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ASHEVILLE, N. C.

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U.S. DISTRICT COURT
W. DIST. OF N. C.

UNITED STATES DISTRICT COURT FOR THE
WESTERN DISTRICT OF NORTH CAROLINA

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)	
SECURITIES AND EXCHANGE COMMISSION,)	<u>COMPLAINT</u>
)	
Plaintiff,)	
v.)	
)	
INGLES MARKETS, INCORPORATED.)	
)	1:06 Civ. 136
Defendant.)	
)	
----- x)	

Plaintiff Securities and Exchange Commission (the "SEC") alleges as follows:

NATURE OF THE ACTION

1. The SEC brings this action as the result of the improper recognition of certain vendor rebates or allowances by Ingles Markets, Incorporated, a publicly-traded regional supermarket chain headquartered in Asheville, North Carolina. Ingles recognized material amounts of income prematurely on the basis of false information provided to the accounting department. In two

instances, differing terms of the agreements were included in secret side agreements. As a result, Ingles materially misstated pretax income as originally reported in two Form 10-Qs, two Form 10-Ks, and bond offering materials between May 2002 and December 2003.

2. The responsible individual was Anthony S. Federico, now deceased. Federico was an Ingles officer and director. From his office near Atlanta, Georgia, Federico negotiated refundable, upfront payments with vendors at or after the end of certain quarters. Federico then papered the transactions to make it look like the money was nonrefundable and for past performance. Senior management was not aware of Federico's false documents. Taken by itself, Federico's misconduct accounted for more than half of the pretax income reported in Form 10-Qs filed in May 2002 and February 2003.

3. Federico was able to do this in large part because Ingles had no meaningful controls over the recognition of income from upfront vendor payments during the relevant period. Ingles restated its financial statements in February 2005 to correct these and other accounting errors, and implemented internal control improvements to properly account for upfront vendor payments. Because many of the restated transactions

balanced each other out, the overall effect on Ingles was to reduce pretax income by \$2.6 million for the year ended September 28, 2002 and to increase pretax income by \$1.2 million for the year ended September 28, 2003.

JURISDICTION

4. This Court has jurisdiction over this action pursuant to Sections 20(b) and 22(a) of the Securities Act of 1933 [15 U.S.C. §§ 77t(b) and 77v(a)] and Sections 21(d), 21(e) and 27 of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78u(d), 78u(e) and 78aa]. Ingles has, directly or indirectly, made use of the means or instrumentalities of interstate commerce and/or of the mails in connection with the transactions described in this Complaint.

DEFENDANT

5. **Ingles Markets, Incorporated** ("Ingles" or the "company") operates 197 supermarkets and a milk processing plant in the region surrounding the company's headquarters in Asheville, North Carolina. Ingles' Class A common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades on the NASDAQ National Market. The company's fiscal year ends on the last Saturday of September.

RELEVANT INDIVIDUAL

6. **Anthony S. Federico** ("Federico"), now deceased, was an Ingles vice president and a member of the board of directors during the relevant period. He was asked to resign from the board in August 2003 and from the company in February 2004 after the discovery of certain of the misconduct alleged in this Complaint and after an internal investigation conducted under the authority of the company's Audit Committee. On July 28, 2005, Federico asserted his Fifth Amendment rights in lieu of testifying. On October 2, 2005, he died of a heart attack.

7. Federico joined Ingles in 1991 as a director and in 1992 became vice-president in charge of health and beauty aids such as shampoos, soaps, cleaning supplies, and non-prescription medications. In practice, Federico took a broader role within the company, stepping in to negotiate vendor contracts outside his department, many of which involved upfront payments.

SUBSTANTIVE ALLEGATIONS

RELEVANT BACKGROUND

8. Like other supermarket chains, Ingles has been under pressure in recent years by a number of competitive factors. In 2001, Ingles issued \$250 million in unsecured bonds to retire existing debt and to improve and renovate

stores. The bond offering increased Ingles interest payments by more than \$2 million a quarter. This put downward pressure on earnings at least for the year or more it took to construct and renovate stores, and thereby improve sales and earnings.

