ANEXOS

CFO Magazine

Kremed!

The rise and fall of Krispy Kreme is a cautionary tale of ambition, greed, and inexperience.

Kate O'Sullivan,

June 01, 2005

What could be more perfect than a Krispy Kreme doughnut? Hot from the fryer and loaded with sugar, the Original Glazed is practically irresistible. For a time, Krispy Kreme's stock seemed irresistible, too. When the company went public in April 2000, at the peak of the Internet whirlwind, investors flocked to buy into a business they could understand. An old-fashioned franchise based in Winston-Salem, North Carolina, Krispy Kreme Doughnuts Inc. boasted solid fundamentals, adding stores at a rapid clip and showing steadily increasing sales and earnings.

But Krispy Kreme also had a mystique. Its doughnuts, available for many years only in the Southeast, had attracted a devoted, even fanatical, customer base. When the company decided to go national, it opened franchises in locations guaranteed to generate buzz — Manhattan, Los Angeles, Las Vegas — and customers lined up around the block. By August 2003, KKD was trading at nearly $50 on the New York Stock Exchange, up 235 percent from its initial public offering price of $21 on Nasdaq, and Fortune magazine was calling Krispy Kreme the "hottest brand in the land." For the fiscal year ended in February 2004, the company reported $665.6 million in sales and

$94.7 million in operating profit from its nearly 400 locations, including stores in Australia, Canada, and South Korea.

And then, just as rapidly as its popularity spiked, Krispy Kreme pitched into a steep downward spiral that may yet end in bankruptcy. The company's woes surfaced in May 2004, when then-CEO Scott Livengood blamed low-carbohydrate diet trends for Krispy Kreme's first-ever missed quarter and first loss as a public company. That raised analysts' eyebrows, as blaming the Atkins diet for disappointing earnings carried a whiff of desperation.

The Securities and Exchange Commission came knocking in July 2004, making an informal inquiry into Krispy Kreme's buybacks of several franchises. As the stock price plunged, shareholders filed suit. Franchisees alleged channel stuffing, claiming that some stores were getting twice their regular shipments in the final weeks of a quarter so that headquarters could make its numbers. The SEC upgraded its inquiry to "formal" status in October 2004. Average weekly sales, a key retailing measure, fell even as the company continued to add stores. In January 2005, Krispy Kreme decided to restate its financials for much of fiscal 2004. Livengood was replaced as CEO by turnaround specialist Stephen Cooper, who also kept his other job: interim CEO of Enron Corp.

The following month, the company announced that the United States Attorney's Office of the Southern District of New York was also joining the fray — a move indicating concern about possible criminal misconduct. In April, Cooper shored up the business by securing $225 million in new financing. The company announced that it expected a loss for its latest quarter, and warned investors not to rely on its published financials for fiscal 2001, 2002, and 2003, and the first three quarters of fiscal 2005, in addition to those for 2004. By early May, Krispy Kreme still hadn't filed its restated financials, and its shares were trading around $6.

What went wrong? How could a company in business for nearly 70 years, with an almost legendary product and a loyal customer base, fall from grace so quickly? The story of Krispy Kreme's troubles is, at bottom, a case study of how not to grow a franchise. According to one count, there are at least 2,300 franchised businesses in the United States, and many are extremely successful. But there are pitfalls in the franchise model, and Krispy Kreme — through a combination of ambition, greed, and inexperience — managed to stumble into most of them.

Aggressive Growth

From its humble beginnings in 1937 as a family-owned business, Krispy Kreme slowly enlarged its footprint in the Southeast. In 1976, three years after founder Vernon Rudolph died, the company was sold to Beatrice Foods Co.; in 1982, a group of franchisees bought it back. In 1996, the company began to stake its claim as a national franchise.

But once Krispy Kreme went public, "there was enormous pressure, as there is for all companies, to grow very quickly and sustain growth quarter after quarter after quarter," comments Steven P. Clark, an assistant professor of finance at Belk College of Business at the University of North Carolina at Charlotte. Unfortunately, adds Clark, "this was not the sort of business that was going to have that kind of unending growth."

McDonald's Corp. is the gold standard in franchising, driving such profitability to individual restaurants that franchisees are eager to join the system and follow the company's stringent operating guidelines. But Krispy Kreme concentrated on growing revenues and profits at the parent-company level, while its outlets struggled. "You can often get a system to grow really large even when particular outlets aren't really profitable," notes Scott Shane, SBC Professor of Economics at Case Western Reserve University's Weatherhead School of Management and an expert on franchising. Franchises, he explains, suffer from "goal conflict": while the franchisor aims to maximize sales, and thus boost royalty payments, the franchisee needs to maximize profits. If a franchisor packs a market with outlets to boost its own growth, it hurts the system in the long run by forcing units to compete with one another.

"You might add another outlet in a market and increase your sales by 50 percent, but you might have turned franchisees in that market from profitable to unprofitable," says Shane. Thus Krispy Kreme reported nearly a 15 percent increase in second-quarter revenues from fiscal 2003 to fiscal 2004, but same-store sales were up just a tenth of a percent during that time. The waning of a fad? Perhaps. But citing the issue of "significantly declining new unit returns" in August 2004, J.P. Morgan analyst John Ivankoe wrote: "These returns declined as [the] incremental appeal of each new retail store fell upon market penetration." A year earlier, Ivankoe had downgraded the stock from "neutral" to "underweight," the equivalent of a "sell" rating.

