Papa John’s
International, Inc.

Risk Assessment


Meredith Cinciripino
Shaquan Abney
Tomi Ogunmoyin
Tom Orr

2015
Memorandum

To: Dane Christensen, Director of Auditing

From: MTTS, LLP (Meredith Cinciripino, Tomi Ogunmoyin, Shaquan Abney, and Tom Orr)

Subject: Papa John’s International, Inc.’s Prospective Client Risk Assessment

Date: April 12, 2015

Papa John’s International, Inc. (“Papa John’s Pizza”) is a pizza restaurant franchise that promises better ingredients and better pizza. They are the world’s third largest take-out and pizza delivery service and is among the top competitors in the pizza industry. It operates in over 34 countries. Papa John’s International, Inc has grown from its opening in 1984 with a single restaurant to now with more than 4,600 restaurants in the world today. The company was built on quality and taking care of its people and customers and continues to do today.

Papa John’s International, Inc were ranked 1st in customer satisfaction by the American Customer Satisfaction Index (ASCI) for the 13th time in the last 15 years. In 2013, Business First awarded Papa John’s Business of the Year. In addition to these awards and achievements, Papa John’s has been steadily growing. Papa John’s revenue has increased 11% over the past year and this has been the norm for Papa John’s in the last few years. Over the past 2 years, there net income has increased 19%.

MTTS, LLP has established a prospective client risk assessment on Papa John’s International, Inc. in order to assess the risk of accepting them as an audit client. The following analysis and attached documents contain information that aided in the decision making process. To create the risk assessment of Papa John’s, we examined their SEC 10-K filing, financial statements, competitors’ financial statements, and the Annual Report. Using these resources we performed a SWOT analysis, constructed a Porter’s Five Forces Model, and calculated a governance score.

After analysis of Papa John’s International Inc., we propose accepting the franchise as an audit client. They have experienced years of increasing sales, strategic expansion, and are continuing to improve ordering convenience to the customer by expand their technological presence. Papa John’s is a medium risk company that is in the growth stage, leading us to believe they would be a beneficial client.
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-Risk Areas</td>
<td>24</td>
</tr>
<tr>
<td>Low-Risk Areas</td>
<td>25</td>
</tr>
<tr>
<td>Management Integrity</td>
<td>26</td>
</tr>
<tr>
<td>Audit Scope</td>
<td>26</td>
</tr>
<tr>
<td>Internal Control Assessment</td>
<td>27</td>
</tr>
<tr>
<td>Use of Internal Audit and Specialists</td>
<td>27</td>
</tr>
<tr>
<td>Audit Opinion Prediction</td>
<td>27</td>
</tr>
<tr>
<td>Sarbanes-Oxley Implications</td>
<td>28</td>
</tr>
<tr>
<td>Client Business Risk Matrix</td>
<td>30</td>
</tr>
<tr>
<td>Appendix: A</td>
<td>32</td>
</tr>
<tr>
<td>Work Cited</td>
<td>32</td>
</tr>
<tr>
<td>Appendix: B</td>
<td>35</td>
</tr>
<tr>
<td>Budget</td>
<td>35</td>
</tr>
<tr>
<td>Leadership</td>
<td>35</td>
</tr>
<tr>
<td>Coordination</td>
<td>36</td>
</tr>
<tr>
<td>Norms</td>
<td>36</td>
</tr>
<tr>
<td>Conflict</td>
<td>37</td>
</tr>
<tr>
<td>Contribution</td>
<td>37</td>
</tr>
</tbody>
</table>
Company Overview

Industry

Papa John’s is an American restaurant company that specializes in pizza delivery. It currently runs the third largest take-out and pizza delivery chain in the world; its headquarters is located in Jeffersontown, Kentucky. There are over 4,600 Papa John’s restaurants internationally; 3200 of them located in the US, while the rest are spread across 34 other countries. Papa John’s mainly deals with carry-out and delivery orders, and is a franchise-style company. The Franchise store owners pay royalty fee of 5% of Net Sales to Papa John’s International and about 7% of Net Sales on advertising efforts. Papa John’s International Inc. is a publicly traded company with 30% of its shares owned by its founder and current CEO, John Schnatter.

Primary Products

Papa John’s primarily focuses on pizza, breadsticks and cheese sticks (canadean) as the products that they are best known for and serve to their customers. Other products they provide include: Desserts- Applepie, Chocolate Pastry Delights, Cinnamon Sweetsticks, Cinnapie; Sides- BBQ Wings, Buffalo Wings, Chicken Strips etc. The raw materials include, but is not limited to mozzarella cheese, olives, tomatoes, specialty cheeses, Pepperoncini Peppers, flour
Corporate Strategy

Papa John’s goal is to build the strongest brand loyalty in the pizza industry. The key elements of their strategy is their High Quality Menu Offerings, Efficient Operating System, Commitment to Team Member Training and Development, Marketing, and a Strong Franchise System.

