

IN THE UNITED STATES DISTRICT COURT FOR THE  
WESTERN DISTRICT OF MISSOURI  
WESTERN DIVISION

Securities and Exchange Commission,     )  
  )  
  Plaintiff,     )  
  )  
v.    )  
  )  
Warren B. Schmidgall and                    )  
David E. Watson,                                )  
  )  
  Defendants.     )

Case No. 4:08-cv-00677-GAF

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**COMPLAINT**

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Plaintiff Securities and Exchange Commission (“Commission” or “SEC”) for its complaint alleges as follows:

**I. INTRODUCTION**

1) This is an SEC enforcement action based upon fraudulent misstatements in financial statements filed with the SEC and disseminated to the investing public by a publicly traded company, American Italian Pasta Company (“AIPC”) from the company’s fiscal year 2002 through the second quarter of the company’s fiscal year 2004. The named defendants are two former officers of AIPC who participated in and directed the fraudulent scheme. As a result of the scheme, AIPC’s reported quarterly pre-tax net income was fraudulently overstated during the time period alleged in the complaint by as much as 219 percent, and its earnings per share by as much as 220 percent. The SEC seeks injunctive relief, disgorgement, penalties, and other relief against the defendants based upon their participation in the fraudulent scheme.

## II. RELATED ENTITY AND DEFENDANTS

- 2) **American Italian Pasta Company** is a Delaware corporation with its principal place of business in Kansas City, Missouri. AIPC claims to be the largest producer and marketer of dry pasta in North America. At all relevant times, AIPC's common stock was registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and the company filed annual, quarterly, and current reports with the Commission on Forms 10-K, 10-Q, and 8-K, respectively. The company's fiscal year end is the last Friday of September or the first Friday of October, resulting in either a 52 or 53-week fiscal year. AIPC's common stock was traded on the New York Stock Exchange ("NYSE") until December 20, 2006, when the NYSE suspended trading based on AIPC's failure to keep current its Commission filings. AIPC's stock is currently quoted on [www.pinksheets.com](http://www.pinksheets.com), which is operated by Pink OTC Markets, Inc.
- 3) **Warren B. Schmidgall ("Schmidgall")**, age 58, of Topeka, Kansas, was hired by AIPC in November 1998 and served as AIPC's chief financial officer ("CFO") and as an executive vice president from that time until August 2004. In his role as CFO, Schmidgall oversaw AIPC's accounting and financial reporting, and was responsible for internal accounting controls. From August 2004 until September 2005, Schmidgall served as AIPC's executive vice president of strategic planning. At all relevant times, Schmidgall reported to AIPC's chief executive officer ("CEO"), Timothy S. Webster. Schmidgall resigned from AIPC in September 2005. Prior to his employment at AIPC, Schmidgall worked at another manufacturing company for 16 years, where he served as CFO and in other senior positions. Schmidgall has held an Illinois CPA certificate since 1980, but has never held a CPA license.

- 4) **David E. Watson (“Watson”)**, age 53, of Kansas City, Missouri, was hired by AIPC as its CFO in 1994 and served in that position for approximately four years. Watson then served as the head of AIPC’s logistics and customer service department for approximately 2 years. From approximately October 2000 through March 2003, Watson served as AIPC’s executive vice president of operations and corporate development (“Operations EVP”). As Operations EVP, Watson oversaw AIPC’s pasta manufacturing operations and supervised its engineering department. From approximately April 2003 through December 2003, when he resigned his AIPC employment, Watson served as AIPC’s executive vice president of corporate development and strategy (“Corporate Development EVP”). Prior to his resignation, Watson agreed to consult with AIPC on an as-needed basis from January 1, 2004 through December 31, 2005. At all times during his tenure at AIPC, Watson reported to the company’s CEO.

