

Kraft Heinz Company and the \$15.4 Billion Impairment Charge: Subsequent Lawsuits

Amanda Grossman
Steven D. Grossman
*D. Larry Crumbley**

Introduction

On July 2, 2015, two of the largest manufacturers of food products merged: Kraft Foods Group Inc. (Kraft) and the H. J. Heinz Holding Corporation (Heinz). Meeting expectations, the merger created the third largest food and beverage company in North America and the fifth largest of such companies in the world. The Kraft Heinz Company offers mainly packaged products, such as ketchup, sauces, infant meals, beans, pasta, potato products, and snacks. Its major brands, besides Kraft and Heinz, include Oscar Mayer, Velveeta, Lunchables, Philadelphia, and Ore-Ida, among others (McClay, 2023). With the ticker symbol “KHC,” the newly created company began publicly trading on the NASDAQ exchange on July 6, 2015.

By 2019, Kraft Heinz’s stock price was underperforming, falling substantially from around \$90 to \$70 per share. Analysts have explained its lackluster performance because of significant debt, the use of zero-based budgeting as a cost curtailment strategy, and the apparent inability to perceive and respond to customers’ burgeoning interest in organic and more health-conscious food choices (LaMonica, 2019). In February, Kraft Heinz became embroiled in scandal after an SEC investigation into procurement malfeasance was announced (Isidore, 2019). On February 22, after the announcement, the company’s share price fell to \$34.95 per share. Ultimately, the Securities and Exchange Commission (SEC) discovered \$208 million in fictitious cost savings and the 2016 and 2017 financial statements required reissuances. In addition, Kraft Heinz had grossly overvalued goodwill and other intangible assets on the balance sheet, resulting in a whopping \$15.4 billion impairment charge on the 2018 financial statements (Lucas, 2019). This write-down effectively wiped-out income and resulted in a loss of \$10,254 million. In 2021, Kraft Heinz and two of its executives settled the SEC charges for \$62 million in penalties for violations of anti-fraud and record keeping requirements (U.S. SEC, 2021).

Although a settlement with the SEC was achieved, the events at Kraft Heinz precipitated several legal actions against the company. These class action securities fraud lawsuits claim that Kraft Heinz issued materially false and misleading financial information. Additionally, plaintiffs argue that Kraft Heinz’s unadvised cost-cutting initiatives were devoid of proper internal control measures and were intentionally aimed at defrauding shareholders.

This study presents and discusses the unfolding of events at Kraft Heinz that prompted shareholders to file suit against the company for perceived gross negligence within their business operations and accounting practices. An event study was conducted to affirm the veracity of plaintiffs’ claims that losses were suffered as a direct result of Kraft Heinz’s misconduct. Coupled with an analysis of the information disseminated regarding the practices at the company, the event study regression analysis results strongly suggest that Kraft Heinz’s inappropriate business practices demonstrably harmed shareholders.

The Merger

The July 2, 2015, merger was orchestrated by 3G Capital, a large Brazilian private equity firm, and Berkshire Hathaway, headed by Warren Buffet. The total consideration given was \$52,637 billion, which included a special cash dividend to Kraft shareholders of \$16.50 per share (\$9.782 billion), an amount representing more than 25 percent of the company’s stock price (Trefis Team, 2015). The merger was approved unanimously by the board of directors of both companies. The Heinz shareholders were given a 51 percent stake in the Kraft Heinz Company while the Kraft Foods shareholders received a 49 percent stake (Kumar, 2019).

With the majority of Heinz's sales generated outside of North America and almost all of Kraft's sales generated within North America, the hope was that the merger would result in increased international sales for Kraft. The larger volume of sales would result in cost synergies due to higher economies of scale. The merger was designed to generate annual costs savings of \$1.5 billion by 2017 (Kumar, 2019). Presumably, cost savings would result from using zero-based budgeting, closing inefficient plants, as well as refinancing some of Heinz's high interest debt with lower interest debt because of Kraft's better credit rating.

Aftermath of the Merger

3G Capital and Berkshire Hathaway have previous experience with mergers and acquisitions, and a signature component of their management of merged companies is to instigate significant cost-cutting measures, including employee layoffs. According to Dowd (2019), this strategy was deployed when 3G Capital supported InBev brewing company buying Anheuser-Busch for \$52 billion in 2008, forming Anheuser-Busch InBev. As another example, in 2010, 3G Capital bought Burger King, which went public in 2012; then, 3G Capital partnered with Burger King and Berkshire Hathaway to purchase Tim Hortons restaurant chain in 2014. In 2013, 3G Capital and Berkshire Hathaway combined to purchase H.J. Heinz for \$23.2 billion. Shortly thereafter, 600 employees were laid off, hundreds of them in their hometown of Pittsburgh.

In the wake of the 2015 merger of Kraft Heinz, 3G Capital and Berkshire Hathaway placed six of their representatives on the eleven-member Board of Directors of Kraft Heinz Company. Both companies agreed to support each other on the board; therefore, 3G Capital gained control of the company (Cheffers, 2020). A short time thereafter, rounds of layoffs and plant closings ensued. These events exemplify 3G Capital's ongoing strategy of buying smaller companies and then rolling them into larger companies to cut costs, remove inefficiencies, achieve economies of sales, and generate profits. 3G Capital's reputation for cutting costs, restructuring, and major layoffs also includes an integral tactic of utilizing zero-based budgeting. Whereas a traditional budget begins a new time period with an existing budget and then incurs additions and subtractions as needed, a zero-based budget begins at zero each year, and every expense and function must be analyzed for its need and cost.

