KKD

Krispy Kreme Doughnuts

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Primary Exchange:	NYSE	**Recent Closing Price:**	$19.63 (05/21/04)
Ticker Symbol:	KKD	**Market Capitalization:**	1.20 Billion
Fiscal Year End:	02/01	**Price-Earnings Ratio:**	21.00
Statements for:	Year ended 02/01/04	**Industry:**	Restaurants

DETAILED REPORT
May 21, 2004

Earnings Quality Grade:
F

(scale: A – F, A is highest)

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Introduction and Executive Summary

A long-time favorite on Wall Street due to its strong growth opportunity and steadily rising profitability (and maybe just a tad because of its famous hot original glazed), Krispy Kreme Doughnuts (KKD) has faced a dramatic turn in investor sentiment in the last two weeks amid scrutiny over the firm's first-ever lowered earnings guidance announcement on May 7. Though the company has blamed its recent misfortunes on the low-carb diet craze, we find that excuse disingenuous, an opinion supported by a number of earnings-quality deficiencies uncovered in our recent comprehensive review of the firm. In fact, given the gravity of the issues uncovered, we assigned our lowest Earnings Quality (EQ) Grade — an indication that we would not want to be holding KKD shares at the time of the firm's 05/25/04 Q1 FY 2004 Earnings Announcement. Our EQ Grade was based on the following findings:

- Declining comparable-store revenues, comparably weaker Q4 FY2004 margins, falling weekly sales in recent months, and the company's first downward earnings revision point to an unusually high level of uncertainty at KKD.

- KKD's franchise business model frontloads revenues and earnings into earlier years, while leading to a more volatile revenue and earnings stream in later periods (compared to a company-owned store model, which produces slower, but much smoother revenue and earnings growth).

- The company's accounting for reacquired franchise rights appears extremely aggressive to us. Despite the materiality of this asset and KKD's apparent increasing reliance on sales growth from reacquired businesses, KKD is the only firm that we are aware of that fails to amortize the underlying asset. In our view, this violates industry practices and significantly overstates profits.

- Tax benefits from stock options accounted for more than 45.0% of operating cash flow in FY2003. Yet these benefits are only tangentially related to operations. Additionally, under the Financial Accounting Standards Board (FASB) Exposure Draft that outlines the accounting for stock options in 2005 and beyond, these benefits will be reported in financing activities. After removing the tax benefits from stock-option exercises, we noted KKD's operating cash flow falls short of net income in FY2003. The growth rate in cash flows and earnings also diverged in 2003, as cash flows are now growing more slowly than earnings.

- A jump in acquisitions activity during FY2003 caused KKD's free cash flow (FCF) to decline 67.2% relative to net income, dropping to its lowest level since the firm's IPO.

- KKD insiders and beneficial owners sold at least 3.6 million shares (worth $155.0 million) on the open market over the past 12 months. The dollar amount of shares sold exceeds 10.0% of the market value of the firm. Only a small number of these sales were reported on the company's Web site.

- The firm failed to disclose a highly material amount of hedging transactions by insiders and beneficial owners. Over the past two years, more than 3.8 million shares have been hedged using forward-sale contracts. The market value of shares hedged totaled $127.0 million, or about 10.0% of the market value of the firm.

- Despite recent restructuring efforts, KKD's board of directors remains unable to shake the stigma of a history of related-party transactions and questionable dealings. Some of these transactions involve highly material amounts that may not have been conducted at arms length.

- The audit environment also is extremely poor. The only committee member with any accounting experience has longstanding ties to the company. Additionally, the auditor has shown a willingness to sign off on aggressive accounting.

Has the Novelty Worn Off?

The legend of Krispy Kreme Doughnuts (KKD) has spread across the land. Operating a popular chain of company-owned and franchised doughnut shops with about 360 locations in 44 states and Canada, KKD also distributes its highly branded sweet indulgences directly to a variety of retail customers, such as supermarkets, convenience stores, and other food service and institutional accounts. The company offers more than 20 varieties of doughnuts, and its original glazed doughnuts have gained cult status among baked-goods junkies, who have been known to go to great lengths to get the "real" (freshly baked) pastries from a secret French recipe. New store openings often attract hundreds of people who line up to be the first through the door, contributing to the legend of Krispy Kreme and helping to justify its franchise fee. A vertically integrated company, KKD supplies all of its mix ingredients and manufactures its own stainless steel doughnut-making equipment.

The enthusiasm for KKD products over the past few years has been driven by the street-level buzz about the sweet treat, supported by the company's efforts to introduce customers to the product via off-premises locations with the hopes of that translating into increased in-store visits fueled by a desire for the "hot doughnuts now" experience. KKD's three-year (five-year) average annualized sales growth rate of 22.9% (21.5%) and 38.8% (283.9%) increase in net income over the same period certainly had investors salivating — at least until two weeks ago.

