

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 59499 / March 4, 2009**

**ACCOUNTING AND AUDITING ENFORCEMENT**  
**Release No. 2941 / March 4, 2009**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13388**

**In the Matter of**

**KRISPY KREME DOUGHNUTS, INC.,**

**Respondent.**

**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER**

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Krispy Kreme Doughnuts, Inc. ("Krispy Kreme" or "Respondent").

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

**III.**

On the basis of this Order and Respondent's Offer, the Commission finds<sup>1</sup> that:

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<sup>1</sup> The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

1. Krispy Kreme is a North Carolina corporation with its principal place of business in Winston-Salem, North Carolina. Since approximately 1937, Krispy Kreme has been engaged in the business of making and selling doughnuts, initially through a single store in Winston-Salem and subsequently through multiple stores across the United States owned either by Krispy Kreme or franchisees. Since April 2000, shares of Krispy Kreme's common stock have been registered with the Commission pursuant to Section 12(b) of the Exchange Act and since May 2001 they have been listed on the New York Stock Exchange.

## **Background**

2. Between approximately February 2003 and May 2004, Krispy Kreme fraudulently inflated or otherwise misrepresented its earnings for the fourth quarter of its 2003 fiscal year, which ended on February 2, 2003, and each quarter of its 2004 fiscal year, and its full year results for fiscal 2004, which ended on February 1, 2004. By this misconduct, the Respondent avoided lowering its earnings guidance and improperly reported for each of those quarters what had become a prime benchmark of its historical performance, *i.e.*, reporting quarterly earnings per share of common stock ("EPS") that exceeded its previously announced EPS guidance by one cent.

3. In the 1990s, Krispy Kreme, which initially operated in the southeastern United States, began expanding nationally through a franchise program through which it opened new stores and increased its annual revenue.

4. Although Krispy Kreme calculated and disclosed quarterly various indices of its sales growth and geographical expansion, Krispy Kreme internally placed primary emphasis on only two measures of financial performance, namely, continual quarter over quarter growth of its quarterly EPS and whether that growth resulted in quarterly earnings that exceeded by at least one cent consensus analyst's expectations or, when issued, Krispy Kreme's own quarterly EPS guidance.

5. In the first three years after Krispy Kreme became a public issuer in April 2000, Krispy Kreme's EPS growth increased at an annual rate of 80%, 67%, and 47%, respectively. Additionally, Krispy Kreme reported EPS that tracked closely and—in almost every quarter—exceeded both consensus analyst's expectations and its own EPS guidance by at least \$.01.

6. Beginning in fiscal 2002 and in much of fiscal 2003, Krispy Kreme's common stock routinely traded at a multiple of over 50 times annual EPS. In fiscal 2004, Krispy Kreme's stock traded between 30 and 50 times annual EPS.

## **The Incentive Plan**

7. From April 2000 through the end of fiscal year 2004, Krispy Kreme's senior executives were compensated annually with a combination of salary, stock option grants, and cash bonuses, the last of which was paid pursuant to Krispy Kreme's Senior Executive Incentive Compensation Plan ("Incentive Plan"). Under the Incentive Plan, as disclosed in Krispy Kreme's proxy statement, bonuses for all executive officers were contingent upon Krispy Kreme meeting or exceeding goals for two performance measures: (i) the attainment of a certain level

of return on assets, measured by earnings before interest, taxes and depreciation, and amortization, and (ii) a percentage increase in EPS.

8. For fiscal years 2002 and 2003, Krispy Kreme set a quarterly EPS target of earnings that exceeded by at least one cent Wall Street expectations, or when issued, Krispy Kreme's quarterly guidance. The EPS target – meeting EPS guidance plus one cent – had to be achieved to trigger the payment of incentive compensation under the Incentive Plan. In these fiscal years, Krispy Kreme achieved this targeted EPS and paid incentive compensation that consisted of all amounts that Krispy Kreme earned in excess of its EPS target.

9. Krispy Kreme accrued for incentive compensation on a quarterly basis by recording incentive compensation expense in the amount of all earnings in excess of the amount needed to achieve the targeted EPS for that quarter. Thus, during fiscal year 2002 and fiscal year 2003, Krispy Kreme's method of accruing for the Incentive Plan effectively acted as a "ceiling" on its earnings.

10. Beginning in the second quarter of fiscal year 2003, Krispy Kreme experienced delays in new store openings, which adversely affected Krispy Kreme's rate of earnings growth and reduced the amount of incentive compensation expense accrued quarterly. Although Krispy Kreme had sufficient earnings to make an incentive compensation accrual in the second and third quarters of fiscal 2003, the accruals were significantly less than in previous quarters.

11. Furthermore, for fiscal year 2003, the incentive compensation paid at the end of the fiscal year was less than had been previously accrued. The lower level of incentive compensation payment resulted from a reversal of \$873,261 of previously accrued incentive compensation expense, which increased earnings by \$528,323 and enabled Krispy Kreme to report earnings for the fourth quarter of fiscal year 2003 that met its EPS guidance plus \$0.01. In making this disclosure, Krispy Kreme did not also disclose that but for the occurrence of the reversal that it would not have reported that result.