High Quality Menu: Papa John is focused on bringing its customers the best in its menu by offering a wide array of high quality pizza as well as side items and beverages to choose from. Papa Johns ensures that all its products are made as fresh as can be; their traditional crust pizza is prepared using fresh (not frozen) dough. Also, their pizza is made from a blend of wheat flour, cheese made from 100% original mozzarella, pizza sauce made from actual vine-ripe tomatoes -not concentrate, a mix of savory spices, and a choice of high quality meat- 100% beef, pork and chicken with no fillers, as well as vegetable toppings, and many more.

Efficient Operating System: Papa John’s tries to effectively lower costs as much as possible, improve food quality as well as promote superior customer service through their operating and distribution system, restaurant layout and designated delivery areas. Its domestic system takes advantage of volume purchasing of food and supplies. and provides economies of scale in fresh dough production, eliminating the needs for each restaurant to order food from multiple vendors and commit substantial labor and other resources to dough production.

Commitment to Team Member Training and Development: Papa John shows it commitment to development of team members through various training programs, incentive compensation and opportunities for advancement that it offers. These team member training programs are conducted for corporate team members and offered to franchisees at training locations both in the
US and internationally. They also offer performance based financial incentives to corporate and restaurant team members at various levels.

**Marketing:** Their marketing strategy consists of both national and local components. Its domestic national strategy includes national advertising on television, through print, direct mail or online. Its local restaurant level marketing programs target consumers within the delivery area of each restaurant and makes extensive use of print materials. Local marketing efforts also include a variety of community-oriented activities within school, sports venues and other organizations. Efforts are also supplemented with radio and television advertising produced both locally and on a national basis.

In international markets, they target customers who live or work within a small radius of a Papa John’s. Majority of their market efforts use print materials such as flyers, newspaper inserts and in-store marketing materials. Some local marketing efforts e.g. sponsoring or participating in community events, sporting events and school programs are also used to build customer awareness.

**Franchise System:** Papa John’s is committed to developing and maintaining a strong franchise system by attracting experienced operators, supporting them to expand and grow their business, and monitoring their compliance with Papa John’s standards. To ensure consistent food quality, Papa John requires each domestic franchise to purchase dough and tomato sauce- key ingredients from their QC centers and all other supplies from their QC Centers or approved suppliers. Papa John’s devote significant resources to provide its franchisees with assistance in restaurant operations, management training, team member training, marketing, site selection and restaurant
design as well as significant assistance to licensed international QC Centers in sourcing high-quality suppliers located in-country or regional suppliers to the extent possible.

**Strategic Financing Model**

Papa John’s uses a franchising business model. With this business model, Papa John’s generates most of its operating profits from local franchises. Local franchises are required to pay royalties and fees in order to use Papa John’s brand, marketing, and other trademark property. These payments have little impact on operating margins. The company is currently expanding the franchise in non-traditional locations such as airports and shopping malls to reach a broad market.

**Company Management**

Management's agenda is an “unrelenting focus on superior-quality products to drive a loyal customer base.” Their focus is on selling the truth about producing superior pizza by using the freshest ingredients. They spend most of their resources on delivering the highest quality pizza with the quickest service, which was achieved when Papa John's earned the highest rating in the prestigious American Customer Satisfaction Index for the 12th time in the last 14 years. This is what drove their 2013 4% comparable North American sales increase. This was the fifth straight year of pretax income growth in North American segment. In order to deliver the fastest service Papa John’s has surpassed many of its competitors by being the first to offer their customers various technological advances. They were the first to near 50% of domestic system sales through the use of technology, provide system wide online ordering, offer systemwide text
ordering, and offer a digital rewards program. The leadership team is dedicated “to innovation through technology has been and remains a commitment.”

In regard to management’s integrity, Papa John’s is impacting the community in a positive way by partnering with The Salvation Army. Last year Papa John's contributed hundreds-of-thousands-of-dollars in monetary and product donations.

**Governance Quickscore**

Papa John’s has a governance quickscore of 2 out of 10, with 1 being the lowest governance risk and 10 being the highest degree of risk. The pillars to this overall score are composed of Board Structure, Compensation, Shareholder Rights, Audit and Risk Oversight with scores of 3, 1, 3, 5 respectively.

**Primary Customers**

At the restaurant-level, each Papa John’s store targets customers based on delivery area. At this level, the customer base is narrow and targets middle income families and individuals. At the global level Papa John’s is geographically diverse and does not concentrate its resources on one particular area. Papa Johns has continually been expanding into new markets and new countries. 70% of expansion in 2014 was in international markets.
Related Parties

Companies that are closely associated with Papa John’s include: Perfect Pizza, National Football League, Six Flags, Olympic Speedskating Oval (CA), The Football League (UK), Papa John’s Marketing Fund, Inc. (“PJMF”)

The Annual Report

The annual report intends to convey global expansion, growth in revenues, operations, and stock performance, and continuing operation of quality restaurant-sites. Sales as of Dec 28, 2014 were $1,598,149,000. The majority of these sales were from Domestic restaurant sales and Domestic commissary sales. Assets were worth $512,803,000 as of Dec 28, 2014. The majority of their assets are net property and equipment, goodwill, and accounts receivable worth 219,457,000, 82,007,000, and 55,933,000, respectively. There were 21,700 total employees as of Dec 18, 2014, around 18,900 were restaurant team members, 900 were restaurant management personnel, 700 were corporate personnel and 1,200 were QC Center and Preferred Personnel. In 2013, personnel turnover was 10.1%. Market Capitalization as of January 25, 2015 totaled 2.49 Billion. The balance sheet total stockholder’s equity was 98,715,000 as of Dec 28, 2014.