Getting Greedy?

Having to share markets with other outlets isn't the only handicap for franchisees. In addition to the standard franchise fee and royalty payments, Krispy Kreme requires franchisees to buy equipment and ingredients from headquarters at marked-up prices. This strategy, while not unheard of, can hurt franchisees in the long run.

"There are a couple of ways that franchise companies can look at the selling of equipment and formula," says Steve Hockett, president of FranChoice Inc., a company that matches potential franchisees with franchisors. "One is that it's a true profit center, even to the point where companies can be aggressive on pricing. But most successful franchise companies build their business around the royalty payment; they don't build it around equipment sales." Over time, says Hockett, "the franchisor is more likely to succeed by building profitable franchisees that can make royalty payments."

Giant Krispy Kreme competitor Dunkin' Donuts, for example, doesn't "generally sell equipment or product to [its] franchisees," says Kate Lavelle, CFO of the 6,400-store chain. "We have a strong royalty stream that is based solely on store sales." This model, says Lavelle, "keeps company and franchisee interests aligned."

Krispy Kreme, on the other hand, raked in $152.7 million — 31 percent of sales in 2003 — through its Krispy Kreme Manufacturing and Distribution (KKM&D) division, which sells the required mix and doughnut-making equipment. With initial equipment packages selling for $400,000, KKM&D can have operating margins of 20 percent or greater. But what's good for the franchisor's bottom line isn't necessarily good for the franchisee's. "[Raw ingredients and equipment] are sold to franchisees at what [is] an exceptionally high margin.... It is difficult to say how much this margin needs to drop to support franchise operations, but it must," wrote Ivankoe in an August 2004 report.

The Thrill Is Gone

In its quest for growth, Krispy Kreme also squandered some of its mystique. "They became ubiquitous," says Jonathan Waite, an analyst for KeyBanc Capital Markets in Los Angeles. "Not just in sheer numbers of restaurant units, but also roughly half of their sales started going to grocery stores, gas stations, kiosks. Anywhere that consumers could be found, you could find a Krispy Kreme."

In what amounted to an act of heresy to Krispy Kreme devotees, the company also added smaller "satellite" stores that didn't actually make doughnuts. Unlike its factory-style franchises where customers could watch as the pastries were showered in glaze — "doughnut-making theater," the company called it — some new stores offered doughnuts that had been made elsewhere. Other products were added to the menu, too, including a line of high-carb, high-calorie frozen drinks, or "drinkable doughnuts," as people dubbed them.

Straying further from the appeal of its key product, in May 2004 the company announced that it was developing, of all things, a sugar-free doughnut, in response to the popularity of low-carb diets. (The sugarless doughnut has yet to be rolled out, however, and the new management team is reviewing the concept.)

Fudging the Numbers

As Krispy Kreme pursued its ambitious growth strategy, it was making missteps in the finance department as well.

Except for the company's plan to finance a $35 million mixing plant in Illinois with an off-balance-sheet synthetic lease — a plan the company scuttled in February 2002, in the face of post-Enron suspicions — Krispy Kreme's accounting seemed unremarkable until October 2003. That's when the company reacquired a seven-store franchise in Michigan, called Dough-Re-Mi Co., for $32.1 million. The company booked most of the purchase price as an intangible asset called "reacquired franchise rights," which it did not amortize, contrary to common industry practice. Krispy Kreme had also agreed to boost its price for Dough-Re-Mi so that the struggling franchise could pay interest owed to the doughnut maker for past-due loans. The company then recorded the subsequent interest payment as income.

Krispy Kreme also rolled into the price the costs of closing stores and compensating the operating manager and principal owner of the Michigan franchise to stay on as a consultant. Both of these expenses became part of the intangible "reacquired franchise rights" asset on the company's balance sheet, rather than costs that would have reduced the company's reported earnings. Krispy Kreme announced in a December 2004 8-K filing that it will need to make a pretax adjustment of between $3.4 million and $4.8 million to properly record the compensation as an expense. A second adjustment of some $500,000 will reverse the improper recording of interest income.

Krispy Kreme's repurchase of its northern California stores from a group of investors is also under scrutiny. In February 2004, the company paid $16.8 million to buy the 33 percent of Golden Gate Doughnuts LLC it did not already own. One of the beneficiaries of the buyout was the ex-wife of CEO Scott Livengood. The company failed to disclose this fact, although Adrienne Livengood's stake was valued at approximately $1.5 million. While the decision not to reveal the connection looks bad, "this is only a significant legal issue if it somehow could be established that [Livengood] was seeking some kind of personal profit or gain through his ex-wife, as opposed to truly serving the company's interest," says Carl Metzger, a partner with Goodwin Procter LLP in Boston.

