since you are putting money into reserve to save for future years when earnings are low. Estimates can also be used to decrease earnings just like stated above except instead of having optimistic estimates, you underestimate.

Chapter 8: Equity Valuation

Operating Leases

Leases are contracts between the owner of the asset, known as the lessor, and the party desiring to use the asset, known as the lessee. The lessee is allowed to use the asset during the lease term and agrees to make periodic payments to the lessor. The title to the asset remains with the lessor who will take back the asset when the lease is finished.

There are two different approaches for identifying leases with GAAP. First is the capital lease method where both the asset and liability are reported on the balance sheet. The operating method is where neither the asset nor liability is reported on the balance sheet. Chipotle does not show any capital leases in their 10-K, but they do report operating leases. This means there are not any lease assets or liabilities reported on the balance sheet for Chipotle.

Because Chipotle only has operating leases which are not shown on the balance sheet, their net operating asset turnover (NOAT) is higher and their financial leverage is improved since they don't show the liability. The portion of ROE that comes from operating activities seems higher which improves the company's ROE. Furthermore, rent expense reported for the lease is less than for capital leases which means net income would be higher in the earlier years. Plus, the more operating leases they add in the future, the more those profits will continue to remain higher.

We want to capitalize the operating leases to analytically see how our ratios will change. First, we want to find the present value of our future operating lease payments. These were found in the most recent 10-K.We use the prime lending rate (3.25 percent) as our discount factor. Normally, a company would impute their own discount factor using the capital and operating lease section, but Chipotle cannot use this method. The prime lending rate was also chosen over LIBOR because the duration of LIBOR was not long enough for our use.

Thereafter: $1,996,859/$211,833= 9.426571875 more years

Five years we are using plus the thereafter (ten) equals fifteen years total.

Present Value of Operating Lease Payments:

Years	Operating Lease Payment	Discount Factor .0325	Present Value
1	$206,413	0.968523002	$199,916
2	208,326	0.938036806	195,417
3	209,012	0.908510224	189,890
4	211,754	0.87991305	186,325
5	211,833	0.852216029	180,527
Thereafter	$211,833	7.17770009	1,520,474
			$2,472,549

The discount factors for years one through five were calculated with the present value of a single sum equation and the discount factor for thereafter was calculated with the present value of an ordinary annuity equation.

Now, we adjust the financial statements with our new capitalized rate. We add $2,472,549 to NOA and NNO to represent the lease asset and lease obligation. Our new NOA for 2014 would be $3,456,169 (983,620+2,472,549). Our new NNO for 2014 would be $1,437,800 (-1,034,749+2,472,549).

For our NOPAT adjustment (net operating profit after tax), we want to deduct the operating lease payment from operating expense. Originally, we calculated NOPAT for 2014 in Chapter 6:

Net Operating Profit Before Tax (NOPBT) - 2014				710,800	
Less Tax on Operating Profit					
Tax Expense			268,929		
Tax Shield			(714,303x37.6	-537,507.00	
Net Operating Profit After Tax (NOPAT)				173,293	

We would subtract the operating lease payment of $206,413 from the NOPBT but then add depreciation expense of $247,555 (straight-line depreciation with ten years= 2,472,549/10).

Our new NOPAT:

NOPBT				751,942	
Less Tax on Operating Profit					
Tax Expense			268,929		
Tax Shield			268,578	-537,597	
NOPAT				214,345	

To adjust Chipotle's non-operating expense, we would add back interest expense of $2,472,549 x 3.25 percent = $80,358. Chipotle's non-operating expense was originally $3,503 so the new non-operating expense is $83,861.

Now we can recompute the RNOA, NOPM, NOAT, and FLEV ratios to include the operating lease adjustments:

RNOA=	NOPAT	214,345	0.0998	**9.98%**		
	Average NOA	(3,456,169+ 838,990)/2				

Operating return (RNOA) was originally 18.95 percent. Adding back the operating lease adjustments brought RNOA down by half. They are not generating as much return on their operating expenses as we initially thought.

NOPM=	NOPAT	214,345	0.0522	**5.21%**		
	Sales	4,108,269				

The net operating profit margin (NOPM) was 4.22 percent before the operating lease adjustments. With the adjustment, it increased almost one percent. We want this to be a higher number because it represents the operating profit Chipotle earns from every dollar of sales.

NOAT=	Sales	4,108,269	**1.913**		
	Average NOA	2,147,580			

The net operating asset turnover (NOAT) decreased when we included the operating lease adjustments. It was initially 4.508. This number shows how much the company realizes in sales from each dollar invested in the operating assets. A decrease in the number is not a good change.