9. Due in large part to the transactions discussed below, Ingles' reported earnings remained consistent with historical results during this interim period. Federico exploited Ingles' ineffective vendor allowance internal controls at that time to cause the immediate recognition of vendor allowances in 2002 and early 2003 that should have been recognized as income over time.

10. In certain instances, Federico called vendors at the end of certain quarters, looking to renegotiate or extend contracts in return for upfront payments. Ingles' suppliers were often willing to make upfront payments to secure long-term supply contracts or to extend existing agreements.

11. On multiple occasions, including the four alleged in this Complaint, Federico negotiated refundable, upfront payments, then papered the transactions to make the money appear nonrefundable or for past performance.

12. Generally accepted accounting principles ("GAAP"), as well as Ingles' own accounting policies,

prohibited the immediate recognition of upfront vendor payment unless two conditions were satisfied: (1) the money needed to be nonrefundable and not tied to performance (e.g. future purchases, passage of time); and (2) the companies needed to have an agreement at the time the money was taken into income.

13. Federico's misconduct caused Ingles' accounting for millions of dollars worth of upfront vendor payments to violate GAAP, as well as the company's own accounting policies. The accounting irregularities included transactions with American Greetings, the News Group, Fieldale Farms and Frito-Lay, as alleged below.

AMERICAN GREETINGS TRANSACTION

14. At the end of the quarter ended March 30, 2002, Federico began negotiating a contract extension with Ingles' long-time greeting cards supplier, American Greetings. A mid-level American Greetings executive and Federico discussed the basic terms of a potential contract extension over the telephone on April 19, 2002. The proposed transaction included a \$2 million upfront payment. That same day, Ingles took the entire \$2 million into income as of the quarter ended March 30, 2002.

15. The support for the relevant journal entry was a "billback" drafted by Federico and submitted to accounting

on or about April 19, 2002. This was almost three weeks after the close of the quarter. Billbacks were forms used by Ingles to process allowances through the accounting department and charge vendors for the underlying sales and promotional activity. Federico's billback -- which was backdated to March 23, 2002 -- mischaracterized the \$2 million proposed upfront payment from American Greetings as a "Rebate for Volume Achieved of \$45,000,000 USD Due In 60 Days."

16. The revised contract between Ingles and American Greetings was not executed until April of 2003, which was more than a year after Ingles had taken the \$2 million into income. The terms of the proposed \$2 million upfront payment changed repeatedly throughout the negotiations. Ingles' accounting for the American Greetings transaction violated GAAP because there was no agreement in March 2002 when the money was taken into income.

NEWS GROUP TRANSACTION

17. At the same time that Federico was negotiating with American Greetings, he was negotiating a new agreement with Ingles' book and magazine supplier, the News Group. On or about April 9, 2002, News Group offered to prepay \$700,000 worth of rebates that Ingles would receive on future purchases in return for a contract extension.

18. On April 19, 2002, Ingles took the entire \$700,000 into income as of the quarter ended March 30, 2002. The support for the relevant journal entry was a billback drafted by Federico and submitted to the accounting department. Federico's billback described the proposed rebate advance as "Slotting For 32 Magazines For Next 12 Months." Federico backdated the billback to March 18, 2002 and either signed the New Group representative's name or had someone else sign it.

19. Federico's characterization of the \$700,000 as a "slotting fee" resulted in the money being taken into income immediately. The money was in truth rebates on past and future purchases, as evidenced by a side letter Federico signed on June 24, 2003. The News Group side letter was not provided to Ingles' accounting personnel or anyone else at Ingles.

20. Ingles' accounting for the News Group transaction violated GAAP because, in March 2002 when the money was taken into income, there was no agreement between the News Group and Ingles and the earnings process was not complete.