### **III. SUMMARY**

- 5) From AIPC’s fiscal year 2002 through the second quarter of its fiscal year 2004, Schmidgall, Watson, and AIPC’s CEO were engaged in a fraudulent scheme to mislead the investing public about the growth of the company’s earnings and increase its stock price. As a result, AIPC fraudulently overstated pre-tax net income by approximately \$11.5 million or 23 percent in fiscal year 2002; by approximately \$19.7 million or 45 percent in fiscal year 2003; by approximately \$4.4 million or 56 percent in the first quarter of fiscal year 2004; and by approximately \$700,000 or seven percent in the second quarter of fiscal year 2004. This fraudulent overstatement of pre-tax net income caused AIPC’s earnings per share (“EPS”) to be overstated by approximately 23 percent

in fiscal year 2002, 41 percent in fiscal year 2003, 59 percent in the first quarter of fiscal year 2004, and eight percent in the second quarter of fiscal year 2004.

- 6) On June 16, 2008, AIPC filed restated consolidated financials statements. The restatement corrected both fraudulent errors and errors arising from inadequate internal controls and reduced AIPC's pre-tax income for fiscal year 2002 through the second quarter of fiscal year 2004 by approximately \$59 million or 66 percent. AIPC admitted in the June 16, 2008 filing that the restatement "corrects errors arising from poor record keeping, recording transactions without economic substance, recording unsupported journal entries to the general ledger, not maintaining a proper tone as to internal controls and failure to adjust accounts for required amounts."
- 7) From the beginning of AIPC's fiscal year 2002 through the second quarter of fiscal year 2004, Schmidgall participated in AIPC's fraudulent scheme by participating in improper accounting practices, by failing to prevent improper accounting practices directed by others that he knew were improper, and by making misrepresentations to AIPC's auditor. As a result of this conduct, Schmidgall, directly and indirectly, has engaged in, and unless restrained and enjoined by this Court, will in the future engage in, transactions, acts, practices, and courses of business that violate Sections 10(b) and 13(b)(5) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78m(b)(5), and Rules 10b-5, 13b2-1, 13b2-2, and 13a-14, thereunder [17 C.F.R. §§ 240.10b-5, 240.13b2-1, 240.13b2-2, and 240.13a-14] and that aid and abet AIPC's violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B)] and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, and 240.13a-13.

- 8) From the beginning of AIPC's fiscal year 2002 through the first quarter of fiscal year 2004, Watson was also a participant in AIPC's fraudulent scheme and directed or facilitated, including through misrepresentations to AIPC's auditor, a significant portion of the improper accounting practices that inflated AIPC's earnings. As a result of this conduct, Watson, directly and indirectly, has engaged in, and unless restrained and enjoined by this Court, will in the future engage in, transactions, acts, practices, and courses of business that violate Sections 10(b) and 13(b)(5) of the Exchange Act, 15 U.S.C. §§ 78j(b) and 78m(b)(5), and Rules 10b-5, 13b2-1, and 13b2-2 thereunder [17 C.F.R. §§ 240.10b-5, 240.13b2-1, and 240.13b2-2] and that aid and abet violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act [15 U.S.C. §§ 78m(a) and 78m(b)(2)(A)] and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, and 240.13a-13.
- 9) The Commission brings this action pursuant to the authority conferred upon it by Sections 21(d) and (e) of the Exchange Act, 15 U.S.C. §§ 78u(d) and (e), for an order: (1) permanently restraining and enjoining Schmidgall and Watson; (2) prohibiting each of Schmidgall and Watson from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 78l] or that is required to file reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)]; (3) finding Schmidgall and Watson liable for disgorgement (plus prejudgment interest); (4) imposing on Schmidgall and Watson third-tier civil penalties; and (5) granting such other equitable relief as the Court deems necessary and appropriate.

#### **IV. JURISDICTION AND VENUE**

- 10) This Court has jurisdiction over this action pursuant to Sections 21(e) and 27 of the Exchange Act, 15 U.S.C. §§ 78u(e) and 78aa. Venue lies in this Court pursuant to Section 27 of the Exchange Act, 15 U.S.C. § 78aa.
- 11) In connection with the transactions, acts, practices, and courses of business described in this Complaint, Schmidgall and Watson, directly and indirectly, have made use of the means or instrumentalities of interstate commerce or of the mails.
- 12) Certain of the transactions, acts, practices and courses of business constituting the violations of law alleged herein occurred within this district.