FLEV =	Average NNO	369,251	**0.208**		
	Average Equity	1,775,329			

FLEV was initially 0.3212 so this is a slight decrease from our first calculation.

Generally, companies prefer to structure lease contracts as operating rather than capital. Because the lease does not have to be recorded as a liability, companies can have large obligations that are not represented on traditional financial statements. “Since the company's asset base is reported lower the immediate benefit would be a higher ROA than it would display had it classified the lease as a capital lease requiring ahigher asset base. It will also allow a company to display better solvency ratios such as debt-to-equity.”

Weighted-Average Cost of Capital

To calculate the Cost of Equity, we use the following equation.

r(e)= r(f) + β [r(m) – r(f)]

- We found β on finance.yahoo.com:
  β=0.57

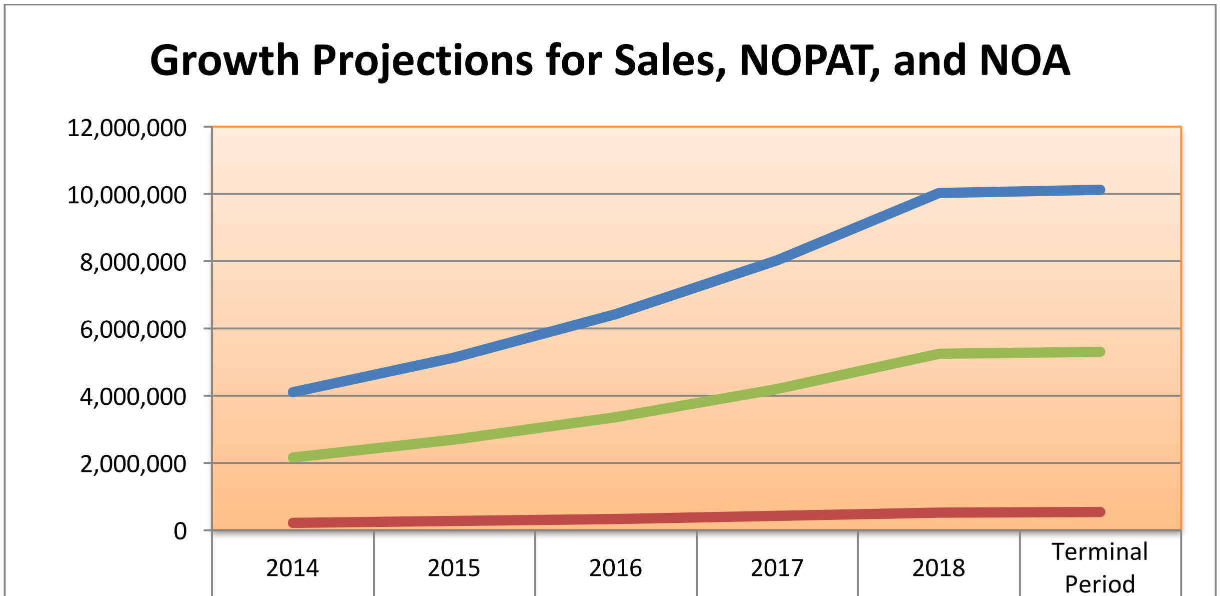
- We assume the market rates are:
  Risk Free Rate= 2.5 percent
  Equity Spread= 6 percent

  =2.5 percent + (0.57) (6 percent)
  =5.92 percent

After calculating cost of equity, you would also calculate the cost of debt. Both of these costs equal weighted-average cost of capital. Chipotle has no debt, however, so the cost of equity is used as the weighted-average cost of capital number.

Growth Projections

The sales growth rate in 2014 was 28 percent. This was a sharp increase from the growth a rate of 17 percent the year before. Because of this, I did not think projecting the growth rate for future periods above 28 percent would be an accurate forecast. Based on how fast this market is growing and that people are becoming more aware of where their food is coming from, Chipotle could still grow at a 25 percent average. Using this percentage, we calculated sales for the next four years and using those numbers, also calculated net operating profit after tax (NOPAT) and net operating assets (NOA). The forecasted sales, NOPAT, and NOA will be used later on to find ROPI in the stock valuation section of this chapter. As you can see in this graph, sales, NOPAT, and NOA are all increasing over the next four years and then level off for the terminal period.



	2014	2015	2016	2017	2018	Terminal Period
Sales	4,108,269	5,135,336	6,419,170	8,023,963	10,029,954	10,130,264
NOPAT	214,041	267,551	334,439	418,048	522,561	527,788
NOA	2,150,926	2,688,658	3,360,822	4,201,028	5,251,285	5,303,803

Stock Value

The discounted cash flow (DCF) model is a valuation method used to estimate the attractiveness of an investment opportunity. Discounted cash flow analysis uses future free cash flow projections and discounts them using WACC to arrive at a present value, which is used to evaluate the potential for investment. The advantages to using DCF is that its cash flows are unaffected by accrual accounting, the FCFF is intuitive, and it is a popular and widely accepted model.