After going through Papa John’s annual report there was no section that referenced R&D specifically. In addition, there were few articles that discussed Papa John’s R&D efforts, therefore we can conclude that the company’s R&D is not significant. They occasionally have specialty pizza deals, but R&D is not one of their primary concerns.
Industry Overview

**Key Economic Factors**

The key economic factors and primary cost drivers that heavily impact the pizza industry are the use of mobile technology, economic crises, food inflation, and labor costs. Papa John’s launched the industry’s first mobile-optimized Web site. Currently the economy is recovering from the economic crisis and has been growing. Due to the sustained growth, easing is coming to an end and consumers are spending more on luxury items such as restaurant food. There has been rising cheese costs, but those costs are expected to decrease in 2015. Labor costs are rising.

**Important Factors for Success**

The most important factors for success in the pizza industry are:

- **Strong competitive advantage/differentiator from other companies:** in order for Papa John’s to really succeed in a business such as the Pizza Industry where the product is relatively generic, it is very important for it to have a differentiating factor from its competitors.

- **Strong/aggressive promotion of the products being sold:** another important factor is constantly promoting products as well as using pull strategies to draw more customers in.

- **Making products that are affordable and easily accessible:** this is very important as the product being sold is one that is easily substitutable. It is therefore important that the product be affordable relative to competing prices and also be easily accessible.
Hiring the right employees and retaining them: having good employees is very critical to the success of this business because the employees are ultimately the ones in charge of seeing to it that customers get what they have been promised. Being able to find the right people is very important and so is retaining them because people with more experience will be able to do the job faster and better—which is cost efficient.

Good geographic location spread: having a good spread of various franchises is very important as well because it draws in more customers from all over and prevents clustering of branches which can be very cost inefficient if it occurs.

Papa John’s is actively taking steps to ensure they have most of the factors in place. Papa John’s owner, John Schnatter, states, “You have to look for people who are positive and have integrity.” He believes one of the most important lessons he learned before starting the business was that hiring the best people does not necessarily mean hiring the most experienced. Also, they focus on a specific group of products (pizza, breadsticks, cheesesticks and chicken strips) and make it the best way they possibly can. They use the freshest products possible by using only the finest ingredients and using organic options when possible. In addition, they offer only carry-out and delivery service, allowing the focus of each store to be solely concentrated on making their products. Again, they have various sales promotions and constant deals throughout the year that encourages consumers to buy their products over competing companies’.
Noteable Accounting Considerations

For companies in the pizza industry there are a variety of accounting procedures that need to be taken into special consideration. Papa John’s needs to carefully monitor cost of goods sold in regards to the treatment of coupons, gift certificates, charitable contributions of food, consumption of food by owners/ employees, employee discounts. They need to continually update inventory specifically aging inventory, spoilage, theft. Other special considerations include foreign currency translation, principles of consolidation, and the effective use of estimates.

Legal and Regulatory Matters

In order to maintain a free a competitive market Papa John’s must abide by antitrust laws. “Antitrust laws prohibit agreements among companies that fix prices, divide markets, limit production or otherwise interfere with the free marketplace.” In addition, “Team members must abide by laws and regulations of any country in which the Company does business, including but not limited to all applicable anti-corruption, import, export control, and economic sanctions laws and regulations.” Since they are expanding internationally, Papa John’s needs to be aware of international trade laws.

Social Matters
Americans are trending towards fast-delivery services and takeout as opposed to traditional
dining out. Papa John’s is a quick-service pizza franchise that allows users to order at home and
avoid paying for travel, tips, and drinks.

**Primary Competitors**

Papa John’s main competitors are Pizza Hut, Domino’s, and Little Caesar’s. There is a strong
competitor presence related to price, service, location, food quality and variety. Dominos is
established in over 70 countries totaling 10,886 delivery centers. Similarly, Pizza Hut
has over 14,967 restaurants including 7,846 restaurants in the US. The main concern regarding
competition is the pricing pressure it places on Papa John’s.

The barriers to entry into the pizza industry include economies of scale, entrenched/ established
competition, regulatory obstacles (strict health requirements), and location. Most of the barriers
of entry are related to the challenge for smaller businesses to compete with the larger, established
businesses.