In its December 8-K, Krispy Kreme revealed that there would need to be adjustments made to the accounting for the Golden Gate Doughnuts purchase as well — a total of $3.5 million to correct improperly recorded compensation expenses and management fees that had been included in the purchase price. The company will also make a similar correction to fix errors made in the acquisition of a franchise in Charlottesville, Virginia.

On top of the questionable accounting and the lack of disclosure, Krispy Kreme may have paid inflated prices for some of the franchises it bought back. In 2003, the company spent $67 million to repurchase six stores in Dallas and rights to stores in Shreveport, Louisiana, that were owned in part by former Krispy Kreme board member and chairman and CEO Joseph A. McAleer Jr. Another longtime director, Steven D. Smith, was also part owner. Compared with the $32.1 million paid for the Michigan stores that same year, the number sounds high — $11.2 million versus $4.6 million per store. A civil suit filed by another former franchisee alleges that a higher bid was offered but ignored.

"I asked a lot of questions about why they paid so much for those acquisitions," says one analyst. "I don't think I ever truly got an answer. They told me it was a different time in terms of valuation, but those were pretty exorbitant prices." The SEC, presumably, will insist on an answer in the course of its investigation.

Who Minded the Store?

The company's own investigation, as detailed in an April notification to the SEC, has turned up accounting problems in other areas, too, involving derivatives, leases, equipment sales, and the consolidation of a bankrupt subsidiary. Even if these turn out to be mostly peccadilloes, they raise a question: Who was minding the store in the finance department?

As it turns out, a lot of people. From 2000 to 2004, Krispy Kreme employed three different CFOs. John Tate joined just after the company went public, in October 2000, after 18 months at kitchenware retailer Williams-Sonoma Inc. Tate was promoted to chief operating officer in 2002, and Randy Casstevens, the company's longtime controller, took the top finance spot. Casstevens, who had spent most of his career at Krispy Kreme, had never been CFO of a public company before. After adding the chief governance officer role to his duties, Casstevens left in December 2003 in a move he then called "purely voluntary," just five months before the company announced its first earnings miss. (Now working as a career counselor at Wake Forest University in Winston-Salem, Casstevens declined to be interviewed for this story.)

To replace Casstevens, Krispy Kreme brought in current finance chief Michael Phalen, who had worked with Krispy Kreme as an investment banker for CIBC World Markets and Deutsche Banc Alex. Brown, but had never held a CFO post before. The company declined to make Phalen available for an interview. John Tate, meanwhile, departed in August 2004, and is now the operations head at Restoration Hardware, working once again with his former boss from Williams-Sonoma. Tate did not return phone calls for comment.

Company watchers come to different conclusions about the meaning of the CFO churn. Ric Marshall, chief analyst at governance watchdog The Corporate Library, says the turnover may mean the CFOs were trying to raise red flags about the company's financial state. "To me, this says the real numbers the CFOs were coming up with were numbers that the rest of management didn't want to hear. They were looking for a CFO who was going to tell them good news." Adds Goodwin Procter's Metzger, "It may be that a particular CFO is the one who brought these issues to the company's attention. You just don't know." But the fact that Tate and Casstevens were both promoted before leaving indicates that they were on good terms with the board and their fellow managers. All three CFOs answered to Livengood, whose 27 years at the company gave him far greater tenure than any of the finance chiefs.

Stephen Mader, vice chairman of executive recruiter Christian & Timbers, says the CFOs simply may not have been up to the task of guiding a high-growth franchise through the public markets. "This happens a lot with companies that enter the public arena that had done well under earlier conditions, but don't have the experience in the public markets," he says. "You could simply have nothing more here than a lot of marginal competence for running a company of that magnitude."

Current finance chief Phalen "is a capable guy," comments Waite. "If you look at his compensation structure, it's mainly stock options. He has incentive to get the ship righted." But Mader is less optimistic about the CFO's chances. "It's very rare to take a company into bankruptcy or a turnaround phase and hold on to the existing CFO to do it," he says. "You need someone with no baggage, no sacred cows, who can look at things with objectivity."

A Missing Ingredient

When Krispy Kreme was a fast-growing private company, it was easy to conceal weaknesses in management and corporate governance. But those weaknesses were magnified by the pressures of the public markets, particularly when the company's growth strategy started to stumble, says Marshall. "When you don't have a fully independent board holding management responsible for operational and strategic shortcomings, a machine moving that quickly is going to fall apart," he says. "They really weren't able to sustain the growth rate."

Until recently, Krispy Kreme's board was stocked with insiders left over from the company's days as a private business, including some, like McAleer and Smith, who owned franchises. And until early 2002, the company maintained a fund through which

35 executives could invest in franchisees, potentially creating conflicts of interest. Management elected to dissolve the fund as part of a push to improve governance.

In another questionable move, in 2003, Krispy Kreme purchased Montana Mills Bread Co., a bakery-café chain at which Tate, then chief operating officer, was a director. Tate has said he was not involved in discussions about the transaction. Krispy Kreme put Montana Mills up for sale a year later, after paying approximately $40 million in stock for the business and then recording a $34 million charge upon closing most Montana Mills stores. Together with the problematic franchise buybacks, the transaction smacks more of an insider deal than simple incompetence.