The impact of the merger was evident within Kraft Heinz's impending financial statements. Issued on August 5, 2016, Kraft Heinz Company's Form 10-Q second quarter report indicated that the company used estimated fair values at the date of the merger in 2015 to allocate the total consideration exchanged to the net tangible and intangible assets acquired and liabilities assumed. The purchase price allocation to identifiable intangible assets acquired was \$43.104 billion for indefinite-lived trademarks, \$1.690 billion for definite-lived trademarks, and \$2.977 billion for customer-related assets. The assumptions inherent in developing the valuations included the estimated annual net cash flows for each intangible asset, the discount rate reflecting the risk inherent in each future cash flow stream, the assessment of each asset's life cycle, and competitive trends.

The result of the allocation is depicted in Exhibit 1. As per the line item, "Net assets acquired," the value assigned was \$22.175 billion; as per the line item, "Goodwill on acquisition," the value assigned was \$30.462 billion. These items resulted in total consideration of \$52.637 billion. Therefore, goodwill was 57.9 percent of the total consideration. The goodwill was for the synergies expected to be achieved from combining the operations of the two companies in the merger and the planned growth in new markets.

Exhibit 1: Kraft Heinz Value Assumptions and Purchase Price Allocation

Cash	\$314
Other current assets	3,423
Property, plant, and equipment	4,179
Identifiable tangible assets	47,771
Other non-current assets	214
Trade and other payables	(3,026)
Long-term debt	(9,286)
Net postemployment benefits and other non-current liabilities	(4,739)

Deferred income tax liabilities	(16,675)
Net assets acquired	22,175
Goodwill on acquisition	30,462
Total consideration	52,637
Fair value of shares exchanged and equity awards	42,855
Total cash consideration paid to Kraft shareholders	9,782
Cash and cash equivalents of Kraft at the 2015 Merger Date	314
Acquisition of business, net of cash on hand	\$9,468
Note: Taken from Kraft Heinz's 2016 10-Q Second Quarter Report. Dollars are in millions.	

2016–2017 Financial Statements

Initially, the Kraft Heinz merger appeared successful: as compared to 2014, the company's total assets doubled in 2016, and some cost savings were achieved due to the debt refinancing (Kumar, 2019). Net sales increased 44.4 percent from 2015 to 2016 primarily due to the 2015 merger. Net sales decreased 1.0 percent from 2016 to 2017 primarily due to an unfavorable volume/mix, partially offset by higher pricing. Operating income increased 10.3 percent from 2016 to 2017 primarily due to lower integration (severance and employee benefit costs and facilities exiting costs) and restructuring expenses and lower overhead costs, partially offset by higher input costs.

Net income increased 201.8 percent primarily due to a lower effective tax rate, driven primarily by the Tax Cuts and Jobs Act passed in December 2017. Diluted EPS was \$2.81 in 2016 but was \$8.95 in 2017 due to the lower effective tax rate and the redemption of the Series A Preferred Stock in 2016; therefore, there were no dividends affecting EPS in 2017. These percentages are slightly different after the restatement of the 2016 and 2017 financial statements (see next section), but the percentages stated in this section are the ones the public would have seen in these years.

The stock price for Kraft Heinz Company was around \$70 per share in early 2016. Higher than expected earnings resulted in the stock price increasing to \$96 per share in February 2017, but then stock prices started falling throughout the year, dipping to \$77.76 per share at year end. The company's teetering sales may have been reflective of growing consumer demand for healthier food products, especially outside of the United States (Chaboud, 2016). People started to change their eating habits, wanting foods that were fresher, organic, and more nutritious. The foods sold by the Kraft Heinz Company did not generally fit that desire (McKenna, 2019). Also, several competing companies were trying to capitalize on the new consumer trends, and Kraft Heinz was becoming left behind.

Per the December 31, 2016, financial statements, Kraft Heinz Company's auditor, PricewaterhouseCoopers (PwC) issued a clean opinion stating that the financial statements are in conformity with U.S. generally accepted accounting principles. PwC also stated that the company maintained effective internal controls over its financial reporting. PwC gave the company a clean opinion in 2017 also.

2016–2017 Restatements and 2018 Financial Statements

The bombshell occurred on February 21, 2019, when Kraft Heinz Company reported that a subpoena from the SEC was received in October 2018, relating to accounting policies, procedures, and internal controls related to the procurement function, including, but not limited to, agreements, side agreements, and changes or modifications to agreements with suppliers. After an internal investigation, the SEC found that multiple employees in the procurement area had engaged in misconduct. Prior period misstatements were corrected that generally increased cost of products sold in prior periods. Other potential misstatements in the timing of the recognition of supplier rebates, incentive payments, and pricing arrangements were discovered. In total, \$208 million in fictitious cost savings were recognized.