**Porter’s Five Forces Model**

Porter’s Five Forces Model analyzes the external environment of the industry by viewing the 5
competitive forces that drive the industry. Those five forces are the intensity of rivals within the
industry, the threat of substitute products, the bargaining power of buyers, the bargaining power
of suppliers, and the threat of new entrants. The implementation of Porter’s Five Forces for the
pizza industry improves the auditor’s knowledge of the external environment that Papa John’s faces.

**Papa Johns Porter’s Five Forces Model**

<table>
<thead>
<tr>
<th>Intensity of Rivals Within the Industry: High</th>
<th>Threat of Substitute Products: High</th>
</tr>
</thead>
<tbody>
<tr>
<td>The intensity of rivals is high because competitors sell the same products at roughly the same prices. This is true of local businesses as well since they have roughly the same size business for the given area.</td>
<td>Customers are readily able to buy from locally owned restaurants or nationally owned chains. There are many options that can substitute for pizza.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bargaining Power of Buyers: High</th>
<th>Threat of New Entrants: High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to the number of pizza restaurants to choose from, buyers will shop elsewhere if prices are too high. Buyers will shop where discounts and coupons are offered.</td>
<td>The industry is easy to enter especially for nationally owned pizza restaurants because of the low cost of capital and the funds available to enable them to expand. The risk is lower for locally owned pizza restaurants due to high fixed cost.</td>
</tr>
</tbody>
</table>

(Papa John’s International, Inc. [Porter’s Five Forces Model])
Financial Health

Papa John’s receives its capital from the stock market and by taking on long-term debt. As of March 20, 2015, Papa John’s had a market capitalization of $2.56 Billion and long-term debt of $230.45 Million as of December 31, 2014. In the past two years, Papa John’s stock price and market capitalization has more than doubled. The stock price went from $30.50 to $64.27 in that same timeframe. As mentioned earlier, Papa John’s has a high ROE and that high return has attracted many new investors to the stock which raised the price significantly. Their most recent earnings report for Q4 2014 were very well received. They beat analyst expectations for many major figures including earnings per share, which they beat projections by 4%. Revenues and income continue to grow substantially and analysts continue to increase their expectations for both measures.

In terms of financial health, Papa Johns competes well with the industry and its competitors. Its diluted earnings per share of 1.75 is higher than the industry average of 1.58. However, its one year sales growth is 11.06% compared to 21% from the rest of the pizza industry. Its gross margin is slightly higher than the industry average, but Papa John’s still trails Domino’s and Pizza Hut in gross sales. Papa John’s has $1.60 Billion in sales while Domino’s and Pizza Hut have $1.99 Billion and $15.95 Billion respectively.

Z Score
According to z score analysis using the financials from their 10K, Papa John’s is not likely to go bankrupt. Any z score higher than 3.0 means the company is not likely to go bankrupt. In 2012, 2013, and 2014, Papa John’s has had z scores of 7.85, 7.53, and 7.37 respectively. From 2013 to 2014, Papa John’s has become slightly less financially healthy based on z score. This is due to rapid the relatively rapid expansion of their business which means that they are taking on more debt. However, Papa John’s is still very stable and not at risk of going bankrupt. Using the strategic profit model, their ROE has increased each year recently with an ROE of 30.06%, 41.93%, and 65.49% respectively from 2012-2014. This shows that the company is continuing to give a high return to its owners and that the company is trending upward rather than downward.

**Analyst Reports**

Most analysts suggest to hold Papa John’s stock and some recommend to buy the stock. This is due to the following reasons:

As of December 2014, Papa John’s has installed a proprietary point-of-sale system ("FOCUS") in 75% of their domestic locations. The company expects to complete installment of the new system by the end of Q1 2015. The cost of this implementation reduced income before income taxes by around $4 million. If one ignores the cost of the FOCUS implementation, year-over-year EPS for 2014 would have been about +18%. With the costs of FOCUS coming to an end, the company can expect to see EPS pick up in 2015.
The company’s target EPS for 2015 is $0.04 under market expectations. Analysts expect Papa John’s to outperform their 2015 EPS target. They state that this target represents EPS growth of about +15%. Even in 2014 when cheese prices were the highest in history, Papa John’s managed to hold a +13% EPS growth. 2015 cheese costs are expected to decrease though, which will decrease production costs.

From 2008-2013, Papa John’s has increase market share to 7.3%; the segment averaged 1.9% during those four years. Analysts expect Papa John’s to continue increasing their market share mainly due to their gradual expansion of online pizza-ordering. Papa John’s increased market share comes at the expense of smaller, local pizza establishments. Food costs also appear to be decreasing.
As you can see in the above graph, Papa John’s continues to increase expectations from Wall Street. This is great for the business and for the stock of the company, but as an auditor, this could be a potential risk. If expectations continue to grow, it may be harder and harder for Papa John’s to continue to meet expectations and potentially raise them even higher. An auditor should spend a lot of time testing sales when Wall Street’s expectations are growing this quickly.