A further warning sign of weak governance was the outsized compensation package awarded to former CEO Livengood, says Marshall. Livengood's total compensation was more than 20 percent greater than the median for similar-size companies, according to The Corporate Library. Despite the company's decline, Krispy Kreme's board allowed Livengood to retire with a six-month consulting position that will pay him $275,000. He holds $1.7 million in options in addition to nearly 100,000 shares of Krispy Kreme stock. Livengood also continues to receive health benefits through the company, but he will no longer have use of the company jet, since one of new CEO Cooper's first moves was to sell off the aircraft lease.

"When we see patterns of excessive compensation, that is usually an indicator that the board is not sufficiently independent," says Marshall. As a result of the board's coziness, he says, no one stepped in to challenge Krispy Kreme's move away from the fresh-doughnut model, and no one questioned the aggressive accounting for franchise buybacks. "It was a classic governance failure," sums up Marshall.

A Fresh Start

Although Krispy Kreme today looks like a company becalmed, if not sinking, some observers believe it will regain momentum. "Krispy Kreme as a company still has a lot of value in its name and in its product," says attorney Metzger. "There should be a way for the company to continue to grow the business."

With the January 2005 replacement of Livengood with Cooper, the revamped board — in which 8 of 10 directors are fully independent, according to The Corporate Library — has shown it is serious about making a turnaround. Since his arrival, Cooper has lined up $225 million in new debt financing led by Credit Suisse First Boston, Silver Point Finance, and Wells Fargo Foothill Inc. to help Krispy Kreme meet its immediate cash-flow needs. Cooper also announced a cost-cutting program that includes a 25 percent reduction in head count.

UNC's Clark suggests the company may need to go private or sell itself to another large chain, like McDonald's. "But I'm not sure that buyers are exactly lining up at the door," he adds. KeyBanc's Waite calls an acquisition doubtful, in part because he says the company is "not terribly cheap," given the amount of work needed to get it back on track. Indeed, Waite hasn't ruled out the possibility of bankruptcy. "The biggest thing they have to do is bring on an operator," he says. "They need an industry insider who can stem the drop in sales at the unit level — somebody who knows how to drive organic sales growth."

Ultimately, Krispy Kreme needs to get back to what fueled its phenomenal growth in the first place: really good doughnuts. "They need to emphasize the hot-doughnut experience," says Waite, "rather than the cold, old doughnut in a gas station."

Half-Baked

Krispy Kreme first reported solid growth, but has since announced that its results for 2001-2005 are not reliable.

2002 2003 2004

Total revenue* $394.4 $491.6 $665.6

Net Income* $26.4 $33.5 $57.1

Total long-term debt* $3.9 $62.4 $146.2

Number of stores 218 276 357

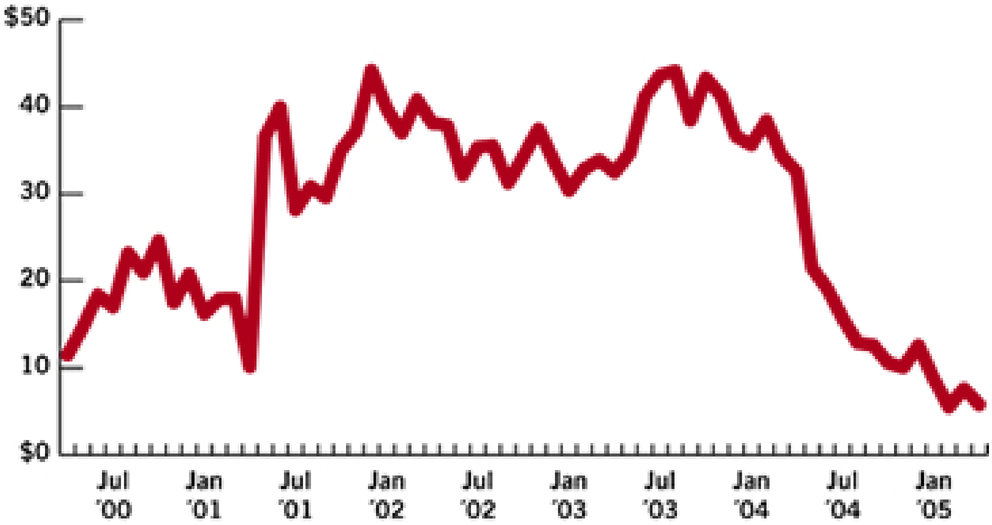
Note: Figures for fiscal years ended in February