#### **V. FACTS**

##### **A. Overview of the Participation of Schmidgall and Watson in AIPC's Fraudulent Scheme**

- 13) From its inception as a public company, AIPC's goal was to be a high-growth company in the low-growth food producers segment of the market. From its 1997 initial public offering ("IPO") through fiscal year 2001, the company achieved rapid revenue and earnings growth based primarily on market share gains by its private label business unit, which generally sold pasta to be marketed under grocery chains' store brands.
- 14) As AIPC's CEO planned for fiscal year 2002, he determined that the company's EPS growth rates relative to other food companies would drive increases in its stock price and developed a "Long Range Plan" for fiscal year 2002 through fiscal year 2004 predicated on top and bottom line annual growth of 15 to 20 percent. The plan targeted annual revenues of \$500 million, earnings (before interest and taxes) of \$100 million, and EPS of three dollars by fiscal year 2004. Schmidgall and Watson were involved in the

development of the Long Range Plan and, like other senior AIPC executives, referred to these results as “5-1-3 Triple Crown Performance.”

- 15) AIPC touted to Wall Street analysts the company’s consistent track record of meeting or beating consensus earnings estimates, and promised that AIPC would continue to “stand out from the crowd” of food companies through high growth.
- 16) For fiscal year 2002 through the second quarter of fiscal year 2004, AIPC established aggressive quarterly and annual revenue and profit expectations, which the company communicated to Wall Street analysts and incorporated into its internal operating budgets. Schmidgall participated in all or nearly all of AIPC’s formal communications with Wall Street analysts relating to AIPC’s projected and reported results from the beginning of fiscal year 2002 through second quarter of fiscal year 2004. Throughout this time period, AIPC’s business consistently failed to generate the profits it had promised analysts.
- 17) In response to its earnings shortfalls, AIPC held “Profit Achievement Task Force” (“PATF”) meetings and other meetings where the participants discussed methods to close the earnings gap. Schmidgall and Watson were primary participants in all or nearly all of these meetings while they were employed at AIPC.
- 18) At PATF and similar meetings, Schmidgall, Watson, and other senior executives committed to execute various practices which they termed “profit initiatives” or “recovery items” to enable AIPC to overcome its earnings shortfalls. In some cases, Schmidgall and Watson were jointly responsible for the same recovery item. The AIPC CEO’s annual evaluations of Schmidgall and Watson were based in part on their ability

to achieve budgeted performance in their respective areas of responsibility and to execute initiatives to help AIPC achieve its earnings targets. Schmidgall and Watson knew that the recovery or profit achievement process was not considered complete until the practices had caused AIPC's net income to be lifted to meet Wall Street's consensus earnings estimate.

- 19) Some of AIPC's PATF initiatives and recovery items were legitimate business strategies, but when AIPC faced a significant gap to the consensus earnings estimate the company turned to accounting manipulations.
- 20) In connection with PATF or similar meetings, Schmidgall or one of his subordinates often prepared a list of the recovery items that needed to be executed in order for AIPC to meet its earnings target. Typically the initials of one or more senior AIPC executives were next to each recovery item on the list to indicate managerial responsibility for the execution of the item. During Schmidgall's tenure as CFO, his initials, "WS," were listed next to a significant number of recovery items, many of which he executed by directing or facilitating fraudulent accounting practices. During Watson's tenure as Operations EVP and Corporate Development EVP, his initials, "DW," were also listed next to a significant number of recovery items, many of which he likewise executed by directing or facilitating fraudulent accounting practices.
- 21) From the beginning of AIPC's fiscal year 2002 through the end of the second quarter of its fiscal year 2004, Watson and Schmidgall each directed or facilitated, jointly or individually, a variety of fraudulent accounting practices to enable AIPC to meet analysts' earnings expectations.