Margins Analysis	Yr Ended 02/01/04	Percent Change	Yr Ended 02/02/03	Percent Change	Yr Ended 02/03/02
Sales (in millions)	$665.6	35.4%	$491.5	24.6%	$394.4
Gross margin	23.8%	6.2%	22.4%	13.9%	19.7%
SG&A/sales	5.5%	-5.7%	5.9%	-16.0%	7.0%
Net margin	8.6%	25.9%	6.8%	1.8%	6.7%

Upon closer inspection, it is apparent that the company's revenue and earnings progress have been driven by the firm's company owned/franchise expansions (and increasing off-premises sales) with attendant marginal growth coming from the vertically integrated supply pipelines — rather than increased consumption of the company's trademark product. The most obvious sign that more than the hole is missing in the construction of the KKD's doughnut empire is the incremental decline in average sales per company store.[1] As illustrated in the table below, over the past three years, the average number of stores has increased approximately 4.8% faster than the increase in sales, while sales have declined 3.5% per average store each year.[2]

Average Store Sales (in millions)	Yr Ended 02/01/04	Percent Change	Yr Ended 02/02/03	Percent Change	Yr Ended 02/03/02
Sales	$665.6	35.4%	$491.5	24.6%	$394.4
Average number company stores	131	40.3%	93	29.2%	72
Average company store sales	$5.1	-3.5%	$5.3	-3.5%	$5.5

An examination of segment operating margins underscores the marginal impact of KKD's vertical-integration program. While the company's operating margins for its stores (franchises) have increased 101.1% (110.9%) over the past three years, the Krispy Kreme Manufacturing and Distribution unit has seen operating margin increases of 117.1% (or 12.2% greater than KKD's total operating income increase) over the same period.

[1] Though we make reference to "company store sales," the sales figures are a combination of both company-owned stores and sales to off-premises vendors. KKD does not separately disclose revenues or costs related to off-premises sales activities. Although company stores (as well as franchise operations) serve as the "factories" for off-premises product, we believe it is important to keep in mind that sales attributable to company stores comprise both an in-store component and off-premises revenues. In this regard, average in-store company store sales (and incidentally higher margin sales) may in fact be lower than KKD's disclosures allow us to analyze.
[2] We calculate the average number of stores to account for the anticipated impact of store openings on a firm's total revenues. Our calculation ((Stores Y1+(Stores Y1+StoresY-1)/2)/2)) may be too generous in the case of KKD in view of anecdotal representations that enthusiasm related to new store openings has tempered in recent periods.

The company's fortunes begin to sour with the January 2003 purchase of Montana Mills, a bread company operating in the northeastern United States KKD's seemingly ill-advised acquisition ran into difficulties immediately, and the company recently announced its intentions to sell its bread-and-pastry concept, which the firm bought for $40.0 million just over a year ago. The divestiture will result in a pre-tax impairment charge of between $35.0 and $40.0 million in the first quarter and between $2.0 and $4.0 million in subsequent periods throughout the remainder of FY2005.

Of greater concern, KKD announced its first downward revision to guidance two weeks ago. The doughnut maker attributed its first profit warning to the popularity of "low-carb" eating trends such as the Atkins and South Beach diets. However, given that KKD's product essentially comprises one part fat and one part carbohydrates, we find this explanation somewhat disingenuous. That is, any change in foods eaten by the diet conscious should have little effect on KKD — as it seems highly logical to assume dieters who previously eschewed fat are now avoiding carbohydrates. Indeed, it appears KKD's results going forward are clearly going to be affected by organizational issues, probably to a greater extent than the health value of the product (doughnuts have typically weathered diet challenges in the past). Moreover, the company's plan to placate investors (probably more so than customers) with the introduction of a "low-carb" doughnut is unlikely to cure KKD's sales slump — even if the resulting creation turns out to be edible and without adverse side effects.[3]

Other recent operational decisions, such as the pricey purchase of Texas and Louisiana franchises (all involving insiders), further weaken the firm's blame on "low-carb" consumption patterns and exacerbate future earnings-quality concerns such as the inventory demands and margins shifts associated with the mix-increase of lower margin company-owned entities. In this regard, we do not believe we have heard the last of issues related to insider transactions and the dumping of their earlier prized franchises back on the parent company at reportedly exorbitant sales prices. As a consequence, we offer an alternative explanation of the company's recent downward revision to guidance — one that is not as trendy as the "low-carb" diet (excuse), but more germane to the topic of earnings quality.