*in $ millions

Source: www.krispykreme.com

Sugar High

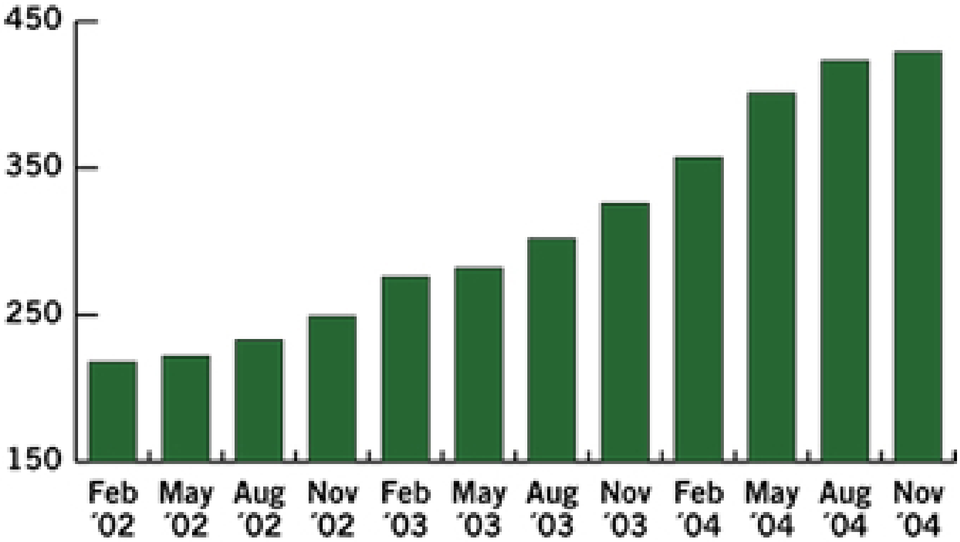
The fall of Krispy Kreme's stock price left investors depressed.



*Monthly close prices, adjusted for dividends and splits.

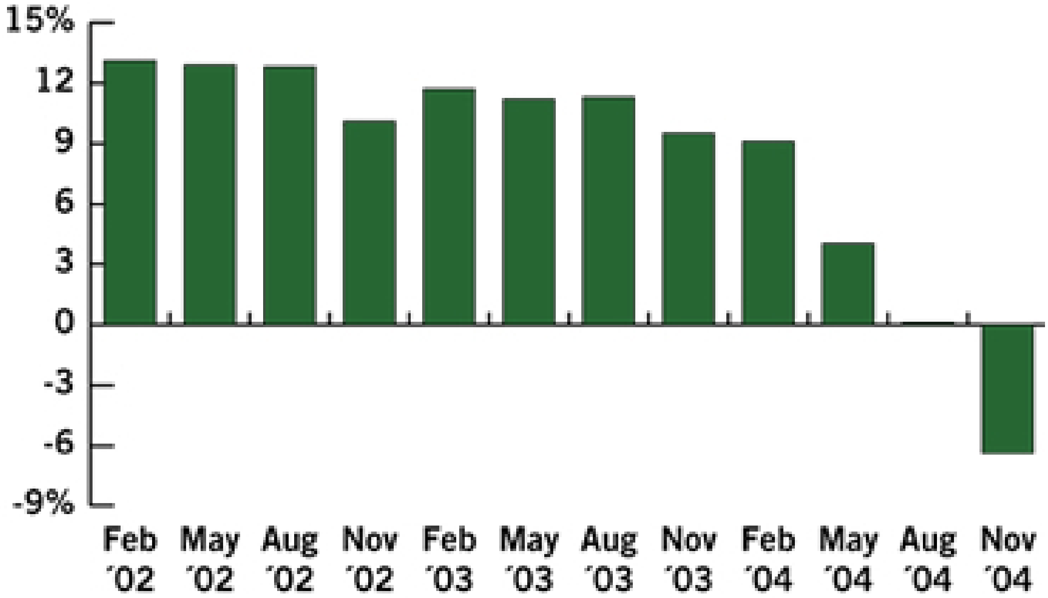
As Stores Go Up...

Number of Krispy Kreme stores systemwide



Growth Goes Down

Percentage change in comparable store sales systemwide



Source: Company documents

The Boston Herald

Krispy's Kremed as 2 stores shut doors

By Donna Goodison

Thursday, December 8, 2005 - Updated: 04:24 PM EST

The red neon "Hot Doughnuts Now" lights will no longer shine in Medford and Saugus.

The Krispy Kreme stores there abruptly closed after debuting to much fanfare, but short-lived crowds for their signature hot "original glazed" doughnuts.

New England Dough LLC - the Cranston, R.I., franchisee that opened seven Krispy Kremes in Massachusetts, Rhode Island and Connecticut since 2002 - is selling its interest in all but one of the stores to its corporate partner, Krispy Kreme Doughnuts Inc.

"The infrastructure for the company to run the stores was too expensive," said Janice Mathews, vice president of New England Dough. "This company is set up to run 50 or 60 of every concept."

New England Dough is operated by Jan Cos., which also owns 76 Burger Kings and 13 Newport Creamery restaurants. A 49 percent equity partner with Krispy Kreme, it originally planned to develop 16 of the doughtnut shops over five years under a 2000 deal.

While Mathews said the Krispy Kremes were not losing money, she acknowledged they weren't making as much as anticipated. The company was unable to launch wholesale operations at its Medford and Saugus stores as planned. Its other locations make doughnuts sold at 300-plus grocery and convenience stores.

At a 24-hour Dunkin' Donuts that sits next to the Saugus Krispy Kreme, manager Carla Alexander had been hearing closing rumors for months.

Krispy Kreme's luster as a power doughnut retailer has faded amid accounting problems, an SEC probe, top executive resignations and shareholder lawsuits. The company, whose stock traded at $6 last week after hitting nearly $50 in 2003, has not filed a financial statement since September 2004.