- 22) As AIPC's CFO, Schmidgall knew or was reckless in not knowing that AIPC's accounting manipulations, whether executed by himself, by Watson, or jointly by himself and Watson, were contrary to GAAP. Schmidgall failed to refuse the CEO's requests for accounting manipulations to improve AIPC's reported earnings and also failed to take meaningful steps to prevent the accounting manipulations directed or facilitated by Watson.
- 23) Prior to his employment at AIPC, Watson worked as an auditor at Arthur Anderson LLP from approximately 1978 to 1994. Before Watson left Arthur Anderson in 1994, he had been a partner at the firm for several years. As an Arthur Anderson auditor, Watson audited the financial statements of many different manufacturing companies. From approximately 1980 to 1994, Watson held active CPA licenses from Missouri and/or Kansas.
- 24) As an auditor at Arthur Anderson, Watson developed an understanding of generally accepted accounting principles ("GAAP") and of the relationships between accounting systems, policies, and procedures, accounting entries, and financial statements. Watson developed particular expertise and understanding in the area of accounting and GAAP relevant to manufacturing company financial statements.
- 25) As AIPC's CFO, Watson developed a detailed and comprehensive understanding of AIPC's financial statements and accounting processes.
- 26) As a certified public accountant with expertise in accounting for manufacturing operations, Watson knew or was reckless in not knowing that the accounting manipulations he directed were contrary to GAAP. Watson also knew or was reckless in

not knowing that his accounting manipulations were part of a scheme that incorporated the manipulations he directed or facilitated and the manipulations directed or facilitated by Schmidgall and others.

27) Watson and Schmidgall were both significantly involved in fraudulent accounting by AIPC in the following areas: (1) improper reduction of current period expenses (which improperly increased net income) by capitalizing approximately \$10 million of current period costs to manufacturing related assets from fiscal year 2002 through the end of the second quarter of fiscal year 2004; (2) improper reduction of current period expenses (which improperly increased net income) by capitalizing approximately \$4.5 million of current period costs to Management Information Systems (“MIS”) related assets from fiscal year 2002 through the end of the second quarter of fiscal year 2004; (3) overstatement of spare parts inventory that should have been written down by approximately \$1.4 million by the third or fourth quarter of fiscal year 2003; (4) improper recognition of approximately \$380,000 of revenue from a customer during fiscal year 2002; (5) reduction of fiscal year 2003 wheat costs by \$500,000 based on an improper reserve related to AIPC’s acquisition of a pasta business; (6) improper expense reductions of approximately \$1.28 million for the fourth quarter of fiscal year 2003 and \$1 million for the first quarter of fiscal year 2004 in connection with reciprocal payment arrangements related to AIPC’s acquisition of a specialty pasta business; and (7) improper reduction of \$1 million of expense for the first quarter of fiscal year 2004 based on a false receivable.

28) In addition, Schmidgall directed or facilitated fraudulent accounting by AIPC in the following areas: (1) errors that understated AIPC’s trade promotion expense from fiscal

year 2002 through the end of fiscal year 2003 by approximately \$10 million; (2) improper recognition of approximately \$346,000 of revenue for the first quarter of fiscal year 2004 in connection with a reciprocal payment arrangement with an AIPC customer; (3) improper recognition of approximately \$3.2 million of revenue for the fourth quarter of fiscal year 2003 on products shipped after the end of the quarter; (4) improper \$1 million income overstatement related to AIPC's improper failure to reduce the carrying value of its inventory at the end of fiscal year 2003 to its actual cost; (5) the improper \$586,000 income overstatement for the first quarter of fiscal year 2004 related to the improper elimination of AIPC's compensated absence liability; (6) an improper \$332,000 receivable that should have been written off no later than the first quarter of fiscal year 2004; (7) improper recognition of \$1 million of revenue related to an up-front payment to AIPC from a new supplier; (8) improper accounting associated with a supply agreement between AIPC and one of its customers; and (9) improper depreciation delays.