<table>
<thead>
<tr>
<th>RECOMMENDATION FACTORS</th>
<th>Value</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Rank</td>
<td></td>
<td>btm 26%</td>
</tr>
<tr>
<td>1Yr Target Price</td>
<td>$60.82</td>
<td>btm 37%</td>
</tr>
<tr>
<td>P/E Ratio</td>
<td>35.11</td>
<td>btm 36%</td>
</tr>
<tr>
<td>Last 1-Y Return</td>
<td>31.07%</td>
<td>top 14%</td>
</tr>
<tr>
<td>Market Cap(bil)</td>
<td>$2.54</td>
<td>top 25%</td>
</tr>
</tbody>
</table>
From the above information, you see that the stock has been very successful in the past five years with an average annual return of 33.65%. As the company matures, one would expect the average annual return to decrease and the dividend yield to increase. Its beta and volatility are relatively low which can be attributed to the nature of their business because people still tend to eat pizza in tougher economic times.
Average PEG for the past 10 years has been 2.45 which is similar to their competitors’ average of 2.48. In terms of their stock’s performance, their growth numbers such as their EPS growth of 22% have led to the stock price doubling in the past two years.

<table>
<thead>
<tr>
<th>Evaluation &amp; Rankings</th>
<th>Value</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation</td>
<td>37.36%</td>
<td>6</td>
</tr>
<tr>
<td>12-Month Return</td>
<td>31.07%</td>
<td>87</td>
</tr>
<tr>
<td>5-Y Avg Ann Rtn</td>
<td>33.65%</td>
<td>97</td>
</tr>
<tr>
<td>Volatility</td>
<td>22.74%</td>
<td>76</td>
</tr>
<tr>
<td>EPS Growth</td>
<td>21.99%</td>
<td>58</td>
</tr>
<tr>
<td>Market Cap(bill)</td>
<td>2.54</td>
<td>76</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>1.48</td>
<td>100</td>
</tr>
<tr>
<td>P/S Ratio</td>
<td>1.63</td>
<td>53</td>
</tr>
<tr>
<td>M/B Ratio</td>
<td>120.03</td>
<td>1</td>
</tr>
<tr>
<td>P/E Ratio</td>
<td>35.11</td>
<td>36</td>
</tr>
</tbody>
</table>

The ValuEngine Valuation Rank measures the relationship between a company’s stock price and its Fair Value. The higher the Valuation rank, the more undervalued the stock. With a Valuation Rank of 0, PZZA is substantially lower than the average of its industry group, which carries a Valuation Rank of 43.

The ValuEngine 12-Month Return Rank reflects the relative stock performance of a stock over the recent 12 months. On a scale of 1 to 100, a higher 12-Month Return rank indicates a stronger performance. With a 12-Month Return Rank of 87, PZZA is moderately higher than the industry’s rank score of 72.

The ValuEngine 5-Years Average Return Rank reflects a stock’s average annual return over the last 5 years, in comparison with the coverage universe. A higher rank indicates a better return performance. With a rank of 87, PZZA is significantly higher than the industry, which has a rank of 66.

The ValuEngine Volatility Rank reflects the volatility associated with the stock. A higher Volatility Rank indicates a lower volatile percentile of stocks. PZZA has a Volatility Rank of 76, which is moderately higher than the industry Rank of 53.
Analyst Concerns

Analysts are concerned about strong competition from Pizza Hut, Domino’s, and Little Caesars and about the rise in cheese prices. Cheese prices are expected to go down so this should be of little concern.

Some risks associated with Papa John’s are changes in health habits and trends. Currently there is a push to eat healthier being detrimental to Papa John’s business. With that being said, consumers will choose Papa John’s over competitors due to the quality of their ingredients. There are other macroeconomic trends such as decreased consumer spending would decrease sales. Competition seems to be a major risk. If competitors offer discounts, Papa John’s will be forced to respond or they will lose sales and market share.

On the other hand, analysts expect the expansion of Papa John’s into international markets will only increase market share, sales, and benefit the company.
Future Expectations