Wall street investors magazine.

01-SEP-04

Snack Food & Wholesale Bakery

Wall Street investors apparently lost their appetite for Krispy Kreme Doughnuts' stock after the chain missed analysts' projections, reported a 55% decline in second quarter earnings and refused to provide earning guidance for its third quarter.

Moreover, the company's independent auditor reportedly declined to sign off on KKD's financial statement for the second quarter.

In a Sept. 10 filing with the SEC, Krispy Kreme noted that the auditors would not complete its review of financial statements until an independent law firm hired by Krispy Kreme's board provided additional information concerning an unspecified acquisition in fiscal 2004.

Krispy Kreme's stock, which has traded upward of $44 dollars during the previous 52 weeks, stood at below the $12 mark in mid-September.

For the second quarter ending Aug. 1, the Winston-Salem, N.C.-based company earned $5.7 million compared with $13 million for the same period year ago.

Additionally, Krispy Kreme lowered system sales guidance for fiscal 2005 by 15% and announced that it will open 75 stores next year--about 25 fewer than anticipated.

Scott Livengood, chairman, president and CEO, stressed that the company was going to focus less on growth and more on building the profitability of existing stores, which experience huge sales when they first open only to see sales moderate as time goes on. As a result, the mini-factories eventually can find themselves overstaffed for their revenue levels.

In some areas where it's not profitable, Krispy Kreme may de-emphasize its once-explosive off-premise sales and focus more on on-site sales where consumers can enjoy hot, glazed donuts fresh from the fryer. Additionally, the company plans to open stores smaller about 2.000 sq. ft.) than its traditional stores, which some analysts say are big for small-and mid-sized markets.

Brief Blog, Revista de publicidad y marketing

Lunes, 30 de Mayo del 2005 | 12:48 pm

Krispy Kreme: Crecimiento en Serio

Por: Arturo de Albornoz

En últimas fechas, Krispy Kreme se ha convertido en una marca que muchas personas buscan. En gran parte, esto se debe a las exitosas campañas de relaciones públicas que se han estado llevando a cabo, tales como Saca 10 con Krispy Kreme y el programa de financiamiento para instituciones sin fines de lucro.

Más allá de lo lucrativas que están resultando sus donas, Krispy Kreme anuncia una nueva promoción al público basada en su gama de bebidas heladas con sabores Krema Original con o sin café, Frambuesa, Latte y Doble Chocolate con o sin café. Para la temporada de calor, promoción consiste en el sistema de "compra frecuente", regalando una presentación por cada 5 compras anteriores de dichos productos.

Por otra parte, la firma anuncia que este año abrirá 10 nuevos puntos de venta, uno de ellos recién inagurado en San Jerónimo y, dentro de dos meses, abrirá una nueva tienda en el Wal-Mart de San Marcos, Cuautitlán Izcalli.

Baking Business Magazine

Krispy Kreme awards development rights in Mexico for 20 stores

(May 13, 2003)

by Lyle Niedens

Regular Format

WINSTON-SALEM, N.C. -- Krispy Kreme Doughnuts, Inc., said Tuesday it has awarded development rights for Mexico to Grupo AXO, founded in 1994 to develop internationally known brands throughout the country.

Krispy Kreme and Grupo AXO will form Krispy Kreme Mexico, S. de R.L. de C.V., which will develop 20 stores during the next six years throughout Mexico. Krispy Kreme will retain a 30% equity stake in the venture.

Grupo AXO has developed brand outlets for Tommy Hilfiger and opened Warner Bros. Studio stores in Mexico. Scott Livengood, Krispy Kreme's chief executive, praised AXO's commitment to high-quality standards.

"Grupo AXO has an impressive history of expanding some of the world's top brands in Mexico," Mr. Livengood said. "They also possess a clear understanding of our business and our brand."

The deal marks the fourth international venture of its kinds for Krispy Kreme. The company also has unveiled plans to open stores in New Zealand, Australia and the

United Kingdom and already has opened an outlet in Canada. It continues exploring franchise opportunities in Japan, South Korea and Spain, Mr. Livengood said.

Arturo Berkstein, who spent most of his career with McDonald's Corp. and helped guide the fast-food chain's expansion into Mexico, will manage Krispy Kreme's day-to-day operations in the country.

Shares of Krispy Kreme rose as much as $1.31, or 4%, to $32.50 in Tuesday trade.

Forbes Magazine

Krispy Gets Kremed

Elizabeth MacDonald, 08.10.05, 1:20 PM ET

NEY YORK - Krispy Kreme Doughnuts needs to restate past profits downward by $25.6 million, says a report from a special committee investigating the Winston-Salem, N.C.-based doughnut maker's financial statements.

The report recommended restating earnings downward by $22.2 million for fiscal 2001 to 2004, and another $3.4 million for previous years. Ouch. The $22.2 million alone represents a 17% downward revision in total profits of $131.7 million for 2001 through 2004. The company's stock closed down 12 cents Tuesday at $7.15.