- 29) For fiscal year 2002, AIPC reported, before unusual items, EPS growth of 28 percent, exactly in line with the consensus earnings estimate. Without the fraudulent accounting that inflated its earnings, AIPC would have had fiscal year 2002 EPS growth of approximately 4 percent. For fiscal year 2003, AIPC reported, before unusual items, EPS growth of 13 percent, again exactly meeting the consensus estimate. Without fraudulent accounting, AIPC's fiscal year 2003 EPS would have declined by approximately 20 percent. For the first quarter of fiscal year 2004, AIPC reported, again in line with the consensus estimate, a decline in EPS of 18 percent. Without fraudulent accounting, AIPC's first quarter fiscal year 2004 EPS would have declined by approximately 49 percent. For the second quarter of fiscal year 2004, AIPC reported, again in line with the

consensus estimate, a decline in EPS of approximately 33 percent. Without fraudulent accounting, second quarter fiscal year 2004 EPS would have declined approximately 38 percent. Schmidgall was involved in virtually all of the fraudulent accounting that enabled AIPC to report earnings consistent with analysts' expectations for these periods. The improper accounting that Watson directed or facilitated was an essential part of this fraudulent scheme.

- 30) From the beginning of fiscal year 2002 through the second quarter of fiscal year 2004, AIPC included these false and misleading financial results in Forms 10-K and 10-Q filed with the Commission. Schmidgall signed all of these filings and, beginning with the Form 10-Q for the third quarter of fiscal year 2002, Schmidgall falsely certified that the filings, to the best of his knowledge, contained no untrue statements of material fact or omissions of a material fact necessary to make the statements made not misleading.
- 31) The misleading results for the first and second quarters of fiscal year 2004 were also included in the company's fiscal year 2004 Form 10-K. Although Schmidgall did not sign the fiscal year 2004 Form 10-K, he reviewed the filing and, on or around December 10, 2004, falsely represented to AIPC's new CFO that the financial statements it contained were correct under GAAP.
- 32) From fiscal year 2003 through the second quarter of 2004, AIPC's misleading financial results were also included in earnings releases attached to Forms 8-K filed with the Commission, which Schmidgall also signed.
- 33) From the beginning of fiscal 2002 through the second quarter of fiscal 2004, Schmidgall also signed representation letters to AIPC's auditor in connection with its audits and

reviews of AIPC's financial statements. The representation letters falsely stated that the referenced financial statements were prepared in accordance with GAAP.

- 34) Watson knew or was reckless in not knowing that from the beginning of fiscal year 2002 through the first quarter of fiscal year 2004, AIPC included false and misleading financial results in Forms 10-K, 10-Q, and 8-K that it filed with the Commission. Watson also knew or was reckless in not knowing that the misleading results for the first quarter of fiscal year 2004 would be included in the company's fiscal year 2004 Form 10-K.

## **B. Capitalization of Manufacturing Expenses**

### **1. AIPC's Capitalization Policy**

- 35) AIPC had significant capital projects that typically involved additions of new pasta production lines in its manufacturing plants. The lines were generally installed by third parties under the direction of AIPC's engineering department, which Watson supervised during his tenure as Operations EVP. When installation of a new line was completed, AIPC's engineering department and other AIPC employees "commissioned" the line through a series of test runs and equipment adjustments. During the commissioning phase, the line produced saleable pasta in quantities that steadily increased.
- 36) In 1998, Watson, in his role as CFO, developed a capitalization policy that (1) provided that only direct installation costs could be capitalized and (2) outlined a method for capturing internal commissioning costs to be capitalized. Watson represented to AIPC's auditor in 1998 that few internal costs would be capitalized during line installations because the installations were performed primarily by third parties. During Watson's tenure at AIPC, his capitalization policy was not superseded by any other written capitalization policy.

37) After Schmidgall became AIPC's CFO he familiarized himself with Watson's capitalization policy and supporting materials that Watson had developed. In addition to describing rationales for AIPC's capitalization policy, the supporting materials explained that "[AIPC's plant] information systems . . . do not allow for the identification of commissioning vs. non-commissioning costs on a person by person or job by job [basis]." Schmidgall therefore knew or was reckless in not knowing that AIPC's information systems were not capable of precisely identifying what internal costs should be capitalized as commissioning costs.