**Figure 3 — International Segment Expected to Contribute $0.60-$0.70 in EPS by 2018**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalties/Franchise Fees</td>
<td>$15,265</td>
<td>$16,327</td>
<td>$15,981</td>
<td>$20,279</td>
<td>$20,730</td>
<td>$21,467</td>
<td>$37,977</td>
<td>$46,369</td>
<td>$46,084</td>
</tr>
<tr>
<td>AUV (est.)</td>
<td>366</td>
<td>414</td>
<td>456</td>
<td>461</td>
<td>406</td>
<td>487</td>
<td>505</td>
<td>521</td>
<td>535</td>
</tr>
<tr>
<td>SRS</td>
<td>2.6%</td>
<td>5.1%</td>
<td>7.1%</td>
<td>7.5%</td>
<td>7.4%</td>
<td>6.6%</td>
<td>6.4%</td>
<td>5.6%</td>
<td>5.4%</td>
</tr>
<tr>
<td>Royalties/Franchise Fee per store</td>
<td>$18.7</td>
<td>$21.1</td>
<td>$23.3</td>
<td>$22.0</td>
<td>$21.8</td>
<td>$22.6</td>
<td>$23.3</td>
<td>$24.4</td>
<td>$25.6</td>
</tr>
<tr>
<td>Avg. # stores</td>
<td>708</td>
<td>773</td>
<td>852</td>
<td>908</td>
<td>1,170</td>
<td>1,300</td>
<td>1,002</td>
<td>2,165</td>
<td>2,165</td>
</tr>
<tr>
<td>Restaurant/Commissary sales</td>
<td>$33,162</td>
<td>$42,231</td>
<td>$53,049</td>
<td>$66,661</td>
<td>$76,726</td>
<td>$86,121</td>
<td>$97,426</td>
<td>$111,335</td>
<td>$126,836</td>
</tr>
<tr>
<td>Restaurant sales</td>
<td>11,000</td>
<td>12,400</td>
<td>16,200</td>
<td>22,700</td>
<td>23,700</td>
<td>22,961</td>
<td>25,387</td>
<td>28,524</td>
<td>31,820</td>
</tr>
<tr>
<td>Commissary sales</td>
<td>22,162</td>
<td>29,631</td>
<td>36,849</td>
<td>43,961</td>
<td>53,025</td>
<td>63,160</td>
<td>72,039</td>
<td>82,812</td>
<td>95,016</td>
</tr>
<tr>
<td>Franchise revenue/store ($)</td>
<td>$18.74</td>
<td>$21.12</td>
<td>$23.35</td>
<td>$22.03</td>
<td>$21.82</td>
<td>$22.65</td>
<td>$23.26</td>
<td>$24.40</td>
<td>$25.55</td>
</tr>
<tr>
<td>Restaurant/Commissary expenses</td>
<td>$(28,429)</td>
<td>$(35,674)</td>
<td>$(44,853)</td>
<td>$(66,669)</td>
<td>$(63,718)</td>
<td>$(70,867)</td>
<td>$(78,436)</td>
<td>$(89,409)</td>
<td>$(103,059)</td>
</tr>
<tr>
<td>Profit (external)</td>
<td>$16,536</td>
<td>$22,884</td>
<td>$28,077</td>
<td>$32,031</td>
<td>$38,737</td>
<td>$46,726</td>
<td>$58,466</td>
<td>$68,326</td>
<td>$79,869</td>
</tr>
<tr>
<td>Profit margin (external)</td>
<td>36.1%</td>
<td>38.6%</td>
<td>38.5%</td>
<td>38.6%</td>
<td>37.8%</td>
<td>39.7%</td>
<td>42.1%</td>
<td>43.3%</td>
<td>43.7%</td>
</tr>
<tr>
<td>D&amp;A</td>
<td>(2,968)</td>
<td>(3,298)</td>
<td>(2,204)</td>
<td>(3,966)</td>
<td>(3,903)</td>
<td>(3,668)</td>
<td>(3,794)</td>
<td>(3,599)</td>
<td>(4,085)</td>
</tr>
<tr>
<td>G&amp;A (est.)</td>
<td>(19,401)</td>
<td>(20,651)</td>
<td>(22,196)</td>
<td>(25,262)</td>
<td>(27,030)</td>
<td>(30,072)</td>
<td>(33,800)</td>
<td>(36,527)</td>
<td>(39,407)</td>
</tr>
<tr>
<td>EBIT (Reported)</td>
<td>$(4,771)</td>
<td>$(166)</td>
<td>$3,063</td>
<td>$2,893</td>
<td>$7,289</td>
<td>$12,401</td>
<td>$19,287</td>
<td>$27,886</td>
<td>$37,297</td>
</tr>
<tr>
<td>EBIT/tstore ($)</td>
<td>$(6.52)</td>
<td>$(0.21)</td>
<td>$3.44</td>
<td>$2.67</td>
<td>$5.58</td>
<td>$8.61</td>
<td>$11.45</td>
<td>$14.25</td>
<td>$16.57</td>
</tr>
<tr>
<td>EBIT margin</td>
<td>(10.5%)</td>
<td>(0.3%)</td>
<td>4.2%</td>
<td>3.2%</td>
<td>7.1%</td>
<td>10.5%</td>
<td>14.2%</td>
<td>17.7%</td>
<td>20.6%</td>
</tr>
<tr>
<td>Tax rate:</td>
<td>33%</td>
<td>31%</td>
<td>33%</td>
<td>31%</td>
<td>30%</td>
<td>32%</td>
<td>32%</td>
<td>32%</td>
<td>32%</td>
</tr>
<tr>
<td>Shares outstanding</td>
<td>52,506</td>
<td>50,620</td>
<td>47,916</td>
<td>44,243</td>
<td>41,716</td>
<td>38,569</td>
<td>36,520</td>
<td>37,806</td>
<td>37,240</td>
</tr>
<tr>
<td>EPS contribution</td>
<td>$(0.06)</td>
<td>$(0.09)</td>
<td>$0.04</td>
<td>$0.21</td>
<td>$0.11</td>
<td>$0.20</td>
<td>$0.33</td>
<td>$0.45</td>
<td>$0.67</td>
</tr>
<tr>
<td>% contribution to EPS growth</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
<td>NM</td>
<td>36%</td>
<td>36%</td>
<td>39%</td>
<td>43%</td>
</tr>
</tbody>
</table>