Franchise-Accounting Model Front Loads Revenues and Profits

As early as 08/22/02 (too early you might argue), we set forth our view that KKD's vertically integrated, franchise-based business model allows the company to boost current period revenues by recognizing the cost of franchise fees, equipment, and supplies sold to new franchisees immediately as income in the current period. So, rather than build out its franchises one at a time through company-owned stores and growing sales progressively through the sale of doughnuts directly to consumers, the company can essentially "sell" something equivalent to "the present value of future profits from selling doughnuts" in the form of franchise fees and the sale of required equipment and supplies to its franchisees. Obviously this is the point of a franchise model. But management and analysts seemed (at the time) to hold the view that the company could grow at the same rate for an indefinite period. In contrast, we argued that revenues and profits are essentially frontloaded during the expansion period, but that this business model (and related accounting) leads to increased volatility in sales and earnings as the concept matures. (In contrast, if the company were selling doughnuts and amortizing its costs of stores and equipment against earnings, a much smoother, but slower growing revenue and earnings stream would result.)

The company's KKM&D segment captures a big chunk of that hypothetical "present value of future doughnuts" described above. Specifically, this segment recognizes revenue from the sale of its custom stainless steel doughnut-making equipment, doughnut mix, and all other necessary supplies to franchisees. Profits are reported when these expensive machines and relatively large quantities of supplies are shipped to franchisees. KKM&D reported $360.0 million (excluding intercompany sales) during FY2003, an increase of 30.4% over the $276.2 million reported in FY2002. Segment operating profits also increased 48.3% to $42.4 million during the period. These are profits that have essentially been shifted to the current period, at the expense of future periods — leading to slower organic revenue growth in future periods. It should also be noted that a similar effect is realized on the upfront portion of franchise fees paid by franchisees. (This is reflected in the profits from the "franchise store operations" segment).

[3] While almost completely off topic, the only means of creating an adequately sweet low-carb product involves the use of artificial sweeteners ending in the letters "tol" (such as mannitol, sorbitol, etc.), which have a tendency to cause great gastrological distress when eaten in anything other than small quantities.

Segment Operating Margin Analysis (in 000s)	Yr Ended 02/01/04	Percent Change	Yr Ended 02/02/03	Percent Change	Yr Ended 02/03/02
Company store operations	$98,116	46.3%	$67,068	37.5%	$48,790
Franchise store operations	$19,217	33.2%	$14,427	58.3%	$9,112
KKM&D	$42,351	48.3%	$28,565	46.4%	$19,506
Montana Mills	-$1,488	NA	$0	NA	$0
Total	$158,196	43.7%	$110,060	42.2%	$77,408

Although we stick by our original projection of ultimately declining (and more volatile) organic sales growth — and provide additional evidence of this below — we also believe now that there is a way out of this box for KKD. Specifically, a growth-by-acquisition strategy can be used to bolster revenues and cash flows going forward. In this regard, the growth in acquisitions activity shows that the company may in fact be juicing profits through increased acquisitions. In FY2004, KKD spent $118.3 million, net of cash acquired, and issued approximately 1.7 million shares of common stock for the acquisition of associate and area developer franchise markets in Kansas, Missouri, Michigan, and parts of Texas and Lousiana, in addition to the acquisition of the firm's remaining minority interest in the joint-venture franchisee that had the rights to develop stores in northern California and its purchase of Montana Mills.

The impact of this strategy is reflected in pro-forma figures presented in the latest 10K As shown below, organic revenues increased at about 26.9% versus the 35.4% rise in as reported sales — suggesting that the top line was boosted by 2003's acquisitions. Similar results were reported for the bottom line. Specifically, organic growth in net income was 52.0%, versus as-reported growth of 70.5%.

Analysis of Organic Growth (in millions)	Yr Ended 02/01/04	Percent Change	Yr Ended 02/02/03
Sales — as reported	$665.6	35.4%	$491.5
Sales — as if all acquisitions occurred on or before 02/01/02	$679.3	26.9%	$535.4
Net income — as reported	$57.0	70.5%	$33.5
Net income — as if all acquisitions occurred on or before 02/01/02	$57.0	52.0%	$37.5

"Reacquired Franchise Rights" — What If We Could Book the Sale of the Same Doughnuts Twice?

In our view, KKD's reacquisition of franchises discussed briefly above has significantly decreased earnings quality. However, the reasoning behind our conclusion is complex and requires some detailed explanation. With respect to these franchise rights reacquired, the company recorded the vast majority of the purchase price for each acquisition — $126.0 million in total — to an asset account called "reacquired franchise rights." Specifically, KKD recorded $27.5 million (83.5%) in reacquired franchise rights in its acquisition of the Kansas and Missouri markets, $54.0 million (80.0%) in its purchase of the Dallas and Shreveport markets, and $29.5 million (91.8%) in its acquisition of certain franchise markets in Michigan. (As we discuss in the corporate governance section of our report, some of these franchises were acquired from former directors and the prices paid may be excessive in relation to fair market value.)