FIELDALE FARMS TRANSACTION

21. Approximately nine months later at the end of the quarter ended December 28, 2002, Federico elicited the aid of a broker to negotiate an upfront payment from a private

chicken company, Fieldale Farms. The broker recommended that Fieldale Farms offer \$1 million upfront to secure a contract to sell 9 million pounds of chicken to Ingles. Fieldale Farms made a \$1 million offer, which remained on the table through the first week of January 2003. On or about January 13, 2003, Fieldale Farms doubled the proposed upfront payment to \$2 million in return for an 18 million pound contract.

22. At Federico's request, Fieldale Farms drafted a term sheet dated January 14, 2003 that described the \$2 million as non-refundable and not based on any sales volume levels. At around the same time, Fieldale Farms demanded and received a side letter from Federico in which he promised that Ingles would refund a pro-rated portion of the money if it did not buy a full 18 million pounds. Federico executed a second side letter with nearly-identical terms later that month. The Fieldale Farms side letters were not provided to Ingles' accounting personnel or anyone else at Ingles.

23. On January 14, 2003, Fieldale Farms presented the \$2 million offer to Ingles senior management, and shortly thereafter Ingles accepted. On January 17, 2003, Ingles took the entire \$2 million into income for the quarter ended December 28, 2002. The support for the relevant

journal entry was a version of the Fieldale Farms term sheet dated December 20, 2002. That document appears to have been backdated.

24. Ingles' accounting for the Fieldale Farms transaction violated GAAP because, in December 2002 when the money was taken into income, there was no agreement and the earnings process had not commenced, let alone finished. GAAP required that the upfront payment from Fieldale Farms be taken into income as Ingles bought the 18 million pounds of chicken, which took about two years.

FRITO-LAY TRANSACTION

25. In the same month of January 2003, Federico negotiated an agreement with Frito-Lay that included "growth" allowances that conceivably amounted to \$700,000 if and when Ingles hit certain quarterly volume targets during 2003. The parties agreed on terms on or about January 10, 2003 and executed a written contract in late January 2003.

26. Ingles took the entire \$700,000 into income during the quarter ended December 28, 2002. The relevant journal entry was made on January 13, 2003. The support for the entry was a billback for \$700,000 that Federico backdated to December 20, 2002 without the knowledge of other Ingles employees. Federico also appears to have

caused the signature of a Frito-Lay representative to appear on the billback. Federico described the money in his own handwriting as "Rebate For Attaining Volume Goal 2002 \$700,000."

27. Ingles accounting for the Frito-Lay transaction violated GAAP because, in December 2002 when the money was taken into income, there was no agreement between Frito-Lay and Ingles and the earnings process had not commenced, let alone finished.

28. Frito-Lay, which normally paid bills in a timely fashion, did not pay the \$700,000, and Ingles became suspicious of Federico's billback. The company began its own internal investigation that ultimately led to Federico's resignation from the board of directors and the company.

INTERNAL CONTROL DEFICIENCIES

29. Federico's misconduct was made possible because Ingles had no meaningful internal controls over the recognition of income from upfront vendor payments during the relevant period.

30. Ingles' only significant control over vendor rebates or allowances was a review of accounts receivable and deferred income. There was no meaningful control over the recognition of income from upfront payments because

they did not appear in the accounts receivables or deferred income accounts. If a vendor provided a check or authorized a credit against accounts payable, then the transaction was not reviewed by senior accounting personnel.

31. In addition, during the relevant period there were no written accounting policies and procedures relating to vendor allowances, no formal training for buyers and vice presidents, and no review of large billbacks by senior accounting personnel.

FALSE FINANCIAL STATEMENTS

32. Taken alone, the improper accounting for the American Greetings and News Group transactions caused Ingles' pretax income for the quarter ended March 30, 2002, to be overstated by 104% as originally reported (\$2.7 million added to \$2.6 million in other income for a \$5.3 million total).