**Franchise units:**

- **Beginning:**
  - 682
  - 754
  - Average: 708

- **Bd:**
  - 754
  - 792
  - Average: 773

- **Average:**
  - 26
  - 21
  - Average: 24

**Company units:**

- **Beginning:**
  - 26
  - 21
  - Average: 24

**Source:** Company reports and KeyBanc Capital Markets Inc. estimates
**Total Quality Sector Comparison**

As you can see in the following graph, Papa John’s has an above average long-term investment rating of 75 compared to the an average of 51 for US listed companies. Papa John’s ranks fourth when compared to its closest competitors. Their ratings in volatility and outperformance were positive, but their ratings in management, price, and total were negative.
Audit Considerations

Papa John’s major transactions include sale of product, restaurant and commissary leases, restaurant sales, franchise and development fees, and franchise royalties. In 2012, 44% of their income came from sales of product in restaurants, 41% of income came from commissary revenue, 6% came from franchising royalties, 5% of sales came from international restaurant revenue, and less than 1% came from franchise fees which are $25,000 per new franchise. This revenue mix remained similar since 2012 with the one exception that international sales are slightly larger percentage of total sales today.

Current Audit Opinion

The company’s current auditor is EY. They have given an unqualified opinion for the financial statement audit every year since they worked with Papa John’s as their client. In 2012, they gave Papa Johns an adverse internal control opinion because of a material weakness regarding management review of non routine transactions. That material weakness has since been fixed, and in 2013 and 2014, Papa Johns received an unqualified opinion regarding internal controls.

High-Risk Areas

Some high risk areas might are competition, number of suppliers, and cost of ingredients. Papa John’s encounters an intense competitive market in the restaurant industry. Some competitors have been in existence longer than Papa John’s and may be in more durable positions in the market. The number of locations, new products, changes in price, and promotional strategies by
competitors can negatively affect Papa John’s demand and sales. In addition to these factors, Papa John’s also face risk from new competitors entering the market.

Papa John’s has one supplier, Leprino, for all of their different types of cheeses. They are supplied both domestically and internationally by a Leprino. This is very risky because if there is a disruption or interruption with their supplier it would be very costly to Papa John’s and they would lose a lot of money. Also, they have very few suppliers for their other ingredients which could result in a similar outcome if something goes wrong with one of their suppliers.

The cost of cheese is very volatile and would negatively affect Papa John’s profits. Cheese represents about 40% of the food cost and have substantial cost fluctuations due to factors beyond control. Papa John’s may not be able to increase its own prices to keep its incremental profit from decreasing.

**Low-Risk Areas**

Management estimates are low-risk areas because management has shown that they have integrity in the past. They also have had minimal management turnover (e.g. the same CEO for the life of the company) which would allow us to rely on management estimates more than a company with high management turnover. Growth estimates could be low risk because pizza consumption can thrive in difficult economic times due to its low cost. The fact that they have low product variability and produce mostly the same core products every year allow for their
growth estimates and cost expectations to be relatively low risk. Some other low-risk areas include their prepaid expenses which by nature have low inherent risk.

Management Integrity

There have been no reasonably large integrity issues among Papa John’s executives. In 2012, Papa John’s CEO John Schnatter was criticized by the media and shareholders for openly speaking out against the Affordable Care Act known as Obamacare. The CEO’s criticism was entirely based off of increased costs and decreased profits for the company as a result of the act. Papa John’s would have to begin providing health insurance plans to employees. The price of their pizza increased slightly as a result. Schnatter did not like the business impact of the act, but that should not reflect poorly on his integrity as a manager and leader.

Accepting Papa John’s as a client would be an appropriate choice based off of the known integrity of management. There are no known or foreseeable unusual business risks that make it a mistake to accept them as a client. Acceptance would not violate rules or code of conduct. With permission of the client, the preceding auditor, EY will be contacted by our firm to get a better understanding of management integrity after client acceptance.

Audit Scope

Although the company is growing quickly internationally, most of the audit scope would remain in the United States. It could be important to partner with foreign audit offices (or travel to) China and Europe to validate samples of some revenue financials. Because of the cost to us as
the auditor, the bulk of the auditing work will take place in Louisville, Kentucky where Papa John’s is headquartered.

Internal Control Assessment

There are currently not any problems with Papa John’s internal control. Papa John’s received an unqualified opinion from EY expressing an effective internal control. In 2012, Papa John’s received an adverse opinion for a material weakness involving non-routine transactions. This control has since been fixed and they have received unqualified opinions for internal controls since 2012.