Analysis of Increase in Goodwill and Reacquired Franchise Rights (in 000s)	02/01/04	Percent Change	02/02/03	Percent Change	02/03/02
Goodwill	$19,865	9783.1%	$201	NA	–
Reacquired franchise rights	$174,537	259.9%	$48,502	NA	–
Other intangible assets, net	$13,322	1946.4%	$651	NA	–
Total intangibles	$207,724	320.9%	$49,354	196.9%	$16,621
Total assets	$660,664	60.9%	$410,487	60.7%	$255,376
Stockholders' equity	$452,207	65.4%	$273,352	45.7%	$187,667
Goodwill as a percent of total assets	31.4%	161.5%	12.0%	84.7%	6.5%
Goodwill as a percent of total stockholders' equity	45.9%	154.4%	18.1%	103.9%	8.9%

Beyond the usual concerns associated with increases in soft assets,[4] the reacquisition of franchise rights also has a particularly perverse impact on earnings quality. In essence, by reacquiring franchisee stores, the company is able to double up on profits, which is possible because, unlike other publicly traded restaurant franchisors that we surveyed, KKD does not amortize reacquired franchise rights against earnings, as it considers them to have an "indefinite life." The company's accounting for reacquired franchise rights is summarized in the 10K as follows (p. 39):

> Reacquired franchise rights represent the value assigned to certain franchise markets acquired by Krispy Kreme. Reacquired franchise rights were determined to have indefinite lives based upon the significant market share of the Company's core product, a history of strong revenue and cash flow from franchise markets that is expected to continue for the foreseeable future, and our ability to refranchise these markets.

Returning to our example from the previous section of the report, the company is in essence reacquiring the "present value of future doughnut sales" and recording it as an asset called "reacquired franchise rights." Over time, the top line will benefit from all future doughnut sales from the reacquired franchise but earnings will never be reduced by the cost of the reacquired rights because they are not amortized to earnings. As a result, the company is able to keep the profit it recorded initially upon the sale of the franchise rights (now reflected in retained earnings) and book the sales of all future doughnuts over time. Put more simply, the company is able to record the "present value of future doughnut sales" twice — a perverse outcome indeed. Although this move is highly aggressive in our view, it is uncertain whether it violates the letter of GAAP (although it certainly violates the spirit of GAAP). Moreover, in our view, it clearly violates industry practices. We surveyed 18 restaurants that also offer franchising arrangements. Only four reported recording reacquired franchise rights. All four amortized those rights over a finite period of time, as shown below.[5]

Ticker	Company Name	Reports Reacquired Franchise Rights?	Amortization Period
BUNZ	Schlotzsky's Inc.	Yes	4–40 years
CHKR	Checkers Drive In Restaurants	Yes	1–11 years
IHP	IHOP Corp.	Yes	≤ 40 years
YUM	YUM Brands Inc.	Yes	≤ 20 years

Other publicly traded restaurants that offer franchise arrangements but did not report holding any reacquired franchise rights include: AFC Enterprises (AFCE), Appleby's International Inc. (APPB), Cracker Barrel Group Inc. (CBRL), CKE Restaurants (CKR), Brinker International (EAT), Jack in the Box Inc. (JBX), McDonald's Corp. (MCD), Outback Steakhouse Inc. (OSI), Panera Bread Company (PNRA), Papa John's Pizza International Inc. (PZZA), Ruby Tuesday's Inc. (RI), Sonic Corp. (SONC), Triarc Co. (TRY), and Wendy's International (WEN).

[4] As a consequence of these acquisitions, total intangible assets increased 320.9% in FY2004 to represent 31.4% (45.9%) of total assets (shareholders' equity).
[5] Reacquired franchise rights appear to be fairly rare. We also found that Pepsi Co. (PEP) reported reacquired franchise rights (purchased from bottlers) until 2000; the company reported amortizing these rights over 20–40 years.

Option Tax Benefits Mask the Divergence Between Income and Cash Flows

KKD's recent operating struggles — culminating in the company's Q1 FY2005 downward earnings revision — also are reflected in the recent divergence between earnings and cash flows. Though the growth in reported operating cash flow was 87.2% (versus 70.5% growth in GAAP income), 44.7% of the company's reported cash flow was actually the result of tax benefits from stock-option exercises. In short, when insiders exercise and dump shares, operating cash flow receives an artificial boost. We routinely eliminate this item in our computation of adjusted operating cash flow as it is only tangential to operating activities and actually foreshadows lower returns per share for outside investors (due to the dilution). Our elimination of this tax benefit also is consistent with the FASB's Exposure Draft related to the accounting for stock options — which will move the tax benefits from option exercises to the financing cash flow section of the statement.