Operating Cash Flows + Investing Cash Flows

:,067 + (-$518,844)

223

Sales Growth and FCFF Projection:

	Reported	Forecasted				Terminal
	2014	2015	2016	2017	2018	Period
(in thousands)						
Sales Growth	28%	25%	25%	25%	25%	1.00%

Discounted Cash Flow Model:		1	2	3	4	
FCFF	163,223	204,029	255,036	318,795	398,494	402,479

(192,626+227,324+268,273+316,599)

FCFF	163,223	204,029	255,036	318,795	398,494	402,479
Discount Factor		0.944109	0.891341	0.841523	0.794489	
PV of Horizon FCFF		192,626	227,324	268,273	316,599	
Cum. PV of horizon FCFF	1,004,812					
PV of terminal FCFF	8,180,467					
Total firm value	9,185,279					
Less NNO	-1,437,800					
Firm equity value	7,747,479					
Shares outstanding	31,038					
Stock value per share	$ 249.61					
Trading price at 4/18/15	$ 683.95					

Based on the stock value we found and the actual trading price, the price is selling for today is much higher than what we value it to be. Prices should generally start to decline based on this assumption.

The residual operating income valuation model (ROPI) estimates firm value equal to the current book value of net operating assets plus the present value of expected ROPI. It focuses on value drivers like profit margins and assets turnovers. Some other advantages are that it uses the balance sheet and income statement and that it reduces the weight placed on the terminal period value.

ROPI= NOPAT – (rw X Net Operating Assets)

- NOPAT = net operating profit after tax
- Rw = weighted average cost of capital (WACC)
- NOA= net operating assets

Sales, NOPAT, NOA, and ROPI Projections:

	Reported		**Forecasted**			**Terminal**
	2014	2015	2016	2017	2018	**Period**
(in thousands)						
Sales Growth	28%	25%	25%	25%	25%	1.00%
NOPM	5.21%					
NOAT	1.91					
Sales	4,108,269	5,135,336	6,419,170	8,023,963	10,029,954	10,130,264
NOPAT	214,041	267,551	334,439	418,048	522,561	527,788
NOA	2,150,926	2,688,658	3,360,822	4,201,028	5,251,285	5,303,803

Residual Income Model:	1	2	3	4	
Required Return	127,335	159,169	198,961	248,701	310,876
ROPI	140,216	175,270	219,087	273,860	216,912

Discounted ROPI:						
		1	2	3	4	
ROPI		140,216	175,270	219,087	273,860	216,912
Discount Factor		0.944109	0.891341	0.841523	0.794489	
PV of Horizon ROPI		132,379	156,225	184,367	217,579	
Cum. PV of Horizon ROPI	690,550					
PV of terminal ROPI	4,408,780					
Total Firm Value	5,099,330					
Less NNO	-1,437,800					
Firm Equity Value	3,661,530					
Shares Outstanding	31,038					
Stock Value Per Share	$ 117.97					
Trading Price at 2/5/2015	$ 671.00					

Based on this stock value that we found, compared to the actual trading price, we expect the stock price to decline. You would want to wait to purchase since it'll be cheaper or not purchase at all.

Chapter 9: Developing Audit and Tax Recommendations

xistence and Occurrence

Management's Assertions

Management assertions are the assertions by management about the accuracy of the financial statement components. Assertions assist auditors in considering a wide range of issues that are relevant to the authenticity of financial statements. The consideration of management assertions during the various stages of audit helps to reduce the audit risk. There are five management assertions: existence and occurrence, completeness, rights and obligations, valuation, and presentation and disclosure.

Existence is the measure of assuring all of the assets and liabilities shown on the balance sheet exist at the balance sheet date. Occurrence is the measure of assuring that all of the transactions reflected in the financial statements occurred during the period. Management has to assert that nothing is overstated or that nothing extraneous has been recorded to inflate any of the account balances.

ghts and Obligations
sentation and Disclosure
aluation

All of the transactions and balances that should be presented in the financial statements are included in them and no events have been overlooked. Some items could be understated to make the company look better.

The third assertion is that all the assets and liabilities reported represent the rights and obligations of the business. Liabilities are also obligations of Chipotle and not the personal obligations of any of the officers.

Valuation or allocation pertains to the rational allocation of costs over time. This section is the analysis of complex transactions to determine the responsibilities and the value of rather rights or obligations.

The final management assertion is presentation and disclosure. This is the measurement that all transactions and balances have been properly classified, that all necessary parenthetical notations appear on the financial statements, and that the footnote disclosures are appropriate and adequate.