Use of Internal Audit and Specialists

Under AU 322, we will choose to use internal audit in order to help lessen the workload and bring down the overall cost of the audit to the client. Additionally, we will need to use outside Information Technology specialists to audit the controls of their computer and technology systems such as those for transactions involving online orders. We may need valuation experts to help audit the clients own valuations of inventory. This involves the pricing of various commodities used as inputs for the client’s products.

Audit Opinion Prediction

I would expect an unqualified report to be issues based on the business trends and previous integrity of management. Past opinions have included material misstatements for the internal audit opinion, but the auditor has never issues a qualified opinion for the financial statement
audit. This tells me that management will correct material misstatements in the financials rather than allow a qualified opinion to be issued. Issuing an unqualified opinion means that the financials are not materially misstated in all reasonable respects of the auditor.

**Sarbanes-Oxley Implications**

SOX section 404 requires management to evaluate their own controls and have support for their evaluation. It also requires the auditor to independently evaluate the controls of the client and issue a report as of year end. The two opinions do not typically vary in practice because it would look bad if the client (Papa John’s) said their controls were fine when an independent party found that there was a material weakness. In 2012 when a material weakness was found in Papa John’s non routine transaction review controls, both the auditor and Papa John’s came to the same conclusion of a material weakness as of year end.
The Client Business Risk Matrix was formed to show the risks associated with Papa John’s International, Inc. The Matrix represents the different level of risks pertaining to significance and expectation on the effect if its financial statements. There are many high risks that can affect the financial statements including competition of established companies because of the differentiation between Papa John’s and other competitors. On the other hand, Papa John’s product variability are of little risk. Their products are unlikely to change from product to product because they have a small number of main products. There variability is primarily with their toppings and limited promotions they offer. They expect new competition to come in from local restaurants but it is of little significance because Papa John’s market demand and customer
loyalty is very high. Papa John’s has a limited number of suppliers which is a very significant risk but the probability that they will have a problem with any suppliers are low. These risks associated with Papa John’s can affect the company in different magnitude and likelihood and the matrix does it job in showing the differences of those risks.
Appendix A: Works Cited


Appendix B

Budget
We initially estimated that we would meet five times and work for about four hours each time we worked. In total, we predicted that we would meet for 20 hours with all four of us working together for those twenty hours, meaning a total of 80 hours of work would be put into the project. As we progressed through the project, we did meet five times, but some meetings went for slightly longer than four hours and some went for slightly shorter than four hours. Most of the work on the project was worked on as a group, but on occasion, some research and other responsibilities were completed outside of our meetings.

Leadership
Our group’s informal leader was Meredith. She initiated the meetings to work on the project, and led the goal setting each individual meeting. As far as the work went, we worked well as a group and no leader consistently stood out as a worker. Each of us has different strengths and weaknesses, so different topics were led by different people regarding research and content. No major leadership changes happened throughout the semester and we never had a formal leader.
Coordination

When we met, we would split up the work informally when we got there. We all worked on the same google doc and we talked with each other to determine who would be working on each specific part. We did not form a contract, and we did not split up the work section by section. We tried getting through a section or two each time we met, and we would work through the sections together.

Norms

One norm our group had was making sure that everyone could meet and work on the project together. A couple of times one of our members could not meet or had to leave early, so that member would do individual research and still contribute to the project. Since this is a group project, we wanted the final result to reflect the work of all of our members, not just one or two. Another norm of our group was to not work on other obligations while we met to work on the project. Although some of us met other times to study or do other homework, we made sure that our work wasn’t divided when we met to work on the project. A third norm of our group was to set a goal when we first met and meet that goal before we left that day. For example, one time we met and set a goal to complete the content for sections 7 and 8 of the project. We did not leave until those parts were completed. Occasionally if one member of our group had to leave early, that was acceptable but our members generally knew not to leave until the work was finished. Lastly, it was a norm for our group to use a Google Document to compile all of the content. This allowed us to easily check other’s work and help each other out when we needed it.
Conflicts

The only conflicts that arose for us throughout the semester were time conflicts with everyone’s busy schedule. Sometimes it was difficult to meet up to work on the project together, especially when one or more of our members had busy exam weeks. We settled this small conflict by communicating with each other and finding times that worked for everyone. Sometimes we had to work multiple times in a week, and other times we had weeks without working much on the project at all. By being understanding of the schedules of others, we were able to successfully meet and work together throughout the semester.

Contribution Mix

We cannot say exactly what one person contributed because we truly worked on every aspect of the project as a group. We all did research, we all answered and contributed to each part to some extent. Some of us contributed more to one part than to others, but our total work was equal in the end. We all worked together to reformat the information into the final document with no one person doing significantly more work than someone else.
<table>
<thead>
<tr>
<th>Individual</th>
<th>Work Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meredith</td>
<td>100%</td>
</tr>
<tr>
<td>Tomi</td>
<td>100%</td>
</tr>
<tr>
<td>Shaquan</td>
<td>100%</td>
</tr>
<tr>
<td>Tom</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>400%</strong></td>
</tr>
</tbody>
</table>