After removing the $42.8 million boost to operating cash flow from option-related tax benefits, KKD's cash-flow figure drops to $52.7 million, a 41.6% increase over the $37.2 million reported in FY2003 — well below the 70.5% jump in net income. Additionally, adjusted operating cash flow fell below GAAP net income for the first time since KKD's public offering. In the same period, the firm's income increased 70.5%, rising from $33.5 million in FY2003 to $57.1 million in FY2004. The ratio of adjusted operating cash flow-to-net is now 0.924 — its lowest point in five years and 30.1% below the company's 5-year average (1.321).

In addition to KKD's faltering cash flow from operations (CFOA), the rise in acquisition activity assisted in driving its FCF balance down to levels previously unvisited. In FY2004, the company used $118.3 million in cash, net of cash acquired, in the reacquisitions of certain franchise markets and its purchase of Montana Mills. Consequently, KKD's FCF-to-net-income ratio declined 67.2% for the year.

Cash Flow Statement Summary (in 000s)	Yr Ended 02/01/04	Percent Change	Yr Ended 02/02/03	Percent Change	Yr Ended 02/03/02
Net income	$57,087	70.5%	$33,478	26.9%	$26,378
Operating cash flow	$95,553	87.2%	$51,036	40.9%	$36,210
Deduct: tax benefit from stock option exercises	($42,806)	210.3%	($13,795)	41.2%	($9,772)
Operating cash flow — adjusted	$52,747	41.6%	$37,241	40.9%	$26,438
Capital expenditures (CAPEX)	($79,649)	-4.3%	($83,196)	123.0%	($37,310)
FCF before acquisitions	($26,902)	41.5%	($45,955)	-322.7%	($10,872)
Acquisitions	($118,300)	2,282.7%	($4,965)	-75.9%	($20,571)
FCF after acquisitions	($145,202)	-185.2%	($50,920)	-61.9%	($31,443)
Adjusted operating cash flow-to-net income	0.924	-16.9%	1.112	11.0%	1.002
FCF-to-net income (after acquisitions)	(2.544)	-67.2%	(1.521)	-27.6%	(1.192)

Historical Analysis of Cash Flow Ratios	5-Yr Average	Yr End 02/01/04	Percent Change	Yr End 02/02/03	Percent Change	Yr End 02/03/02	Percent Change	Yr End 01/28/01	Percent Change	Yr End 01/30/00
Adjusted operating cash flow-to-net income	1.321	0.924	-16.9%	1.112	11.0%	1.002	-53.2%	2.140	50.0%	1.427
FCF after acquisitions-to-net income	(0.500)	(2.544)	-67.2%	(1.521)	-27.6%	(1.192)	-1435.6%	(0.078)	89.4%	(0.731)

KKD Fails to Adequately Disclose Highly Material Hedging Transactions by Insiders

Though there have been no insider transactions over the past several months — as one would expect given the likelihood of a trading blackout in advance of an earnings warning (and subsequent earnings announcement) — during 2003, company executives and directors sold 681,410 shares of KKD common stock ($28.3 million) on the open market. Included among the selling activity was a block of 235,500 shares sold by CEO Scott A. Livengood, netting proceeds of roughly $10.3 million. Additionally, the company's since-departed CFO Randy S. Casstevens sold 60,000 shares worth nearly $2.3 million. But the open-market sales reported on SEC Form 4 (and summarized at the bottom of this section) barely scratch the surface.

A far more significant concern is that KKD insiders have used complex hedging transactions — called forward sales[6] — to essentially liquidate 3,835,400 shares since 10/02/02. This equates to 200.2% of the company's outstanding shares, or 216.8% of the current float. The total market value of the shares hedged through forward sales was $122.7 million, or about 10.3% of KKD's current market value. The insiders engaging in these transactions were primarily KKD founders. Note also that Jubilee Investments Ltd.'s general partner is John McAleer. Details of the hedging transactions appear below.