	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure
Cash and Cash Equivalents	Make sure that the cash amount actually exists and is correct at the end of the period.	Find that all the cash transactions are included have taken place in the period of collection and that the correct cash equivalents are included.	Chipotle has the ownership and right of this cash except for any that would be considered restricted.	That it is recorded at its fair value.	To make sure to disclose if there is any restricted cash.
Accounts Receivable	Determine that accounts receivable is not inflated and that the transaction and receivables were recorded at the right time.	Make sure that they're all accounted for correctly and in the period that the sale occurred or that cash was collected.	Chipotle has the ownership of all the accounts receivable and future benefits.	Allowance for doubtful accounts should be estimated as accurately as possible for net accounts receivable to reflect the most correct amount.	Find that all appropriate accounts have been disclosed if needed.
Inventory	Determine that the entire inventory is actually there and that the balance isn't inflated.	Should include all inventory transactions that occurred that year.	Chipotle has the ownership of their entire inventory until it is sold.	The inventory is properly valued at the lower of FIFO or market cost.	The valuation method and any changes in it should be disclosed.
Current Deferred Taxes	See that these are all actual current deferred taxes reported	All the current deferred taxes are included for this period.	All of the current deferred taxes belong to Chipotle.	Find no mistakes were made in calculating current and long-term and make sure correct tax rates were used.	Any carrybacks/ carryforwards should be disclosed along with their valuation info and if any deferred tax assets were or weren't realized.
Prepaid Expenses	That all prepaid expenses actually exist, were	That all the prepaid expenses for this	Chipotle has rights to all of the prepaid	Know the unexpired portion.	They have been properly classified and disclosed

	recorded correctly, and are not inflated.	period are included and recognized.	expenses.		in the financial statement.
Investments	That all the investments are real and the balance is not overstated.	All transactions for the period should be included.	All of the investments belong to Chipotle.	To make sure that it is properly recorded at fair value.	Make sure any restrictions have been disclosed.
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure
Leasehold Improvements	That these leasehold improvements exist and are not overstated.	All of the transactions from this period are included.	Chipotle has the right to use the leasehold assets.	They are recorded at cost. All depreciation accounts should be recorded using the straight-line method.	The changes in estimated useful lives and any other important accounts should be disclosed.
Long-term Investments	The long-term investments are long term and not current.	That the long-term investments from this period are included.	Chipotle has ownership of their long-term investments.	Make sure they are properly recorded at fair value.	Any restrictions should be disclosed.
Other Assets	This account is mostly restricted cash and the correct amount needs to be determined.	That all the other assets are included from this period.	Chipotle has ownership of all their other assets.	Make sure they are properly measured at lower of cost or market.	All other assets should be disclosed in the footnotes.
Goodwill	That the amount of goodwill that exists is accurate and not inflated.	That all of the goodwill from this period is included.	Chipotle has the rights to all of the goodwill.	Should be recorded at proper amount. Impairment should be measured properly at excess of carrying over fair market value.	Should disclose any impairment to goodwill.
Accounts Payable	That all accounts payable transactions were	The accounts payable account	All of the accounts payable are Chipotle's	Make sure it's measured at	All of the accounts payable should be

	recorded correctly and that the number at the year-end is correct.	includes all transaction from this period.	obligation.	itsproper fair value.	properly classified and disclosed.
Accrued Payroll and Benefits	That the payroll and benefits are recorded correctly.	That the payroll and benefits total includes all of this period's transactions.	The entire accrued payroll and benefits account is Chipotle's obligation.	Determine that accrued payroll and benefits was measured at its proper value.	Make sure it is classified correctly and disclosed.
Accrued Liabilities	That all the accrued liabilities are correctly accounted for and are not understated.	All of the accrued liabilities from this period are included.	All of the accrued liabilities are Chipotle's obligation.	Make sure accrued liabilities were measured at its proper value.	Accrued liabilities should be classified properly and disclosed.
	Existence or Occurrence	Completeness	Rights and Obligations	Valuation or Allocation	Presentation and Disclosure
Current Deemed Landlord Financing	That the financing account is in fact current and does not include any long-term financing.	That all of the current financing are included from this period.	The entire current landlord financing is considered Chipotle's obligation.	The financing should be recorded at its proper value.	The current portion of the landlord financing should be disclosed and all accounts affecting it.
Income Tax Payable	That the income taxes were recorded correctly and not understated.	That all the income taxes payable from this period are included in the balance.	Chipotle has the entire income tax payable account as an obligation.	The income tax payable needs to be measured correctly at its proper value.	Income tax payable should be classified and disclosed.
Deferred Rent	That the deferred rent is the correct amount. Should not be understated.	That the deferred rent from this period is included.	The deferred rent is part of their obligation.	Make sure the deferred rent is recorded at its value.	All of the deferred rent needs to be properly classified and disclosed.