12. As implemented, the Incentive Plan operated as a *de facto* reserve accounting mechanism which, within certain limits, virtually guaranteed that reported quarterly EPS would equal Krispy Kreme's quarterly guidance plus \$0.01. Specifically, under Generally Accepted Accounting Principles ("GAAP"), (*see* Accounting Principles Board Opinion No. 28, ¶¶ 12, 15, 16, and 26). Krispy Kreme should have accounted for the plan by periodically comparing a real-time estimate of its projected, pre-incentive compensation expense EPS for the full fiscal year to its full-year EPS target and then reconciling the then-projected payout under the plan with amounts accrued to date for incentive compensation expense. However, despite the fact that Krispy Kreme consistently maintained a real-time estimate of its EPS for the full fiscal year, Krispy Kreme accounted for the plan by booking the difference between Krispy Kreme's actual quarterly EPS results and its quarterly target EPS, *i.e.*, achieving EPS guidance plus one cent. This accounting, in effect, created a "collar" on shareholder earnings, *i.e.*, in good quarters, excess profits were accrued to fund the Incentive Plan and in weak quarters, accruals to the Incentive Plan were reversed to improve earnings, with shareholders consistently being told that Krispy Kreme had exceeded its EPS guidance by \$0.01—no more and no less.

13. In the first quarter of fiscal 2004, Krispy Kreme's performance improved from the last quarter of fiscal year 2003, which, combined with a one-time, disclosed partial reversal of previously accrued litigation expense, resulted in Krispy Kreme having sufficient earnings to report EPS of \$0.22—or EPS guidance for the first quarter plus \$0.02—and accrue \$2,050,000

14. Beginning in the second quarter of fiscal 2004, as sales growth continued to slacken, Krispy Kreme reduced the incentive compensation accrual causing it to exceed its EPS guidance. Specifically, at the end of that quarter, Krispy Kreme made a net \$949,999 reversal in previously accrued incentive compensation expense, which increased after-tax earnings by \$569,999. By effecting the \$949,999 reversal, Krispy Kreme increased its earnings for the quarter and reported EPS of \$0.21 for the quarter, equaling its previously announced EPS guidance plus \$0.01. In making this disclosure, Krispy Kreme did not also disclose that but for the occurrence of the reversal it would not have reported that result.

15. In the third quarter of fiscal 2004, Krispy Kreme made no additional incentive compensation accruals and, instead, reversed the remaining available balance in the account, *i.e.*, \$833,332. This increased Krispy Kreme's after-tax earnings by \$499,999 and Krispy Kreme reported EPS of \$0.23 for the quarter, equaling its previously announced EPS guidance plus \$0.01.

16. Each of the incentive compensation accruals or reversals described above was the next to last entry done by Krispy Kreme before its books were closed for the quarter, with the last entry being for the provision for taxes.

### **Round-Trip Transactions**

17. In each of the second, third and fourth quarters of fiscal 2004, Krispy Kreme engaged in a round-trip transaction in connection with the reacquisition of a franchise. Each transaction followed essentially the same pattern, Krispy Kreme paid money to the franchise with the understanding that the franchise would pay the money back to Krispy Kreme in a pre-arranged manner that would allow Krispy Kreme to record additional pre-tax net income in an amount roughly equal to the funds originally paid to the franchise.

#### **First Round Trip Transaction**

18. The first of the round-trip transactions occurred in June 2003, the second quarter of fiscal 2004, in connection with the reacquisition of a franchise in Texas. In connection with this reacquisition, Krispy Kreme increased the price it paid for the franchise by \$800,000, *i.e.*, from \$65,000,000 to \$65,800,000, in return for the franchise purchasing from Krispy Kreme certain doughnut making equipment.

19. The purchase of the equipment was made at the request of Krispy Kreme and was arranged after the parties had orally agreed to the \$65 million reacquisition price. But for the

\$800,000 increase in that price, the franchise would not have agreed to purchase the equipment. On the day of the closing, as Krispy Kreme paid \$65.8 million to the franchise, Krispy Kreme debited the franchise's bank account for \$744,000, which was the aggregate list price of the equipment. This additional revenue boosted Krispy Kreme's quarterly net income by approximately \$365,000 after taxes.

### **Second Round Trip Transaction**

20. The second round-trip transaction occurred at the end of October 2003, four days from the closing of Krispy Kreme's third quarter of fiscal 2004, in connection with the reacquisition of a franchise in Michigan.

21. In this reacquisition transaction, Krispy Kreme agreed to increase the price it paid for the franchise by \$535,463, which represented an approximation of the total of two disputed amounts that Krispy Kreme claimed it was owed by the Michigan franchise.