The financial statements for 2016 and 2017 were restated. Exhibit 2 presents the restated income statement for 2017, including the reasons for the restatements. While the misstatements are not quantitatively material to any period presented

in the prior financial statements, net income was reduced by \$58 million in 2017 and \$36 million in 2016. The company reported that the SEC investigation did not identify any misconduct by any member of the senior management team.

Exhibit 2: Kraft Heinz Restated 2017 Income Statement

The Kraft Heinz Company						
Consolidated Statement of Income						
(in millions, except per share data)						
	As Previously Reported	Restatement Impacts	Restatement Reference	As Restated	ASU Adoption Impacts	As Restated and Recast
Net Sales	\$26,232	\$(156)	(c)(g)	\$26,076	\$-	\$26,076
Cost of products sold	16,529	(44)	(a)(b)(c)(g)	16,485	558	17,043
Gross Profit	9,703	(112)		9,591	(558)	9,033
Selling, general, and administrative expenses, excluding impairment losses	2,881	(32)	(c)(g)	2,849	78	2,927
Goodwill impairment losses	-	-		-	-	-
Intangible asset impairment losses	49	-	(f)	49	-	49
Selling, general and administrative expenses	2,930	(32)		2,898	78	2,976
Operating income/(loss)	6,773	(80)		6,693	(636)	6,057
Interest expense	1,234	-		1,234	-	1,234
Other expenses (income), net	9	-		9	(636)	(627)
Income/(loss) before income taxes	5,530	(80)	(a)(b)(c)(f)(g)	5,450	-	5,450
Provision for/(benefit from) income taxes	(5,460)	(22)		(5,482)	-	(5,482)
Net Income/(loss)	10,990	(58)		10,932	-	10,932
Net income/(loss) attributable to noncontrolling interest	(9)	-		(9)	-	(9)

Net income/(loss) attributable to Kraft Heinz Preferred dividends	10,999	(58)	10,941	-	10,941
Net income/(loss) attributable to common shareholders	\$10,999	\$(58)	\$10,941	\$-	\$10,941
Per share data applicable to common shareholders:					
Basic earnings/(loss)	\$9.03	\$ (0.05)	\$ 8.98	\$ -	\$ 8.98
Diluted earnings/(loss)	8.95	(0.04)	8.91	-	8.91
<p>(a) Supplier Rebates: The correction of these misstatements resulted in an increase in the cost of products sold of \$94 million and an increase to benefit from income taxes of \$18 million for the year ended December 30, 2017.</p> <p>(b) Capital Leases: The correction of these misstatements resulted in a decrease to cost of products sold of less than \$1 million, a decrease to interest expense of less than \$1 million, and a decrease to benefit from income taxes of less than \$1 million for the year ended December 30, 2017.</p> <p>(c) Customer Incentive Program Expense Misclassifications: As previously disclosed in March 2018, the correction of these misstatements resulted in a decrease to net sales of \$147 million, a decrease to cost of products sold of \$139 million, and a decrease to selling, general and administrative expense (SG&A) of \$8 million for the year ended December 30, 2017.</p> <p>(d) Balance Sheet Misclassifications: None.</p> <p>(e) Income Taxes: The correction of these misstatements resulted in an increase to benefit from income taxes of \$12 million for the year ended December 30, 2017.</p> <p>(f) Impairments: The correction of these misstatements resulted in a decrease to SG&A of less than \$1 million and a decrease to benefit from income taxes of less than \$1 million for the year ended December 30, 2017.</p> <p>(g) Other: The correction of these misstatements resulted in a decrease to net sales of \$9 million, an increase to cost of products sold of \$1 million, a decrease to SG&A of \$24 million, a decrease to interest expense of less than \$1 million, and a decrease to benefit from income taxes of \$8 million for the year ended December 30, 2017.</p> <p>The values as previously reported for the year ended December 30, 2017, were derived from our Annual Report on Form 10-K for the year ended December 30, 2017, filed on February 16, 2018.</p>					

In her May 7, 2019, article for CNBC, Lauren Hirsch reported that about a dozen Kraft Heinz employees were reprimanded. One reason for the misstatements could be the company's bonus structure, since employees had to meet targets for earnings before interest, taxes, depreciation, and amortization (EBITDA) to receive bonuses. Thus, much pressure was placed on the procurement and operations teams, which was crucial to cost savings and meeting EBITDA goals. EBITDA grew by only 3 percent in 2017; the minimum goal was 6.1 percent (Hirsch, 2019). Additionally, in 2017, the company recognized a non-cash impairment loss of \$49 million in selling, general and administrative expenses, due ostensibly to continued declining sales of nutritional beverages piloted in India.

On February 21, 2019, Kraft Heinz Company reported its 2018 results. As a standout disclosure, the company concluded during the fourth quarter that the fair values of certain goodwill and intangible assets were below their carrying amounts. As a result, the company recorded non-cash impairment charges totaling \$15.4 billion. Of this amount, \$7.1 billion served to lower the carrying amount of goodwill in certain reporting units (primarily U.S. Refrigerated and Canada Retail),

and \$8.3 billion served to lower the carrying value of certain intangible assets (primarily Kraft and Oscar Meyer trademarks). These charges resulted in a net loss of \$12.6 billion and a diluted loss per share of \$10.34.