The report poses yet another setback for the once-legendary doughnut maker, which met with much positive press when it went public in April 2000 at $21. Before its problems engulfed it, Krispy Kreme (nyse: KKD - news - people) had an aura to it. Its doughnuts--celebrated in the Southeast--had created an obsessive customer base. All that, plus solid fundamentals, an aggressive expansion plan (with stores added almost daily) and climbing sales pushed its shares to almost $50 by August 2003.

What happened?

The report, from the special investigative committee co-chaired by Michael Sutton, formerly chief accountant of the U.S. Securities and Exchange Commission, and

Lizanne Thomas of the Jones Day law firm, blames a corporate culture that was focused on Wall Street earnings estimates with a fanaticism matched only by its zealous customers.

"The Krispy Kreme story is one of a newly public company, experiencing rapid growth, that failed to meet its accounting and financial reporting obligations to its shareholders and the public," the report says. "While some may see the accounting errors discussed in our summary as relatively small in magnitude, they were critical in a corporate culture driven by a narrowly focused goal of exceeding projected earnings by a penny (per share) each quarter." Moreover, the report points the finger at former Chief Executive Scott Livengood and his aide, John Tate, as being responsible for the company's problems.

The company's problems date back to May 2004. At that time, Livengood blamed the low-carb Atkins diet for the company's first-ever miss in its quarterly earnings and its first loss as a public company. Blaming a diet for poor profits seemed a stretch, and that led to some head scratching among analysts.

Then the SEC swooped down in July 2004, with an informal inquiry into Krispy Kreme's repurchases of several franchises.

Allegations of channel stuffing surfaced, where franchises alleged they were getting double their usual shipments at the end of a quarter in order for the company to make its numbers. In January 2005, Krispy Kreme announced it would restate its financials for much of fiscal 2004. Livengood was then dumped as CEO, and turnaround specialist

Stephen Cooper stepped in. Shareholder and employee suits were filed, and the United States Attorney's Office of the Southern District of New York also announced it was investigating, raising concerns about possible criminal misconduct.

"While the company still faces serious challenges, we believe we are addressing the critical issues," Cooper said in a statement.

THE DALLAS MORNING NEWS

1st Latin American store opens near Mexico City

By Ricardo Sandoval

January 30, 2004

MEXICO CITY – Fast-growing Krispy Kreme opened its first Latin American store last week in Interlomas, a wealthy community just west of Mexico City, to crowds mirroring its success in its first few years as a public company.

The Mexico City store marks the fourth international joint venture for Krispy Kreme.

Grupo Axo – a Mexican marketer of international brands such as Tommy Hilfiger – owns 70 percent of the Mexico City operation. Within six years, the franchise is expected to include 19 more locations in large Mexican cities, according to company officials.

"Mexicans are good consumers of name brands," said Arturo Berkstein, director general of Krispy Kreme de Mexico. "We've seen that in the other Grupo Axo lines in Mexico – Koch, Donna Karan and Warner Bros. clothing. But food is different because of the strong traditions here. We were pleased to see cars following our promotion trucks to see where the new store would be."

At the Interlomas store, a Krispy Kreme employee studied the long queue stretching out onto the sidewalk. "This is the kind of globalization I like. This is the kind of investment Americans should make with Mexican partners. Just look at all these people working in a clean environment," he said.

Long-range plans for the company include a network of stores in other Latin American countries, a spokeswoman said.

Last year, Krispy Kreme opened stores in Australia and the United Kingdom, and added 10 more to its Canadian chain. Beyond Mexico, new Krispy Kreme stores are slated in 2004 for Japan and other Asian nations.

"We've had good luck," spokeswoman Robin Phefferkorn said. "None of our U.S. markets is saturated yet, and now we are an outward-looking company."

Based in Winston-Salem, N.C., the company has grown rapidly since its initial public offering in April 2000. It's weathered a recession and skeptical analysts who said the company was overvalued and close to the market-saturation point in the United States.

Despite some 326 locations in the United States today, there are still some states without the tell-tale Krispy Kreme storefronts and flashing "Hot Doughnuts Now" signs. And like Starbucks before it, Krispy Kreme is finding it has millions of taste buds yet to conquer beyond U.S. borders.

But bringing the hottest thing in American doughnuts to Mexico presented new challenges: Mexicans routinely look down on new American food imports or see them as threats to their traditional cuisine.

Mexicans booed the opening 15 years ago of the first McDonald's. And Starbucks was greeted with disdain when it arrived last year. Both brands now are doing well in Mexico.

Pricing is another challenge.

North of the border, Krispy Kreme bills itself as a family bargain. In Mexico, however, an original glazed confection costs just under $1, while a box of mixed doughnuts runs just over $10, based on current exchange rates.

Still, there are several million upper-middle class and high-income people living in and around Mexico City. There are enough good earners to fuel dozens of high-end restaurants, shopping centers and upscale coffee houses such as Starbucks, whose brews fetch double what most neighborhood coffee stands charge in Mexico City.

"Nothing can replace pan dulce," said Marissa Perdomo, a housewife who sampled a hot glazed doughnut recently. "First, these are expensive for Mexico. But these are good, unlike any of the American-style doughnuts we've seen here before. I'll come back as an occasional treat to myself and then spend an extra hour in the gym to work it off."