## **2. Improper Capitalization Practices**

38) Under GAAP, costs directly related to getting assets ready for their intended use may be capitalized as a cost of those assets instead of being recorded as current period expenses.

39) As Operations EVP, Watson executed capitalization practices that caused internal costs to be improperly capitalized. Schmidgall facilitated the execution of Watson's improper capitalization practices and failed to implement adequate internal controls and procedures for capitalization to manufacturing capital projects. Watson's capitalization practices, Schmidgall's facilitation of those practices, Schmidgall's failures to implement adequate internal controls and procedures, and other conduct by Watson and Schmidgall caused AIPC to understate expenses by approximately \$10 million from fiscal year 2002 through the second quarter of fiscal year 2004.

40) Contrary to the written policy Watson had developed, in practice AIPC capitalized internal costs based on arbitrary capitalization estimates contained in its annual budgets without reviewing the internal resources actually used to install or commission new lines. As Operations EVP, Watson perpetuated this improper practice. During AIPC's annual

budgeting process, Watson gave his subordinates estimates of the amounts of internal costs that would be capitalized to proposed capital projects and the subordinates incorporated the estimates into AIPC's plant operating budgets. At the end of each month of the respective fiscal year, Watson's subordinates instructed AIPC's accounting department to record internal cost capitalization based on these budgets.

- 41) Watson's internal cost capitalization estimates that he gave to his subordinates were not based on proper analysis. Instead, Watson's estimates of internal cost capitalization were inflated by Watson's imprecise determination of how much the equipment installations might disrupt pasta production on AIPC's existing lines. Watson knew or was reckless in not knowing that capitalization of disruption costs was contrary to GAAP and to AIPC's written capitalization policy.
- 42) Watson knew or was reckless in not knowing that his inflated capitalization estimates would become the basis for monthly capitalization entries.
- 43) Throughout fiscal 2002 and 2003, Watson directed his subordinates to capitalize internal costs based on his inflated budget estimates. Watson knew or was reckless in not knowing that this capitalization practice was fraudulent.
- 44) Prior to fiscal year 2002, Schmidgall learned about AIPC's practice of recording capitalization based on estimates in its budgets. Schmidgall believed the practice was bad accounting and an internal control weakness. In or around June 2001, Schmidgall told Watson's subordinates that they would have to support monthly capitalization of internal costs with lists that detailed the names of employees who had worked on capital projects and the number of hours they had worked. Schmidgall knew or was reckless in

not knowing that AIPC did not have a system in place to capture this information.

Schmidgall also failed to take any meaningful steps to evaluate the effectiveness of his capitalization support requirement.

- 45) In response to Schmidgall's requirement, Watson directed his subordinates to continue following AIPC's historical capitalization practices. As a result, Watson's subordinates continued to base monthly capitalization entries on Watson's budget estimates and created false lists of employee names and hours to support the entries.
- 46) The capitalization of internal costs recorded based on Watson's budget estimates was the minimum amount of internal cost capitalization recorded for each fiscal quarter during Watson's tenure as the Operations EVP. Watson often instructed his subordinates to capitalize additional internal costs on top of the amounts that had been capitalized based on his budget estimates. In some cases, Watson initiated the additional capitalization himself. In other cases, Watson committed to deliver additional capitalization at the request of AIPC's CEO during PATF or similar meetings.
- 47) AIPC's CEO often requested additional capitalization from Watson when AIPC projected that its quarterly or annual earnings would fall short of Wall Street's consensus estimates. Watson complied with these requests without doing adequate analysis to determine the extent to which internal resources had been used on capital projects. In response to the CEO's requests, Watson fraudulently caused AIPC to record additional improper capitalization.
- 48) Schmidgall attended all or nearly all meetings at which AIPC's CEO requested additional capitalization from Watson. Schmidgall knew or was reckless in not knowing that the

additional capitalization was fraudulent but did not adjust AIPC's internal controls or take any other meaningful steps to prevent the fraudulent capitalization.