Long-term Deemed Landlord Financing	That this financing is long-term and does not include any current financing.	That the long-term deemed financing from this period is updated and included.	All of the deemed landlord financing is part of Chipotle’s obligation.	The financing should be recorded at its proper value.	The long-term portion of the landlord financing needs to be disclosed.
Deferred Income Tax Liability	That the income tax liability is correctly recorded and is not understated.	That all the income tax liability is included from this current period.	All of the deferred income tax liability is Chipotle’s obligation.	The income tax liability should be recorded at its proper value.	The deferred income tax liability and all accounts affecting it should be disclosed.
Other Liabilities	That any liabilities not belonging to another account is correctly recorded here and is not understated.	That all other liabilities from this current period is recorded.	All other liabilities is considered part of Chipotle’s obligation.	Make sure all other liabilities are properly recorded at the correct value.	All accounts included in other liabilities should be disclosed.

ash and Cash Equivalents

Audit Risks

There are two accounts that could be considered audit risks: cash and payroll.

Almost all of Chipotle's sales come through cash and cash equivalents. Most of their day-to-day interactions with customers deal with the transfer of cash and credit/debit card sales, and because the operations do not require significant receivables, nor do they require significant inventories due the use of fresh ingredients, the amount of cash could be a significant audit risk. Their primary use of cash is in new restaurant development. The total capital expenditures for 2014 were $252.6 million, which included the purchase of a corporate aircraft for a total cost of approximately $24 million; the majority of that amount was paid during 2014. They also are not required to pay any dividends and have not declared or paid any cash dividends on common stock. "We intend to continue to retain earnings for use in the operation and expansion of our business."Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and investments. Approximately one third of the Company's cash and investment balances are held at six financial institutions and are not federally backed or federally insured." Foreign currency translations could affect this account also and the fair value changes often.

As an auditor you would want to test the cash balance in some different ways. We can confirm all the cash is there physically by asking the bank directly to verify the balance and also by testing the translation of the foreign currency. The book cash balance could have some differences with the bank cash balance so a bank reconciliation would help explain those differences and restricted cash would also need to be evaluated to make sure it is classified correctly.

In October 2014, a lawsuit was filed in Colorado and Minnesota against Chipotle claiming that they were not paying employees for hours that they worked.The workers filed written statements describing how the restaurant's time keeping system would automatically punch them out at 12:30 a.m., even though they had to stay later to finish cleaning up. With this information being released, the accrued payroll could be seen as an audit risk. An auditor could check the timekeeping technology and the payroll directly to make sure they are being used correctly. “You could compare direct labor as a percentage of sales with previous years.”

Both: Review records monthly for accuracy

Payroll: Get approval for changes
eeping, review attendance records
racy, and reconcile ledgers monthly

Anyone that does not need access to the asset or account should not have it and no one should have access to all of them.

Cash: Give receipts to each customer; give each cashier a separate cash drawer, keep funds secure, and record cash receipts

Internal Controls

There are some different types of internal controls that could provide comfort to the external auditors when dealing with these audit risks:

- Authorization of activities
- Maintenance of adequate accounting records
- Limited access to assets

Both: To ensure the reliability of accounting information and the efficiency of operations, an employee's duties should be verified by others who did not do the work themselves.

Payroll: Have different people prepare and update payroll, approve payroll, review payroll expense, and distribute payroll

Cash: Have different people receive and deposit cash, distribute payroll, record cash payments to receivables, etc.

❖ Independent verification

❖ Segregation of duties.

Chipotle mentions their internal control in their most recent 10-K. "our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of assets that could have a material effect on our financial statements." Ernst and Young (Chipotle's auditor) said, "In our opinion, Chipotle Mexican Grill, Inc.