22. As a result, when the reacquisition closed, Krispy Kreme paid an increased purchase price of \$535,463, and recorded the transaction on its books and records as if it had been reimbursed for the two disputed amounts. This overstated Krispy Kreme's net income in the third quarter by approximately \$310,000 after taxes.

### **Third Round Trip Transaction**

23. The third round-trip transaction occurred in January 2004, in the fourth quarter of fiscal 2004, in connection with Krispy Kreme's reacquisition of the remaining interests in a franchise in California.

24. Krispy Kreme owned a majority interest in the California franchise and, beginning in or about October 2003, initiated negotiations with the remaining interest holders for acquisition of their interests. During those negotiations, the principal manager of the California franchise, who individually owned 25% of the franchise, ceased to manage the California franchise and Krispy Kreme, through its employees, assumed management responsibility.

25. During the course of negotiations, Krispy Kreme demanded payment of a "management fee" in consideration for Krispy Kreme's handling of the management duties since October 2003. A few days before the closing and only about a week before quarter-end, Krispy Kreme engaged a round-trip means that provided the former franchise manager with funds that he could then use to pay a management fee to Krispy Kreme.

26. Specifically, Krispy Kreme proposed that the former franchise manager would receive a distribution from his capital account, which he could then pay back to Krispy Kreme as a management fee. No adjustment was made to the purchase price for his interest in the California franchise to reflect this distribution. As a result, the former franchise manager received the full value for his franchise interest, including his capital account, plus an additional amount provided that he paid back that amount as the management fee. Krispy Kreme, acting through the California franchise, made a distribution to the former franchise manager in the

amount of \$597,415, which he immediately transferred back to Krispy Kreme as payment of the management fee. Krispy Kreme booked this fee as income, thereby overstating Krispy Kreme's net income in the fourth quarter by approximately \$361,000.

27. In May 2004, Krispy Kreme disclosed disappointing earnings for the first quarter of fiscal 2005 and lowered its future earnings guidance. Subsequently, as a result of the conduct described above, as well as the discovery of other accounting errors, on January 4, 2005, Krispy Kreme announced that it would restate its financial statements for fiscal 2003 and 2004. The restatement reduced net income for fiscal years 2003 and 2004 by \$2,420,000 and \$8,524,000, respectively. Krispy Kreme also forced the retirement or resignation of a number of senior executives who were identified as bearing some degree of responsibility for events leading to the restatement.

28. Krispy Kreme materially misstated its earnings in its financial statements filed with the Commission between the fourth quarter of fiscal 2003 and the fourth quarter of fiscal 2004. In each of these periods, Krispy Kreme falsely reported that it had achieved earnings equal to its EPS guidance plus one cent in the fourth quarter of fiscal 2003 through the third quarter of fiscal 2004 or, in the case of the fourth quarter of fiscal 2004, earnings that met its EPS guidance.

### **Krispy Kreme's Violations**

29. As a result of the conduct described above, Krispy Kreme violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission information, documents, and annual, quarterly, and current reports as the Commission may require, and mandate that periodic reports contain such further material information as may be necessary to make the required statements not misleading.

30. Because Krispy Kreme improperly accounted for its Incentive Plan and improperly accounted for three franchise reacquisitions, its books, records and accounts did not, in reasonable detail, accurately and fairly reflect its transactions and dispositions of assets.

31. In addition, Krispy Kreme failed to implement internal accounting controls relating to its Incentive Plan and franchise reacquisitions which were sufficient to provide reasonable assurances that its accounts were accurately stated in accordance with generally accepted accounting principles.

32. As a result of the conduct described above, Krispy Kreme violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets.

33. Lastly, as a result of the conduct described above, Krispy Kreme violated Section 13(b)(2)(B) of the Exchange Act, which requires all reporting companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles.

### **Krispy Kreme's Remedial Efforts**

34. In determining to accept the offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

### **Undertakings**

35. Respondent shall cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in the Order. In connection with such cooperation, Respondent has undertaken:

a. To produce, without service of a notice or subpoena, any and all documents and other information requested by the Commission's staff;

b. To use its best efforts to cause its employees to be interviewed by the Commission's staff at such times as the staff reasonably may direct;

c. To use its best efforts to cause its employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission's staff; and

d. That in connection with any testimony of Respondent to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, Respondent:

(i) Agrees that any such notice or subpoena for Respondent's appearance and testimony may be served by regular mail on their attorney, Jerome F. Birn, Jr., Esq., at Wilson Sonsini Goodrich & Rosati, 650 Page Mill Road, Palo Alto, California 94304-1050; and

(ii.) Agrees that any such notice or subpoena for Respondent's appearance and testimony in an action pending in a United States District Court may be served, and may require testimony, beyond the territorial limits imposed by the Federal Rules of Civil Procedure.

36. In determining whether to accept the Offer, the Commission has considered these undertakings.

#### **IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanction agreed to in Respondent Krispy Kreme's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Krispy Kreme cease and desist from committing or causing violations and future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 promulgated thereunder.

By the Commission.

Elizabeth M. Murphy  
Secretary