Comparing the 2018 income statement to the restated 2017 income statement, the following can be gleaned:

- Net sales increased from \$26,076 million to \$26,268 million (0.7 percent).
- Cost of products sold increased from \$17,043 million to \$17,347 million (1.8 percent).
- Operating income, which includes the two impairment losses, decreased from income of \$6,057 million to a loss of \$10,220 million (–268.7 percent).
- Net income decreased from income of \$10,932 million to a loss of \$10,254 million (–193.8 percent).
- Diluted EPS fell from \$8.91 to a loss of \$8.36 (–193.8 percent).

Pricing was flat, with lower pricing in the U.S. and Canada and higher pricing in the rest of the world. While supplies and transportation costs rose, Amazon and Walmart continued to provide stiff competition by lowering their food prices. To make matters worse, Kraft Heinz Company announced on February 21, 2019, that the March 22, 2019, dividends were being cut from \$0.625 per share to \$0.40 per share, representing a 36 percent decrease (Wattles, 2019). The CEO, Bernardo Hees, stated his belief that this action would help to accelerate the deleveraging plan, strengthen the balance sheet, divest poorly performing businesses, and improve the company's growth and returns over time.

The financial statements for the calendar year 2018 were not filed by the due date because of the needed restatements; the auditor's opinion is dated June 7, 2019. PwC stated that the financial statements for each of the three years in the period ended December 29, 2018, were presented fairly in accordance with U.S. Generally Accepted Accounting Principles (GAAP), but the "Company did not maintain, in all material respects, effective internal control over financial reporting as of December 29, 2018, ... because material weaknesses in internal control over financial reporting existed ... as the Company did not appropriately design controls in response to the risk of material misstatements due to changes in the business environment, ... and the Company did not design and maintain effective controls over the accounting for supplier contracts and related arrangements or to reassess the level of precision used to review the impairment assessments related to forecasted cash flows used with goodwill and indefinite-lived intangible asset impairment calculations."

2019–2020 Financial Difficulties

The year 2019 was not a good year. In response to the \$15.4 billion write-down, Kraft Heinz's stock price plummeted 27 percent from \$48.18 per share on February 21, 2019, to \$34.95 per share on February 22, 2019. In April, the Company fired CEO Bernardo Hees, CFO David Knopf, and other executives; Miguel Patricio became the new CEO. From the partial disclosure of the fraud when the stock price was \$56.20 per share, the stock dropped to \$26.50 per share on August 8, 2019. This drop of 53 percent caused a loss of \$36 billion in market capitalization. The company's cost-cutting strategy could only go so far and needed to be reevaluated. As an example, the company was far behind other competitors in offering plant-based food.

The company's net sales fell from \$26,268 million in 2018 to \$24,977 million in 2019 (a 4.9 percent decrease). Operating income rose from a loss of \$10,205 million to income of \$3,070 million primarily due to goodwill impairment losses being only \$1,197 million in 2019 compared to \$7,008 million in 2018 and intangible asset impairment losses being only \$702 million in 2019 compared to \$8,928 million in 2018. Therefore, the company had net income of \$1,933 million and diluted EPS of \$1.58 in 2019 compared to a net loss of \$10,254 million and diluted loss per share of \$8.36 in 2018.

The onset of 2020 brought Kraft Heinz no relief from financial difficulties. While net sales increased 4.8 percent from 2019 to 2020, net income dropped from \$1,933 million in 2019 to \$361 million in 2020. Goodwill impairment loss was \$2,343 million and intangible asset impairment losses were \$1,056 million. Diluted EPS was only 29 cents per share.

Along Came 2021 and 2022

Net income for 2021 was higher than in 2020; \$1,024 million vs. \$361 million. While net sales were down slightly, goodwill impairment losses were \$318 million in 2021 compared to \$2,343 in 2020. Diluted EPS rose from 29 cents per share to 82 cents per share. The company sold Planters as well as other assets in its Nuts Transaction which netted the company \$3.4 billion in the second quarter. The company recorded a non-cash impairment loss of \$230 million in selling, general, and administrative expenses in the first quarter and a loss on sale of a business of \$17 million in the second quarter.

Also, the company had a Cheese Transaction in November 2021 for \$3.34 billion. The total gain/loss on this transaction was insignificant.

Even though Kraft Heinz was still struggling (the company's stock price was \$38.99 on March 6, 2022), company executives presented a sunny financial forecast. According to a statement from Kraft Heinz Company CEO and Chairperson of the Board Miguel Patricio, "2022 was an incredible year for Kraft Heinz, delivering strong results and ending the fourth quarter with solid momentum that positions us well for 2023." Net sales increased 1.7 percent from the previous year, operating income increased 5.0 percent, and net income rose from \$1,024 million to \$2,368 million, an increase of 131.3 percent. Diluted EPS rose 132.9 percent. Factors affecting these positive trends included higher pricing (Sheildlower, 2023), lower non-cash impairment losses, efficiency gains, a favorable impact of a 53rd week of shipments, lower interest expense, and lower income tax expense. These operational factors more than offset obstacles to financial recovery, including higher supply chain and manufacturing costs due to inflationary pressure, and an unfavorable product volume/mix.

