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**HEARD ON THE STREET****Krispy Kreme Franchise Buybacks  
May Spur New Concerns**By **MARK MAREMONT** and **RICK BROOKS**Staff Reporters of **THE WALL STREET JOURNAL***May 25, 2004; Page C1*


Since going public in 2000, **Krispy Kreme Doughnuts** Inc. has faced questions about its accounting transparency and potential for conflicts of interest in investments that its executives made in its franchises. Investors bought the sugar-fueled stock anyway.

But two recent deals in which Krispy Kreme bought back franchisees could spark new concerns. Some independent accounting experts say the Winston-Salem, N.C., company may have used aggressive bookkeeping to boost its earnings when it acquired its Michigan franchise last year. In the other buyout, completed in January, Krispy Kreme didn't disclose that one of the sellers was Chief Executive Scott Livengood's ex-wife, whose share was valued at about \$1.5 million.

A closer look at the franchise acquisitions may give little comfort to investors looking for reassurance as Krispy Kreme reports results today for its fiscal first quarter ended May 2. The company's stock is down 38% since Krispy Kreme announced its first-ever profit warning on May 7 -- and 60% from its peak last August. Company officials have blamed the slower growth mostly on the popularity of low-carbohydrate diets, though some analysts and investors are concerned that this is a scapegoat for internal problems such as overexpansion.

As of 4 p.m. in composite trading on the New York Stock Exchange, Krispy Kreme shares were up 22 cents at \$19.85.

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## SWEET SPOT

Krispy Kreme's net income has been rising, but the company has warned investors to expect less dough in the next fiscal quarter.



\*Fiscal year ended Feb. 1

Source: the company

Krispy Kreme staunchly defends its handling of the two franchise deals. In a statement, the company says the "accounting for the Michigan acquisition was in accordance with generally accepted accounting principles and any assertion to the contrary is false and inaccurate." There was no reason to disclose the stake in the second franchise held by the CEO's ex-wife because the couple had divorced, meaning she was "a nonrelated party," according to a Krispy Kreme spokeswoman.

Last year, Krispy Kreme began negotiating to buy back its struggling Michigan franchise. The seven-unit operation, Dough-Re-Mi Co., owed Krispy Kreme several million dollars for equipment, ingredients and franchise fees, and was behind on its payments, according to a person familiar with

the situation. After reaching a preliminary agreement, this person says, Krispy Kreme asked Dough-Re-Mi to close two underperforming stores and pay Krispy Kreme accrued interest on past-due loans. Krispy Kreme agreed to boost the purchase price to cover the additional cost of the moves.

Krispy Kreme declines to discuss details, saying only that the final contract called for Dough-Re-Mi to cover the new costs. Part of the deal, company executives add, was that Krispy Kreme would "reimburse" Dough-Re-Mi more than \$1 million for store-closing expenses. They decline to provide any figure for the interest payment. The deal closed in October 2003, for a price that Krispy Kreme eventually pegged at \$32.1 million.

Why would Krispy Kreme pay its franchisee extra money just so the franchisee could turn around and repay that same amount in past interest? One possible answer, accounting experts say: boosted earnings.

Collecting on the unpaid interest resulted in an immediate profit for Krispy Kreme in the form of "interest income." The cost was rolled into the total purchase price, nearly all of which was put on Krispy Kreme's balance sheet as an intangible asset called "reacquired franchise rights." That asset doesn't get amortized, or subtracted from earnings over time.

"It looks like they took money from one pocket, put it into another pocket, and called it income," says Lori Holder-Webb, an accounting professor at the University of Wisconsin who specializes in acquisition accounting. "I can't tell you that's illegal, but it's not something I would suggest my students get into." Charles Mulford, a professor at Georgia Institute of Technology, says that "if true, that sounds to me like a flat-out violation" of accounting principles, which he believes may have resulted in earnings being overstated.

Accounting experts also raise questions about how Krispy Kreme treated store-closing costs. Had the company bought the franchise and then closed the stores by terminating their leases, it would have been an operating cost. But by rolling the store-closing costs into the price of the deal, there was no hit to Krispy Kreme's bottom line -- and the costs also became an intangible balance-sheet asset.