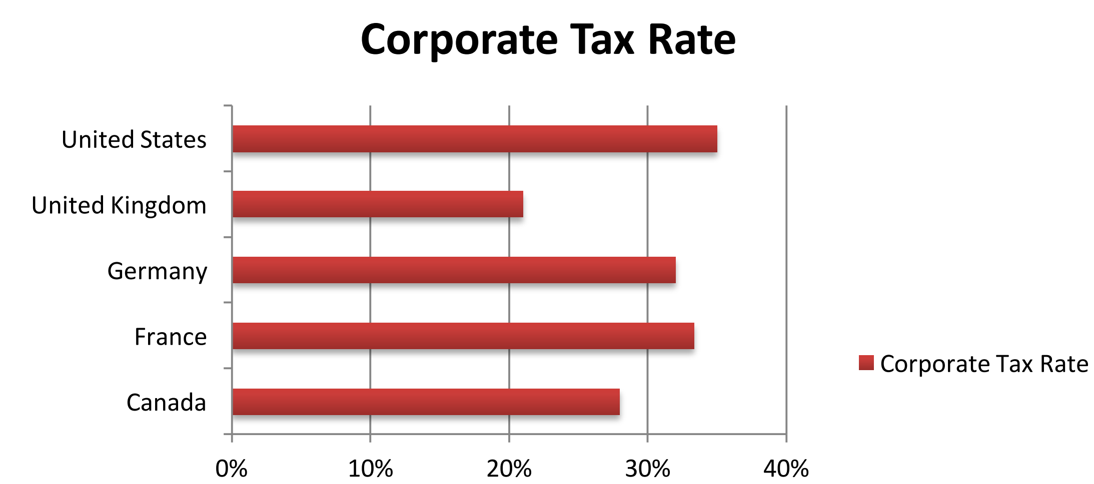
maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the COSO criteria."

External Pressures

As mentioned in chapter seven, many managers can feel pressure to meet certain their earnings targets. With the wages lawsuit in Minnesota and Colorado, employees claimed it was part of an unwritten policy to save money on payroll budgets and that store managers felt pressure to make workers stay late. This led to a fault in the internal controls and they were not paying employees for time that they were working. Managers can also manipulate accounts that deal with estimates to increase or decrease their earnings.

Corporate Tax Rates and the Federal Statutory Tax Rate

Chipotle operates in five different countries.



	Canada	France	Germany	United Kingdom	United States
Corporate Tax Rate	28%	33.33%	32%	21%	35%

The federal statutory rate for the United States is 35 percent, however the rates in every other country tend to be a little lower than the United States.

Tax Credits

Tax credits are economic development subsidies that reduce a company's taxes by allowing it to deduct all or part of certain expenses from its income tax bill on a dollar for dollar basis. In January 2013, the United States Congress authorized, and the President signed into law, certain federal tax credits that were reflected in the Company's U.S. tax return for 2012, however since this law was enacted in 2013, the financial statement benefit of such credits were reflected in 2013. The lack of availability of such credits caused the 2012 effective tax rate to be approximately 0.7 percent higher than it would have been had the credits been approved in 2012. Recognizing the 2012 credits during 2013 benefited the 2013 rate by 0.6 percent. The 2013 effective tax rate decreased by 0.6 percent from 2012 due to certain federal tax credits that were extended in 2013, for both 2013 and 2012, which benefited the rate by 1.1 percent. This decrease was partially offset by non-recurring adjustments related to state income taxes. Chipotle estimates the 2015 annual effective tax rate will be 39.0 percent, increasing from 2014 due to the expiration of certain federal tax credits.

Chipotle could be taking advantage of the Work Opportunity Tax Credit (WOTC). This is a Federal tax credit available to employers for hiring individuals from certain target groups who have consistently faced significant barriers to employment. WOTC joins other workforce programs that incentivize workplace diversity and facilitate access to good jobs for American workers.

There is also the Empowerment Zone Tax Credit. This is an incentive to businesses that are located in an empowerment zone to hire and retain employees who also live there. Empowerment Zones are distressed urban and rural areas nationwide that are in need of revitalization. This initiative brings communities together through public and private partnerships to create the investment necessary for economic development.Both full time and part time employees may qualify, as long as they work at least 90 days during the year in which the credit is claimed. The credit amount is 20 percent of the first $15,000 of wages paid to the employee. The credit is renewable each year, and both newly hired and current employees are eligible.

Tax Recommendation

I recommend that Chipotle continue expanding their restaurants globally to stay competitive. The tax rates are less overseas than they are in the United States so this could be a way for them to save more money. They could move their headquarters somewhere in the United Kingdom which would lower their tax rates and hopefully decrease their currency translation costs.

As they expand overseas, Chipotle needs to establish some long-term contracts with suppliers so that they have an established and consistent food supply. They don’t want to open a store and immediately have to pull pork when they are starting to gain customers. I also suggest that they keep a close eye on how people react to their Food with Integrity campaign. Since this is a whole new market, they aren’t sure how it will resonate with customers there.

ınovation and Learning

Chapter 10: Developing Advisory Recommendations

Balanced Scorecard

The balanced scorecard is “a strategic planning and management system that is used extensively in business and industry, government, and nonprofit organizations worldwide to align business activities to the vision and strategy of the organization, improve internal and external communications, and monitor organization performance against strategic goals.” It is used as a performance measurement framework that added strategic non-financial performance measures to traditional financial metrics to give managers and executives a more 'balanced' view of organizational performance. “Balanced’ measures includes innovation and learning, internal processes, customer satisfaction, and then financials.