Insider Name	Insider Role	Date of Transaction	Date of Expiration	No. of Shares	Market Value on Date of Sale
Patricia McAleer Dorgan	Beneficial owner	10/02/2002	10/05/2006	110,212	$3,328,661
Jubilee Investments Ltd.	Beneficial owner	10/02/2002	10/05/2006	937,732	$28,321,708
Sandra McAleer Middlebrooks	Beneficial owner	10/02/2002	10/05/2006	19,402	$585,986
Robert L. McCoy	Director	10/02/2002	05/23/2006	125,000	$3,958,733
Jeanne McAleer Sanderford	Beneficial owner	10/02/2002	10/02/2006	118,831	$3,588,975
Shannon McAleer Silvernail	Beneficial owner	10/02/2002	10/02/2006	143,253	$4,326,577
Elizabeth McAleer Tillman	Beneficial owner	10/02/2002	10/05/2006	155,570	$4,698,579
Robert L. McCoy	Director	06/04/2003	06/09/2008	100,000	$2,822,704
Patricia McAleer Dorgan	Beneficial owner	09/03/2003	09/07/2007	90,000	$3,055,456
Patricia McAleer Dorgan	Beneficial owner	09/03/2003	03/13/2008	90,000	$2,966,939*
Jubilee Investments Ltd.	Beneficial owner	09/03/2003	03/13/2008	750,000	$24,724,488
Jeanne McAleer Sanderford	Beneficial owner	09/03/2003	09/07/2007	57,700	$1,952,097
Jeanne McAleer Sanderford	Beneficial owner	09/03/2003	03/13/2008	57,700	$1,895,544
Shannon McAleer Silvernail	Beneficial owner	09/03/2003	09/07/2007	90,000	$3,055,456
Shannon McAleer Silvernail	Beneficial owner	09/03/2003	03/13/2008	90,000	$2,966,939
Elizabeth McAleer Tillman	Beneficial owner	09/03/2003	09/07/2007	75,000	$2,546,213
Elizabeth McAleer Tillman	Beneficial owner	09/03/2003	03/13/2008	75,000	$2,472,448
Totals				3,835,400	$122,729,633

Though it could be argued that forward sales summarized above were a prudent and tax-efficient means for KKD insiders to diversify their wealth, it also is clear that these individuals have significantly reduced their exposure to KKD shares while the company failed to adequately disclose these transactions. The transactions summarized above were disclosed in footnotes to the individual's SEC Form 4 filings. However, these footnote disclosures are not available in any publicly available source except for one proprietary service marketed by Thomson Financial. So, for example, none of the Web sites available on the Internet are able to display these transactions. Furthermore, while the company apparently reported the August 2003 Jubilee Investments Ltd. transaction on its Web site late last year, the transaction is no longer listed on the Web site. Additionally, to our knowledge, none of the other transactions highlighted above have been reported by KKD.

KKD executives and founders are not the only ones selling, however. Perhaps bringing to light even more concern regarding insider expectations at the firm was a prospectus filed by KKD on behalf of its Michigan-based Dough-Re-Mi franchisee on 11/07/03 stating the intention of Dough-Re-Mi to sell all 443,917 shares received when KKD purchased a majority stake in its operations.

[6] Forward sales involve a contract between the insider and a bank to sell shares at a predetermined date in the future. The contract is used primarily as a hedging technique, allowing the insider to reduce his or her exposure to share-price declines. Other benefits include liquidity and deferral of taxation.

Finally, sales reported on Form 4 do not include all sales by KKD insiders. Specifically, certain beneficial owners are only required to file their intention to sell restricted shares (on Form 144) — but need not file a Form 4 upon actual sale. The company also fails to disclose these transactions on its Web site. Review of Form 144 transactions during 2003 shows that KKD beneficial owners proposed selling nearly 3.0 million additional shares that were never reported on a Form 4. Thus, it appears that these people, who the company does not consider to meet the legal definition of an insider, liquidated up to an additional $127.8 million in KKD shares during 2003. The underlying proposed sale transactions are summarized below.

Insider Name	Transaction Type	Transaction Date	No. of Shares	Market Value
Randy S. Casstevens	Prop Sale	12/24/2003	14,800	$566,544
Deborah G. Casstevens	Prop Sale	12/24/2003	25,800	$1,032,520
Krispy Kreme Foundation	Prop Sale	9/23/2003	1,000	$39,800
Connie Smith	Prop Sale	9/18/2003	50,000	$2,000,000
Krispy Kreme Foundation	Prop Sale	9/8/2003	1,165	$48,445
Robert Bailey	Prop Sale	8/28/2003	4,000	$176,000
Julie A. McCoy MGT	Prop Sale	8/28/2003	4,000	$176,000
Lisa M. McCoy Management	Prop Sale	8/28/2003	4,000	$176,000
Sarah E. McCoy MGT	Prop Sale	8/28/2003	4,000	$176,000
Michael P. McCoy MGT	Prop Sale	8/28/2003	4,000	$176,000
William R. McCoy MGT	Prop Sale	8/28/2003	4,000	$176,000
Robert L. McCoy	Prop Sale	8/26/2003	16,000	$697,678
Sandra McAleer Middlebrooks	Prop Sale	8/26/2003	155,000	$6,742,500
Jeanne McAleer Sanderford	Prop Sale	8/26/2003	115,000	$5,002,500
Jubilee Investments Ltd	Prop Sale	8/26/2003	1,500,000	$65,250,000
Shannon McAleer Silvernail	Prop Sale	8/26/2003	180,000	$7,830,000
Elizabeth McAleer Tillman	Prop Sale	8/26/2003	150,000	$6,525,000
Patricia McAleer Dorgan	Prop Sale	8/26/2003	180,000	$7,830,000
R & P Six LP	Prop Sale	8/26/2003	40,000	$1,744,200
John W. Tate	Prop Sale	8/25/2003	65,000	$2,857,240
Joseph A. McAleer Jr.	Prop Sale	8/14/2003	300,000	$13,401,400
Krispy Kreme Foundation	Prop Sale	8/4/2003	2,500	$108,125
Krispy Kreme Foundation	Prop Sale	7/11/2003	2,300	$103,500
Frank E. Guthrie	Prop Sale	6/25/2003	13,000	$494,048
BL McCoy Revocable Tr.	Prop Sale	6/2/2003	100,000	$3,525,000
Connie Smith	Prop Sale	6/2/2003	15,000	$525,000
Wake Forest University	Prop Sale	2/4/2003	1,680	$50,618
Donna Q. Green	Prop Sale	1/7/2003	4,029	$138,678
Totals			2,963,348	$127,814,264