Concurrently, Kraft Heinz had to contend with non-operational factors which impeded its ability to rebound from prior years' missteps. The company not only reached an agreement with the SEC over its ongoing investigation, but it also became entangled in several legal actions within 2021 and 2022. For instance, in 2022, Kraft Heinz booked an accrual related to a previously disclosed punitive securities class action lawsuit, *Union Asset Management Holding AG et al. v. Kraft Heinz Company, et al.* A net expense of \$210 million within selling, general, and administrative expenses in the fourth quarter was the current estimate for the resolution of this matter. The company represented the estimated liability after insurance recoveries and contributions from other defendants.

Despite the glaring missteps by Kraft Heinz, the independent auditor's role in substantiating the company's financial reporting was not officially scrutinized. The SEC and the PCAOB have never charged PwC for negligence in providing clean opinions on the financial statements and internal controls over financial reporting for Kraft Heinz Company in the years under contention. The next two sections detail the SEC investigation as well as the class action securities fraud lawsuits levied against Kraft Heinz.

SEC Action Against Kraft Heinz and Its Procurement Executives

On September 3, 2021, Kraft Heinz Company filed a Form 8-K report in which it reported the company had reached a settlement with the SEC in connection with the ongoing investigation and agreed to pay a civil penalty of \$62 million. The accrual for the penalty was recognized in the financial results within selling, general, and administrative expenses on the income statement on Form 10-Q for the period ending June 26, 2021. Generally, fines and penalties are not tax deductible (i.e., a permanent tax adjustment).

The SEC charged Kraft Heinz with engaging in a long-running expense management scheme from the last quarter of 2015 to the end of 2018. The SEC held that Kraft Heinz engaged in numerous types of accounting misconduct, such as recognizing unearned discounts from suppliers and maintaining false and misleading supplier contracts, which reduced the company's cost of goods sold and thereby increased net income. These so-called "cost savings" were widely covered by financial analysts, and the accounting schemes resulted in an inflated adjusted "EBITA" earnings performance metric. After the SEC investigation began in June 2019, the company restated its financials, eliminating \$208 million in improperly recognized cost savings from less than 300 transactions. Consequently, as opposed to inflating revenues, Kraft Heinz underreported expenses to increase income and thereby mislead investors and other stakeholders.

More specifically, the SEC indicated that Kraft Heinz failed to design and maintain effective internal controls in the procurement division. Personnel repeatedly overlooked red flags that expenses were being accounted for improperly. Essentially, the procurement division employees circumvented internal controls and certified the accuracy and completeness of the procurement division's figures when the misconduct was occurring. Although the misreporting of expenses amounted to approximately \$181 million (Hirsch and Sheetz, 2019), Chief Operational Officer (COO) Eduardo Pelleissone improperly approved the company's financial statements, and PwC issued unqualified opinions.

According to the SEC, Kraft Heinz violated anti-fraud and recordkeeping requirements in federal securities laws. In particular, the company and its executives were charged with engaging in improper expense management practices involving numerous misleading transactions, overinflated cost savings, manipulated agreements with suppliers, and a pervasive breakdown in internal controls. As is often the situation with cases settled with the SEC, the company did not admit or deny the SEC's findings. Further, the company stated that it has fully cooperated with the SEC throughout its investigation and has taken prompt and remedial action to improve its internal controls.

Two former Kraft Heinz executives were penalized for their misconduct related to the accounting schemes, former COO Eduardo Pelleissone and former Chief Procurement Officer Klaus Hoffman. Pelleissone was charged with negligence-based anti-fraud, books and records, and internal accounting controls violations and agreed to a penalty of \$300,000 and another \$14,211.31 in disgorgement and prejudgment interest. Hoffman was also charged with negligence-based anti-fraud, books and records, and internal accounting controls violations, as well as failure to furnish accurate information to accountants. He agreed to pay \$100,000 in penalties and was barred from serving as a public company officer or director for five years.

Class Action Lawsuits Filed Against Kraft Heinz

Most class action lawsuits related to securities fraud are couched within the context of SEC Rule 10b-5 of the Securities and Exchange Act of 1934, which forbids a company to make a false statement of a material fact or to omit stating a material fact that would thereby make the statements made misleading. The six proof elements of a private securities fraud claim are (1) a material misrepresentation or omission by a defendant; (2) scienter (meaning an offending party has knowledge of the wrongness of an action or event prior to committing it); (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) relying on the misrepresentation or omission; (5) economic loss; and (6) loss causation (*Matrixx Initiatives, Inc. v. Siracusano*, 2011). Proceeding, several class action securities fraud lawsuits against Kraft Heinz are discussed.

Union Asset Management Holding AG et al. v. Kraft Heinz Company

On August 14, 2020, a class action lawsuit against Kraft Heinz was filed in District Court for the Northern District of Illinois by Germany's Union Asset Management Holding AG and Sweden's Sjunde AP-Fonden. The lawsuit alleged that Kraft Heinz's aggressive cost cutting measures drove away customers and suppliers. The plaintiffs claim that there was an intent to defraud as the company made optimistic statements which turned out to be false and misleading. Specifically, Kraft Heinz Company failed to disclose that its inadequate internal controls would initiate a significant write down of goodwill and certain intangible assets in its natural cheese business, Oscar Meyer cold cut business, and its Canadian retail business, due to supply chain issues.