The innovation and learning section of the balanced scorecard calls upon improving to achieve superior operations that create value for the customers and shareholders. These are things like new products, marketing and sales promotions, amount spent on employee training, employee satisfaction, etc. Chipotle is known for keeping the same menu for simplicity but that does not ternal Processes mean there is no innovation. As stated in chapters one and two, Chipotle spends little on their marketing, but has had extremely effective campaigns. Food with Integrity is the main idea they are working off of. They've created their Cultivate music and food festival to get the word out about farming and food plus they've recently created a mini-series called Farmed and Dangerous to teach people. The Scarecrow videos were first released online before going viral and hitting television stations. Chipotle's marketing team has done what no other restaurant chain has been able to do and must continue to think creatively to market not only Chipotle but their Food with Integrity values as well.

Steve Ells has talked about the pride they take in their employees; however, some issues have come up in this topic. The lawsuit mentioned in previous chapters affects employee satisfaction. Chipotle is being accused of forcing employees to work overtime hours without pay. There was also the hiring of illegal workers that was discovered in 2010.

The internal process section focuses on the internal operations that provide value for customers. Some examples include production ratios, spoilage, defects, employee turnover, number of suppliers, variance analysis, etc. Chipotle has few suppliers. This has been an issue recently with one of their major pork suppliers failing to meet their Food with Integrity values. In January 2015, Chipotle had to pull pork from over 500 locations which hurt their sales and ultimately their stock value. When it comes to spoilage, Chipotle estimates how much food they'll need each day before prepping the food that morning. Any leftovers go to feeding the homeless.

This section identifies and measures the company's success in the targeted customer market segments. The time between the customer's order and when they receive it affects this section. Chipotle tends to be quick between the time customers order and the time they receive their food because it's made right in front of them.

Unless there's a long line, it shouldn't take longer than five minutes. Due to food shortages, Chipotle has also had to increase menu prices, however this did not seem to affect the number of customers that come through. This proves they have loyal customers that continue to return.

The financial section focuses on the profitability of their strategy which creates value for shareholders. Examples include cash flows, RNOA, ROPI, sales growth, net income, etc. These ratios were computed in Chapter 6.

Recommendations

Recommendation One

Rising costs of food and losing a major pork supplier lead to price increases. Chipotle doesn’t want to raise them anymore because they still want to be affordable. Chipotle CFO John Hartung stated on the company's earnings call that food inflation averaged 7.5 percent in 2014. By contrast, the menu price increase averaged 6.3 percent, and since it was not implemented until the spring, the full-year impact on pricing was only 3.8 percent. These high standards place the company in a bind when suitable suppliers are scarce. Last year, Chipotle only found naturally raised beef for 80 to 85 percent of its sourcing needs, compared to 100 percent in the year prior.If beef supplies continue to plunge, Chipotle's supply chain could take a hit. If Chipotle sacrifices quality, though, its brand -- and consequently, its stock -- could, too. However, Chipotle’s biggest expense is food, beverage, and packaging.

“We have almost no long-term contracts with suppliers, and we have relied largely on a third party distribution network with a limited number of distribution partners. If any of our distributors or suppliers performs inadequately, or our distribution or supply relationships are disrupted for any reason, the risk of ingredient shortages may increase and our business, financial condition, results of operations or cash flows could be adversely affected. We currently depend on a limited number of suppliers for some of our key ingredients, including beef, pork, chicken, tofu, beans, rice, sour cream, cheese, and tortillas." I recommend that Chipotle not only start looking for long-term contracts, but look at controlling their own farms to decrease the chances of this happening again. Chipotle had to pull pork out of almost five hundred locations (one-third of their stores). On April 22, 2015, their stock dropped almost ten percent alone. Steve Ells said that if the farms have the demand from Chipotle then they should be able to have the money to create the supply. With no long-term contracts, this puts menu items at risk. If there is not an adequate number of farms, Chipotle could start a whole entire new segment based around farming practices. They could open their own, not only to supply the restaurants, but to also show other farms how to operate and sustain business.

This would add a new segment to their business and increase their assets exponentially increasing NOA and RNOA. I think this would also have an effect on stock price making it more stable. As stated before, their stock price decreased greatly with the pork scenario so producing their own should help that. Weather could affect the efficiency at times but no more than it already does now.