All 2003 insider sales reported on SEC Form 4 are summarized below. There also is a proposed sale pending, for 7,074 shares, which former CFO Randy Casstevens intends to sell within 90 days of 03/15/04.

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Insider Name	Date Range	Position	Shares Sold	Market Value
William T. Lynch Jr.	09/09/03–09/19/03	D	30,460	$1,241,012
Steven D. Smith	05/30/03–09/19/03	D	25,000	$928,537
Mary Davis Holt	09/08/03	D	50,000	$2,061,610
James H. Morgan Jr.	09/05/03	D	9,000	$380,250
Togo D. West Jr.	09/03/03–09/05/03	D	90,450	$3,905,501
Randy S. Casstevens	03/21/03–08/27/03	CFO	60,000	$2,287,500
Robert L. McCoy	08/26/03	D	56,000	$2,441,874
Scott A. Livengood	08/25/03	CEO	235,500	$10,324,155
John W. Tate	03/20/03–08/25/03	COO	125,000	$4,826,437
Totals			681,410	$28,396,876

Decline in Deferred Revenue

Further evidence of declining revenue prospects is evident from a review of the company's deferred franchise revenue balance. At 02/01/04 KKD reported $1.353 million in deferred franchise fees, down 8.9% from $1.485 million a year ago. According to the 10K, franchise revenue is recognized as follows:

> Franchise Operations revenue is derived from: (1) development and franchise fees from the opening of new stores; and (2) royalties charged to franchisees based on sales. Development and franchise fees are charged for certain new stores and are deferred until the store is opened and the Company has performed substantially all of the initial services it is required to provide.

Resignation of Chief Financial Officer

On 12/23/03, KKD's CFO Randy Casstevens announced his resignation from the company to pursue personal interests. He was appointed chief financial officer just two years ago, and the announcement of his departure comes on the heels of his appointment as chief governance officer in April 2003. Because a chief financial officer's resignation can be indicative of fundamental accounting disagreements or latent accounting irregularities, Casstevens' sudden departure is cause for concern. Moreover, his resignation preceded a disappointing earnings release and comes during a period in which earnings quality appears to have declined markedly prior to the company's first-ever earnings shortfall. Finally, Casstevens and his family have liquidated more than $4.5 million in KKD stock within the past year.

Corporate Governance

Board independence tarnished by related-party dealings: Five directors on KKD's nine-member board fail our independence criteria. More importantly, however, a history of questionable related-party dealings suggests that corporate governance is extremely poor.

In light of the company's board restructuring, three of the company's prior directors — Frank E. Guthrie, Robert L. McCoy, and Steven D. Smith — resigned from the board and were appointed as emeritus directors (i.e. non-voting directors). Although they are not included in the table below, their independence was severely blemished due to their role as KKD franchisees. At present, the remaining non-independent KKD directors include Chairman and CEO Scott A. Livengood, who has impaired independence because of his employment with the firm and an extended length of service (a KKD director since February 1994), and John N. McAleer, the company's current EVP, Concept Development and former chairman of the board. McAleer has served as a KKD director since September 1990. Additionally, we noted an interlocking relationship between director James H. Morgan and KKD's audit committee Chairman Robert S. McCoy Jr., each of whom formerly served in executive roles at Wachovia Securities Inc. and Wachovia Corporation, respectively. Mr. McCoy Jr. also is the son of former Director Robert L. McCoy. Finally, Togo D. West Jr. cannot be considered fully independent, because he is an attorney at the law firm of Covington & Burling, which has provided legal services to KKD. The remaining independent members on KKD's board are Dr. Su Hua Newton, William T. Lynch Jr., Robert L. Strickland and Mary Davis Holt.