In this dispute, the plaintiffs claim that Kraft Heinz stated that synergies, efficiencies, and eliminating redundancies would be beneficial to the merged entity; however, these claims proved to be false and instead resulted in indiscriminate cost-cutting measures that led to inferior products, deteriorating relationships with distributors, and an inability to meet retailers' demand. The merger and zero-based budgeting strategy did not result in the promised \$1.5 billion savings. These actions forced the company to recognize a \$15.4 billion impairment charge to goodwill and intangible assets in February 2019, thereby causing a precipitous drop in Kraft Heinz's stock price (*George Hedick v. Kraft Heinz Co.*, 2021). The defendants moved to dismiss the complaint, arguing that the plaintiffs did not provide sufficient facts to establish materially false statements, scienter, loss causation, a primary violation of the securities laws, and an insider trading claim.

George A. Hedick, Jr. v. The Kraft Heinz Company

The Hedick dispute was consolidated with the Union Asset Management Holding AG and Sjunde AP-Fonden lawsuit. Although the SEC apparently did not find any misconduct by Kraft Heinz senior management, the Hedick class action lawsuit includes the officers as defendants: CEO Bernado Hees, CFO Paul Babilio, CFO David Knopf, Alexandre Behring (Board of Directors), COO George Zoghbi, and Rafael Oliverira (President of Kraft Heinz Europe). The plaintiffs argued that defendant's certification that the internal controls were effective and provided reasonable assurances regarding the reliability of the defendant's financial reports was misleading.

The defendants argued that the \$208 million improperly-recognized cost savings were not material out of \$63.3 billion (only 0.04 percent) over years 2015–2018. However, Federal Judge Robert M. Dow, Jr. refused to rule on this issue. He suggested that both quantitative and qualitative factors should be considered in assessing financial statement materiality. He also indicated that securities attorneys often use 5 percent as a rule-of-thumb approach as to what is material. He cited the Fifth Circuit Court, in that the determination of materiality requires a delicate assessment of the inferences a reasonable shareholder would draw from a given set of facts and the significance of those inferences to the shareholder. Further, materiality determination is rarely appropriate at the summary judgment stage or on a motion to dismiss (*Marks v. DCW Computer Ctrs., Inc.*, 1997). A summary judgment stage refers to a motion to promptly dispose of a dispute where there is no genuine issue to any material fact of the lawsuit.

Judge Dow ruled that the mere fact that financial statements are restated is sufficient to plead that the statements are false and misleading. Moreover, the judge responded to the defendants' objection to the plaintiffs' use of anonymous employees as sources of information. Judge Dow made allowances for such a strategy, especially if the information from the anonymous witnesses is presented in "convincing detail," and the witnesses provide enough information about their jobs to show that they know "first-hand" the facts to which they were prepared to testify.

Judge Dow did not approve of Kraft Heinz Company's use of channel stuffing, a scheme in which the distribution channel is overrun with sales and revenues that may be fraudulent, such as bill-and-hold schemes (Crumbly and Fenton, Jr., 2021). Within this scheme, a company can send more goods to customers than they need, and the goods are later returned. Deep discounts, rebates, and extended payment terms can be used to stuff the distribution channel to cause an artificial bump in accounts receivable and revenue which misleads investors. Channel stuffing eventually collapses because the company cannot maintain sales of products at such an overinflated rate. A red flag of this scheme is that accounts receivable is increasing at a faster pace than sales. Part of PwC's auditing procedures should have been to investigate any side agreements with customers, calculate days sales outstanding in receivables, and evaluate the reasonableness of the results as compared to industry data.

Upon reviewing 233 pages of the amended complaint, 265 pages of briefings (prepared by lawyers on both sides) on two motions to dismiss, and other material, Judge Dow denied the defendants' motions to dismiss the shareholders' consolidated class action lawsuit on August 11, 2021. The plaintiffs overcame the initial hurdle in this federal securities fraud case, and the dispute is now in discovery. The plaintiffs moved for class certification in March 2022, and the case is ongoing as of January 31, 2023.

City of Hollywood Police Officers' Retirement System v. the Kraft Heinz Company

On March 25, 2020, another class action lawsuit against Kraft Heinz was filed in District Court, again arising from the company's alleged materially false and misleading statements and omissions after the \$15.4 billion write-down in value of its Oscar Meyer and Kraft trademarks and other intangible assets. In its complaint, the plaintiff, the *City of Hollywood Police Officers' Retirement System*, alleges that the company employed devices and schemes to defraud, made untrue statements of material facts or omitted to state material facts, and/or engaged in practices that operated as a fraud or deceit upon those purchasing common stock and options. Specifically, the complaint alleges misleading statements pertaining to: concealing that the company's cost-cutting measures had severely impaired its supply chain and brand value; accurately reporting the company's financial results; concealing that the cost reductions were not synergistic or efficiency-generating but instead impaired core business functions; and, reassuring investors about the integrity of the company's internal controls and the robustness of its goodwill impairment testing.

In May of 2020, Judge Dow ordered that the *Hollywood Police* case be transferred to his docket, in which the *Union Asset* case is pending (Cision PR Newswire, 2020). This action dovetails with the *Union Asset's* request for class certification. This case was ongoing as of November 9, 2022, but may be viewed in light of the consolidation of these disparate class action lawsuits.