Recommendation Two

One theme throughout the Chipotle brand is simplicity. They have a simple menu with the same items they started with in 1993 (give or take one or two items). The interior design is minimalistic with its wooden tables and pipe chairs. As of April 2015, Chipotle has about three different types of apps available in the app store:

1. To find locations/see menu items/order food.
2. The "Scarecrow" game
3. The Chipotle Nutrition Calculator

I recommend combining all of these into one app to make it easier and simpler for customers. Generally, people do not like downloading multiple apps for one service. I also recommend incorporating a rewards program through the app. There could be a spot in the menu for a scanner, so that when you order or purchase food at a Chipotle restaurant, you can open the app and let the cashier scan your phone for added points. These points could add up to a meal or for free merchandise. This would be an incentive for customers to return and can be a reward for the loyal customers.

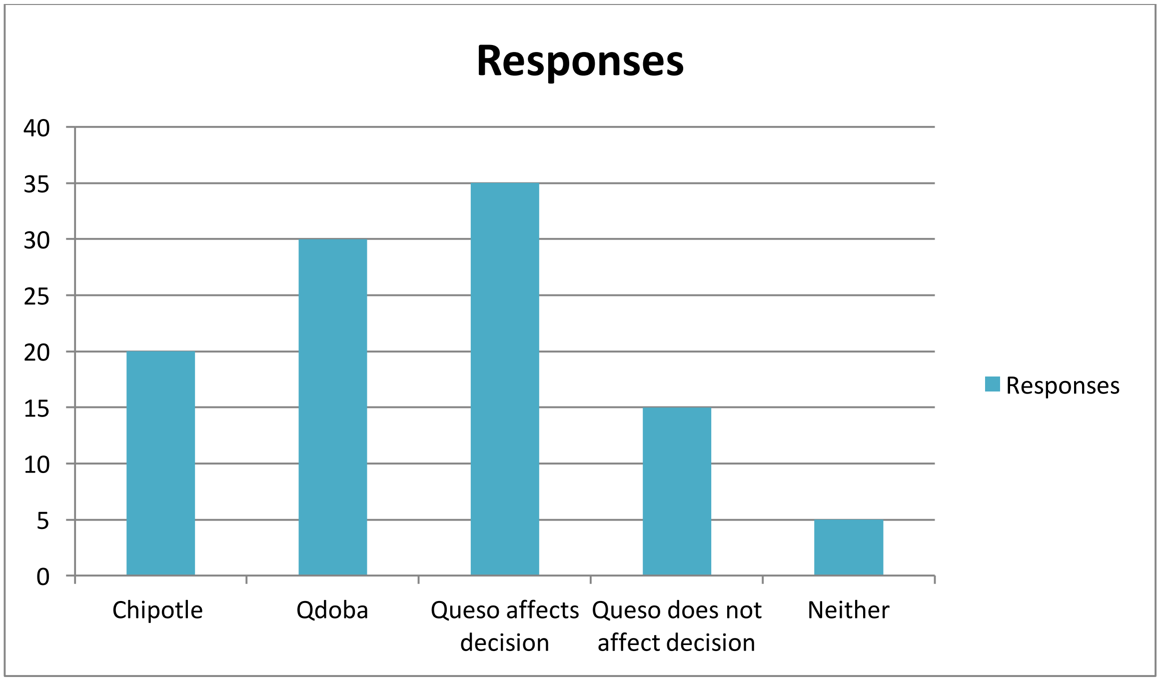
Recommendation Three

A question that Chipotle employees face every day is, "Do you have queso?" As of 2015, Chipotle does not have queso as a menu item. This is questionable to people because queso is seen as a typical food item when going to eat Mexican. One of the main problems Chipotle has now is losing customers due to rising menu costs because of the shortage of suppliers. Chipotle could get those customers back plus gain new customers as well by adding queso to their menu.

How is queso made?Chipotle Mexican Grille representatives themselves say, "in order to keep cheese at a semi-liquid state for queso dip, you need to add chemical stabilizers that prevent it from becoming too runny and also prevent it from becoming too thick. Many places also kick in artificial flavors to make it look like real cheese too." Stabilizers, color additives, and preservatives are the complete opposite of Chipotle's commitment to serving Food with Integrity.Steve created a Chipotle queso featuring an artisan blend of Mexican cheeses and let it loose on a blind taste testing focus group. The focus group was asked to sample two types of queso, one was Steve's recipe and the other was melted Velveeta cheese. Everyone in the focus group voted for the Velveeta.

I recommend Chipotle continue testing to find a tasty, healthy queso dip. A recent survey on college students, ages 18-22, shows that adding queso would have a positive effect on Chipotle's revenue. They were asked two questions:

1. If your options were Qdoba or Chipotle, which would you choose?
2. If Chipotle added queso dip to their menu, would that affect your decision?



Right now, Chipotle is in the mature stage of the life cycle. Adding queso could bring them back to the growth stage and it would bring in new customers, therefore increasing sales.

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