Although board independence has improved in recent periods, a checkered history of insider transactions and related-party dealings has long given rise to distress over the corporate governance structure at KKD and exacerbates our consternation with respect to the quality of KKD's corporate governance. A brief summary of the most material transactions appears below:

- KKD continues to be a party to franchise agreements with three of its former directors (the aforementioned emeritus directors Guthrie, McCoy and Smith). Under KKD's various franchise-license agreements, franchisees are required to purchase certain materials from the company's manufacturing and distribution arm (KKM&D) in addition to paying franchise royalty fees. During FY2004, mix and equipment sales to and royalties received from franchise companies affiliated with Guthrie, McCoy, and Smith totaled $5.2 million, $6.5 million, and $6.0 million, respectively.

- Casting an even larger shroud of doubt over the arrangements between the affiliated franchisees is the relationship between Smith and Joseph A. McAleer, who together co-own KKD franchises in the Dallas area. Joseph A. McAleer is a retired member of KKD's board of directors and the brother of current KKD director and EVP John N. McAleer. It should also be noted that just three months after Smith's departure from the board in March of 2003, KKD paid $67.5 million to purchase the aforementioned Dallas franchises and Shreveport, La., franchises from Smith and Joseph A. McAleer. The purchase included a total of five stores and one commissary. The amount of this transaction appears highly suspicious, as KKD has thus far declined to purchase an independently owned, 22-store franchise in Southern California (Golden Circle Family Foods) for a reported $80.0 million.

- The company also is involved with certain licensing agreements with two relatives of John N. McAleer, former chairman of the board and current KKD director and employee (EVP of Concept Development). Two of McAleer's brothers-in-law, William J. Dorgan and Pat Silvernail, operate stores in Mississippi and Georgia, respectively. Sales to and royalties received from Mr. Dorgan's operations totaled $1.7 million in FY2004 and sales to and royalties received from Silvernail amounted to $1.2 million in the latest fiscal year. According to SEC filings, Dorgan's wife owns approximately 500,000 KKD shares. Silvernail's wife owns approximately 560,000 KKD shares.

Corporate Governance Analysis — Board of Directors	**2004**
Number of members	9
Number of possibly non-independent members	5
Percent of members possibly lacking independence	55.6%
Employees or past employees	2
Length of service over 10 years	2
Interlocking board memberships or firm relationships	2
Family relationships	0
Other relationship to firm	1
Significant related-party transactions?	Yes
Overall grade	F

Audit environment also may be severely impaired: Two of the three-person committee met our aforementioned independence criteria (Lynch and Holt). The lone non-independent member is the committee's chair, McCoy, who incidentally appears to be the only audit committee member with any significant accounting/auditing experience as the former chief financial officer of Wachovia Corp. Given that the only experienced member of the committee has a longstanding relationship with company founders and management (and his family still owns KKD franchises), we believe that the effectiveness of the committee could be severely impaired.

Corporate Governance Analysis — Audit Committee	2004
Number of members	3
Number of possibly non-independent members	1
Percent of members possibly lacking independence	33.3%
Employees or past employees	0
Length of service over 10 years	0
Interlocking board memberships or firm relationships	1
Other relationship to firm	0
Percent of members possibly lacking auditing/accounting expertise	66.7%
Overall EQ Grade	D-

An analysis of the fees paid to the firm's independent auditor PricewaterhouseCoopers LLP (PWC) revealed no unusual engagements. In FY2004 (FY2003), fees incurred for audit and audit-related services were $443,000 ($292,000) or 56.1% (41.1%) of the aggregate fees billed. Tax services — a service that we feel is reasonable for an auditor to provide — comprised the majority of the remaining fees in both periods examined; and while we did note $42,000 in fees related to a cost-segregation study performed in FY2004, the amount appears relatively immaterial and thus did not significantly affect our analysis.

Despite no apparent signs of unusual fees, we do not agree with PWC's decision to sign off on KKD's treatment of reacquired franchise rights. As discussed above, we believe that the failure to amortize these costs overstates earnings, is aggressive in relation to industry practices, and violates the spirit of GAAP. Accordingly, we question the objectivity and effectiveness of the firm's audit.

Analysis of Auditor Independence	2004	2003
Reasonable fee structure?	Yes	Yes
Audit and audit-related services	$443,000	$292,000
Tax services	$305,000	$383,000
All other fees	$42,000	$36,000
Years of service	12+ yrs.	11 yrs.
Relationships to company personnel?	No	No
Evidence of a lack of independence?	No	No

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