BISNIS

International Market Insight: FAST FOOD MARKET IN THE RUSSIAN FAR EAST

Date: 28 Mar 2004

Source: U.S. Commercial Service Vladivostok

Where to have lunch –served fast and inexpensive?

It is difficult to answer this question in the RFE. Russian cuisine has always been delicious and nutritious, but Russian cafes and restaurants have always been notoriously slow. A hungry person limited to an hour at lunchtime should be ready to exceed this time limit in a restaurant, be served by a leisurely waiter in a half-empty room, and pay 90-120 rubles ($3-4, when the average salary is $100) for just a single course. Most of the cities in the region do not have inexpensive cafes, where one can be served within ten minutes or have a boxed meal for takeout. This niche is filled by old women in aprons that sell cheap low quality piroshkis (stuffed buns) from plastic boxes at train and bus stations, central streets and rynoks (open air shopping sites and flea markets). Those who have courage to buy this food have to then search for a soft drink seller, and must consume their meal as they walk. Unable to buy prepared or half-prepared food of good quality, Russians tend to spend extra time preparing food at home, which they bring to their offices in jars and boxes.

Chinese Cuisine

The niche for Chinese food was not occupied till the middle of the 1990s, when the omnipresent Chinese rapidly penetrated the market and set up several cafes in the RFE with Chinese cuisine and faster service (though still not at what would be considered "fast food"). Asian food with much fat (unlike "American" Chinese cuisine) and unusual spices does not appeal to many Russian consumers, and though prices are not very high, these cafes are not considered to be inexpensive either.

Fast Food Cafes

Fast food cafes in the RFE are located mainly in large cities -- Vladivostok, Khabarovsk, Yuzhno-Sakhalinsk, and Blagoveshchensk, which are visited more often and have a high concentration of educational institutions and businesses. Middle-aged Russians have very conservative tastes -- usually, they stick to Russian cuisine. Most RFE cafes that serve other countries' cuisine have to offer traditional Russian food on the menu as well. There are few fast food cafes in the RFE with decent food and service – Pizza-M, Pizza-Land, Zhemchuzhina (pizza), Skandinaviya (buffet) in Vladivostok and Pacific Cafe in Yuzhno-Sakhalinsk (a U.S. joint venture). Coffee shops are also starting to enter the market, and in Vladivostok Studio Cafe and Paparazzi recently opened. Each have modern design, European cuisine and good service.

The major problem with RFE fast food service is the low quality of both food and services (usually personnel are not properly trained) and primitive interior design. This is Magic Burger (Vladivostok), a low-quality fast food café that was initially designed to look like McDonald's. Likewise, Chikki-Rikki (Vladivostok) is a primitive copy of Kentucky Fried Chicken. Magic Bell Mexican cuisine (Vladivostok) serves a low-quality food, which hardly resembles Mexican. The directors of these two cafes failed to buy franchising rights and attempted to use the idea of world-famous brands. Till recently, there was not a tradition in Russia to establish cafes and snack bars in malls. Today, only several RFE shopping centers have coffee shops, but usually instant coffee is served and the assortment of food is poor – chocolate bars, soft drinks, and hot dogs.

Summer Outdoor Cafes

In summer, many restaurants set up downtown outdoor cafes under colored umbrellas. Season cafes bring a lot of problems to their parent companies -- being located outdoor (4-5 tables under umbrellas), they have to switch ice-cream freezers and beverage coolers to power, provide bathroom service to clients, hire seasonal employees, keep plastic furniture safe from theft, etc. There is a high demand in summer for outdoor cafes, at least in Vladivostok, Khabarovsk, and Blagoveshchensk, which are located on sea/rivers. People traditionally sunbathe or enjoy after-hour walks on the embankment and the few near-by snack bars are always overcrowded.

Fast Food Delivery Service

Few companies in the RFE deliver fast food to customers. Vladivostok (Primorskiy Krai) has better- developed fast food service than other RFE regions. Autopilot and China Town are the leading fast food suppliers in Vladivostok. Autopilot offers a limited assortment from traditional Russian cuisine packed in 100 gram (salads) and 400 gram (second course) portions. One expects to get Chinese food in China Town, but surprisingly the company's assortment is over 150 dishes from Asian, European, Russian, etc. cuisine. After training in the U.S., the director of China Town started four stores, where she sells processed food in portions weighed and packed according to client's needs. This is exactly what the local clients need – the business was so successful that within a year she generated working capital to start two restaurants. Pizza delivery service is increasing in demand, though mainly among people under 30.

Best Sales Prospects

The following products and services can have the best sales prospects in the RFE fast food market:

· Fast food franchising or food new to the market (Eg. Donuts, ethnic food/Mexican, etc.)

· High quality coffee (Starbucks)

· Coffee and espresso machines

· Technologies for fast food processing

· Equipment for fast food processing – Mongolian grill, grill, ovens, etc.

· Refrigerating/cooling equipment for outdoor cafes

· Bio-toilets

· Disposable food containers, cups, plates

· Long-lasting outdoor umbrellas and furniture

· Training to fast food managers

This report is provided courtesy of the Business Information Service for the Newly Independent States (BISNIS)

http://trade.gov/index.asp