Event Study

A major problem of estimating the damages in these types of class action lawsuits is to isolate the impact of other information or events that are unrelated to the misrepresentation that also affects the stock price. These other events, such as the general economic climate, affect the stock price. Two common methods, but-for-price lines and event studies can assist expert witnesses in avoiding trouble on cross-examination (Cheng and Crumbly, 2016). In particular, an expert witness would want to avoid possible *Frye* or *Daubert* challenges. According to Funk (2022), a *Frye* challenge refers to presenting the jury with a scientific methodology that is generally accepted in the scientific community, and based upon correct utilization of the methodology, little objection can be proffered to its findings; alternatively, in a *Daubert* challenge, the judge determines the admissibility of the method on preponderance of evidence, and not necessarily based on widely accepted use. In effect, the *Daubert* challenge is invoked more on a case-by-case basis and ostensibly provides more flexibility of acceptance.

The but-for-price line approach determines an estimate of the daily stock price had there been no fraud (i.e., but-for the fraud). This line is then compared to the actual daily price line to compute inflation per share. However, the Supreme Court has suggested that event studies are needed in securities fraud disputes (*Basic, Inc. v. Levinson*, 1988; *Dura*

Pharmaceuticals, Inc. v. Broudo, 2005). Accountants often are used by both plaintiff and defense attorneys as consultants and expert witnesses in these types of disputes.

Event Study Steps

Event study regression analysis can be used to ascertain the effect of particular happenings, such as company or SEC press releases, or the issuance of a Form 8-K describing a current event such as projected earnings or changes in dividend rates on the stock price of a company. Event study utilization relies on the efficient market hypothesis, described by Fama, Fischer, Jensen, and Roll (1969), which states that the market reflects all available information, and the price of a traded security responds quickly to new information. Event studies are most useful, according to Frank Torchio (2009), when the time that the new disclosure becomes public is known, the new disclosure was not anticipated, and the new disclosure's effect can be separated from market, industry, and issue-specific factors that can affect the company's stock price.

The steps needed to implement an event study on an alleged fraud consist of the following:

- a. Identify the event that is alleged to be a fraud and the time that it was disclosed to the public.
- b. Determine the time period in which the disclosure of the fraud affected the company's stock price.
- c. Choose a market index such as the S&P 500 Index or the NASDAQ Composite Index to remove the market effects from the day-to-day stock prices for the company.
- d. Choose an industry index or an average of competitors' returns to remove industry effects from the day-to-day stock prices for the company.
- e. The market returns and industry returns are used to calculate the predicted returns for the company assuming there was no fraud disclosed.
- f. Collect the daily stock prices for the company and the daily indices for the market and the industry over a period of time, such as 200 to 250 trading days.
- g. The regression equation for the event study is $CR = a + bMR + cIR$.
Where
CR is the company's returns (stock prices)
MR is the market returns (indices)
IR is the industry returns (indices)
- h. Apply the market model to compute the predicted returns for the company during the event window (the time period just before the disclosure date to just after the disclosure date) and compare them to the actual returns during that time period.
- i. The differences yield abnormal returns due to the disclosure.
- j. Test the abnormal returns for statistical significance.

Event Study Methodology and Results

In performing an event study, a three or five-day trading window is commonly used to ascertain the impact of the event on the company's stock price. Information may be leaked to the market before the event day; lagged market reactions to announcements on the event day may continue for a few days hence. In light of this, a five-day event window was chosen.

In order to isolate company-specific factors that are responsible for changes in a company's stock price, market and industry forces must be extracted. Once that process is accomplished, statistical tests can be conducted on the remaining stock price change to ascertain if the daily changes for the company's stock price is statistically different from normal random price movements (Feitzinger and Rozen, 2014). Therefore, prior to performing the regression analysis for Kraft Heinz, press releases and Form 8-Ks for the competitor companies were examined to determine if any detrimental events occurred during the month of February 2019. None was found.

To perform the regression, closing stock price data was gathered between the time period of May 1, 2018, through February 25, 2019. The event day is February 21, 2019, on which Kraft Heinz reported receipt of the SEC subpoena, the \$15.4 billion impairment loss, and a 36 percent dividend reduction. Stock price data was collected for Kraft Heinz Company (KHC), the NASDAQ Composite (^IXIC), Mondelez International, Inc. (MDLZ), Kellogg Company (K), General Mills, Inc. (GIS), and Conagra Brands, Inc. (CAG). The four companies listed represent close competitors of KHC, and an average was computed using their closing stock prices over the aforementioned time period as a gauge of the most likely trending stock fluctuations within the competitive space. Therefore, a regression equation was constructed with the dependent