33. As a result of those accounting irregularities, the financial statements that were incorporated into the Form 10-Q Ingles filed on May 13, 2002, and the Form 10-K Ingles filed on December 12, 2002, were materially false and misleading. These misstatements were corrected by the company in its 2005 restatement.

34. Taken alone, the improper accounting for the Fieldale Farms and Frito-Lay transactions caused Ingles' pretax income for the quarter ended December 28, 2002, to be overstated by 123% (\$2.7 million added to \$2.2 million in other income for a \$4.9 million total).

35. As a result of those accounting irregularities, the financial statements that were incorporated into the Form 10-Q Ingles filed on February 10, 2003, a bond offering memorandum dated May 20, 2003, and the Form 10-K Ingles filed on December 22, 2003 were materially false and misleading. These misstatements were corrected by the company in its 2005 restatement.

36. The misstatements alleged above, as well as other errors, were corrected through the company's February 2005 restated financial statements. The correction of all 101 errors decreased income before income taxes by \$2.6 million for the year ended September 28, 2002, by \$368,000 for the quarter ended December 28, 2002 and increased income before income taxes by \$1.2 million for the year ended September 27, 2003.

FIRST CLAIM FOR RELIEF

**(Violations of Section 17(a)
of the Securities Act)**

37. Plaintiff SEC hereby incorporates ¶¶ 1 through 36 with the same force and effect as if set out here.

38. By reason of the foregoing, Ingles, in the offer or sale of securities, by the use of means or instruments of interstate commerce or by the mails, directly or indirectly (a) employed devices, schemes or artifices to defraud; (b) obtained money or property by means of untrue statements of material facts or omissions of material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon purchasers of securities, in violation of Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)].

39. Ingles may violate those antifraud provisions of the Securities Act unless enjoined.

SECOND CLAIM FOR RELIEF

**(Violations of Section 10(b) and
Rule 10b-5 of the Exchange Act)**

40. Plaintiff SEC hereby incorporates ¶¶ 1 through 39 with the same force and effect as if set out here.

41. By reason of the foregoing, Ingles, in connection with the purchase or sale of securities, by the use of means or instrumentalities of interstate commerce or of the mails, directly or indirectly (a) employed devices, schemes or artifices to defraud; (b) made untrue statements of material facts or omissions of material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon persons, in violation of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated thereunder

42. Ingles may violate those antifraud provisions of the Exchange Act unless enjoined.

THIRD CLAIM FOR RELIEF

**(Violations of the Reporting Provisions
of the Exchange Act)**

43. Plaintiff SEC hereby incorporates ¶¶ 1 through 42 with the same force and effect as if set out here.

44. By reason of the foregoing, Ingles failed to file with the SEC annual and quarterly reports that accurately reflected the company's financial results, in violation of Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and

Rules 12b-20, 13a-1 and 13-a13 promulgated thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1 and 240.13a-13].

45. Ingles may violate those reporting provisions of the Exchange Act unless enjoined.

FOURTH CLAIM FOR RELIEF

**(Violations of the Books and Records and
Internal Control provisions
of the Exchange Act)**

46. Plaintiff SEC hereby incorporates ¶¶ 1 through 45 with the same force and effect as if set out here.

47. By reason of the foregoing, Ingles failed to make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the company, in violation of Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)], and failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were executed in accordance with management's general and specific authorization, in violation of Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(B)].

48. Ingles may violate those books and records and internal controls provisions of the Exchange Act unless enjoined.

PRAYER FOR RELIEF

WHEREFORE, the SEC respectfully requests that this Court enter a judgment permanently enjoining Ingles, and its agents, servants, employees, attorneys, and those in active concert or participation with it, who receive actual notice by personal service or otherwise, from violating (i) Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)], (ii) Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated thereunder; (iii) Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder [17 C.F.R. § 240.12b-20, 240.13a-1 and 240.13a-13]; and (iv) Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A) and (b)(2)(B)].

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