Ms. Holder-Webb says one problem is that an asset is supposed to be something that will provide future economic benefit for the company, which a closed store typically doesn't do. "I'm not going to say it can't be done," she says. "But there would have to be some pretty good justification."

Krispy Kreme's fiscal third quarter ended less than a week after the Michigan deal closed. The company reported results that exactly met Wall Street expectations -- net income of \$14.5 million, or 23 cents a share. Had the company not gotten the interest income from the Michigan deal and recognized the store-closing costs as an expense, it could well have fallen short of expectations.

Krispy Kreme executives steadfastly defend the company's accounting. John Tate, chief operating officer, says outside auditor PricewaterhouseCoopers LLP "signed off on every single journal entry as proper purchase accounting." Michael Phalen, Krispy Kreme's chief financial officer, says it was appropriate to recognize interest income from the Michigan deal because that was a "valid amount due to us." The interest payment by Dough-Re-Mi was unrelated to the acquisition, he says, even though it was made on the same day and Krispy Kreme deducted the interest owed from the final remittance to Dough-Re-Mi. As for the store-closing costs, Krispy Kreme says those were booked properly in accordance with standard purchase-accounting rules.

There was still another oddity about the Michigan deal. Krispy Kreme originally said it was paying the equivalent of \$25.4 million for the franchise. But it eventually disclosed a purchase price of \$32.1 million, a 26% jump, in its securities filings. Mr. Phalen now says Krispy Kreme initially gave investors an "incomplete assessment" of the deal's costs. He says it should have included the potential added costs of a promissory note, under which the Michigan franchise's top executive and major shareholder agreed in effect to defer his portion of the purchase price while staying on to work for Krispy.

Krispy Kreme let the executive go shortly after the deal, and had to pay about \$5 million more than the sum it had included for the promissory note in its original estimate. The extra sum was again rolled into "reacquired franchise rights," and so didn't hit Krispy Kreme's bottom line.

Accounting experts say such a big increase in the payout in such a short period raises questions about whether at least some of the dispersal was akin to a severance or settlement cost -- which typically is expensed immediately -- not really part of buying the franchise. At the very least, they say, the big increase raises questions about whether the "reacquired franchise rights" asset is overvalued. Krispy Kreme says its accounting was accurate, adding that the payment wasn't severance because it was made to Dough-Re-Mi, not directly to the executive.

The ex-wife of Mr. Livengood, the company's chief executive, got her stake in the company's northern California franchise through a complicated chain of events. Krispy Kreme allowed its executives to own stakes in franchises, a holdover from the era when the company was closely held. That practice is unusual and **Yum Brands Inc.**, operator of KFC and Pizza Hut, bans employee ownership of franchisees, viewing it as a conflict of interest. Wendy's International Inc. allows its employees to hold only "nominal" amounts of a publicly traded franchisee's stock.

Krispy Kreme in 2002 bought out the interests of several company officers, at no profit to them, in an investment pool that owned a piece of seven franchisees. Mr. Livengood also sold what he described as "my 3% in the same seven franchise operations" back to Krispy Kreme for the "original investment." While the company didn't acknowledge any wrongdoing, Mr. Livengood said in March 2002 that he hoped "these actions will affirm the trust and confidence that investors have placed in Krispy Kreme."

Mr. Livengood and Krispy Kreme didn't tell investors that the 3% stakes hadn't been his entire investment. He actually held 6% stakes until reaching a separation agreement with his then-wife, Adrienne, in August 2001, when she "got half of whatever I had," Mr. Livengood says. They divorced in June 2002. According to a company spokeswoman, a 10k filed in May 2002 that reported Mr. Livengood had only "3% investments" in the franchises as of January 2001 "was incorrect," adding that "whoever proofed that, missed it." She also noted that Krispy Kreme doesn't plan to correct the error in a revised filing because "it's not a material issue."

Mr. Tate, the chief operating officer, acknowledges that the franchise stakes were valued as part of Mr. Livengood's separation-agreement talks, but "because everything was split down the middle, he didn't avoid giving her" other assets.

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