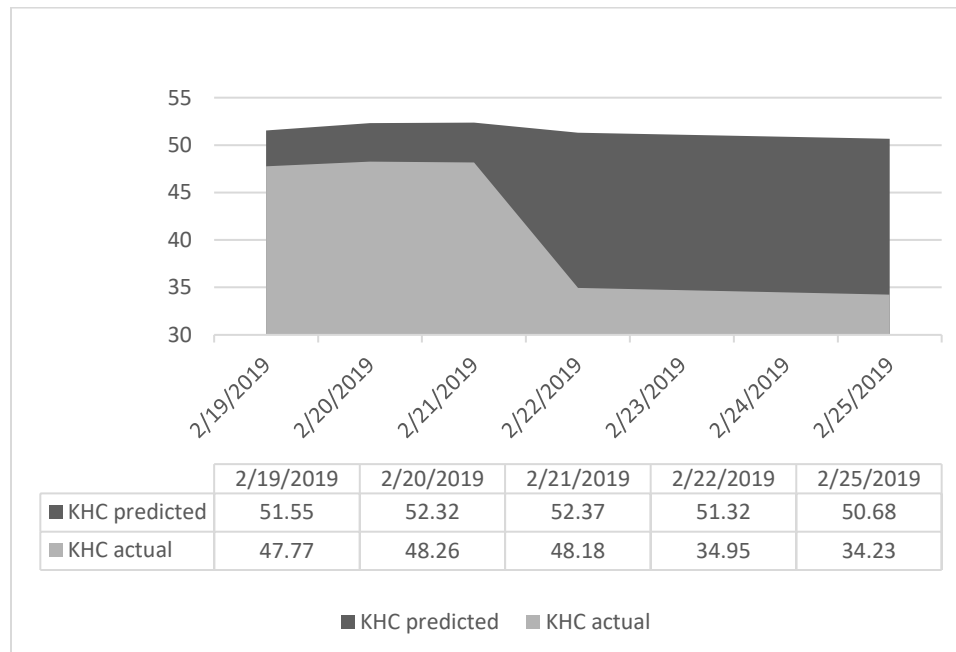
variable, KHC predicted, as a function of two independent variables: the NASDAQ Composite (NASDAQComposite) and the average of the four of KHC's closest competitors (CompepitorAVE).

The regression analysis stopped short of February 19, 2019, providing a five-day comparative window until February 25, 2019 (this included a weekend on February 23 and 24). The mean KHC stock price over the 201 data observation points was 55.05, with a standard deviation of 5.83. The regression was, not surprisingly, highly significant [$R^2 = 0.738$ $F(2, 198) = 279.579$, $p < 0.001$]. The analysis produced the following predictive equation:

$$KHC_{predicted} = -25.032 + 0.002(NASDAQComposite) + 1.406(CompetitorAVE)$$

Next, the regression equation was used to predict the KHC closing stock prices over the aforementioned five-day event window, and these results were compared to the actual closing stock prices over that window. A dependent, one-tailed t-test generated highly significant results between the predicted and actual stock price values [$t(4) = 2.13$, $p = 0.021$]. Exhibit 3 displays a graphical comparison of KHC's predictive and actual stock prices. As the graph clearly indicates, a precipitous drop in the actual stock price is observed between February 21 and 22 (from 48.18 to 34.95); this drop appears unaccounted for within the regression model. Such a shock to the stock price suggests that the investigative revelations had a significant effect on the stock price, thus substantiating the plaintiffs' claim that losses were suffered because of the improper activities afoot at Kraft Heinz.

Exhibit 3: Kraft Heinz Stock Price Five-Day Event Window



Note: A weekend occurred on 2/23 and 2/24.

Conclusion

Although the 2015 merger that created the Kraft Heinz Company initially appeared successful, 2019 disclosures painted a much different picture. Kraft Heinz made public an SEC subpoena, related to the investigation of ill-advised cost cutting strategies and arguably fraudulent activities in the procurement department. Adding to its woes, Kraft Heinz was compelled to report a \$15.4 billion impairment charge on goodwill and other intangible assets. Directly following these events, Kraft Heinz's stock price declined around 27 percent in one day (February 22) to \$34.95 per share, significantly curtailing its financial outlook. The company also was obligated to restate its 2016 and 2017 financial statements.

In 2021, the SEC contended that Kraft Heinz violated anti-fraud and recordkeeping requirements within the federal securities laws. Although Kraft Heinz paid \$62 million in restitution for this violation, the company neither confirmed nor denied its culpability regarding these allegations. In the meantime, Kraft Heinz was facing several class action securities fraud lawsuits, which is a common occurrence after a company restates its financials. These lawsuits were consolidated, under an action for class certification, with the *Sjunde AP-Fonden* and *Union Asset* case at the forefront. The parties reached

a settlement on May 2, 2023, in which the defendants, and insurers, will pay the plaintiffs \$450 million. The defendants continue to maintain their innocence as to the charges but agreed to the settlement to eliminate the protracted risk and expense of continued litigation (Kraft-Heinz-Settlement Stipulation, 2023). According to LaCroix (2023), this settlement is “massive,” and substantial enough to be included within the list of all-time largest settlements of its kind.

Upon consideration of the alleged procurement misconduct charges and the apparently abandoned accounting principles and appropriate internal control measures, this study presents observations that strongly suggest culpability on the part of Kraft Heinz in misleading its shareholders. Moreover, as the Supreme Court has suggested, this study conducts an event study regression analysis to determine the impact of the fraud disclosure event on the price of the stock. Results indicate that the shock of the fraud event had a significant effect on Kraft Heinz’s stock price and substantiate the plaintiffs’ position that shareholder losses were suffered in direct response to the company’s malfeasance.

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