### **3. Examples of Fraudulent Additional Capitalization**

- 49) In or about November 2001, the head of AIPC's engineering department sent an email to Watson regarding a request by one of Watson's subordinates for additional capitalization of internal costs to AIPC's largest ongoing capital project, which involved the installation of a long-goods pasta production line in AIPC's Excelsior Springs, Missouri production plant and which was known internally as the I-line project (the "I-Line Project"). The email explained that the internal costs could not have been caused by the I-Line Project. Watson directed the additional capitalization to be recorded anyway. Watson knew or was reckless in not knowing that this additional capitalization was fraudulent.
- 50) In October 2001, Watson and Schmidgall both received a report from the head of AIPC's engineering department that indicated that the I-Line Project would be completed during the first quarter of fiscal year 2002. During December 2001 and January 2002, Watson received two additional reports from the head of the engineering department confirming that the I-Line Project had been completed.
- 51) During January 2002, Watson, Schmidgall, and AIPC's CEO learned that AIPC was projecting earnings shortfalls for both the second quarter and full year for fiscal year 2002. On or around January 21, 2002, Watson, Schmidgall, AIPC's CEO, and other senior executives discussed, among other recovery items, recording additional capitalization during the remaining months of the year to help AIPC overcome the earnings shortfall.

- 52) Schmidgall knew or was reckless in not knowing that increasing future capitalization to “recover” from the projected earnings shortfall was fraudulent, but took no action to prevent Watson from executing the recovery item.
- 53) Watson knew or was reckless in not knowing that the I-Line Project was complete, but he agreed with the CEO to record the additional capitalization to the I-Line Project to help AIPC overcome the projected shortfall.
- 54) As planned, the additional improper capitalization to the I-Line Project was recorded gradually during the remaining months of fiscal year 2002.
- 55) During March 2002 (the last month of the second fiscal quarter), Watson, Schmidgall, and the CEO learned that AIPC’s earnings were still short of the second quarter consensus estimate. In response, Schmidgall created a list of recovery items for the second quarter that included an item that read “increase capitalized expense.” Schmidgall, Watson, and AIPC’s CEO discussed the recovery items on Schmidgall’s list and Watson agreed to instruct his subordinates to further increase internal cost capitalization.
- 56) On or around March 18, 2002, Watson informed his subordinates that “increased capitalization on capital projects has been ‘offered’ by Finance as a tool to aide [*sic*] in the achievement of QII earnings.” Watson then directed his subordinates to add the additional capitalization to the I-Line Project. Watson knew or was reckless in not knowing that the I-Line Project was complete and that this additional capitalization was fraudulent.

57) On or around April 15, 2002, Schmidgall received a report that confirmed that the additional capitalization had been recorded. Schmidgall knew or was reckless in not knowing that this additional capitalization was fraudulent. During and following the third quarter of fiscal year 2002 (April through June), Schmidgall received a series of reports that showed that capitalization of internal costs to the I-Line Project continued during that quarter. Schmidgall knew or was reckless in not knowing that this capitalization to the I-Line Project, which by the end of the third quarter had been complete for more than six months, was fraudulent. Schmidgall took no meaningful steps to prevent or correct the fraudulent capitalization to the I-Line Project.

**C. Capitalization of Information Technology Expenses**

58) From fiscal year 2002 through the second quarter of fiscal year 2004, AIPC fraudulently and improperly capitalized over \$4.5 million to information technology related assets.

59) Watson had management responsibility for AIPC's MIS department prior to approximately early or mid 2002, and he had continuing involvement and responsibilities related to MIS during 2002 and 2003. Watson was actively involved in the preparation of the MIS department operating expense budgets for fiscal years 2002 and 2003, and he may have been involved in preparation of the MIS budget for fiscal 2004.

60) Schmidgall had management responsibility for the MIS department from approximately early or mid 2002 until at least approximately August 2004. Schmidgall was actively involved in the preparation of the MIS department operating expense budgets for fiscal years 2002, 2003 and 2004.

- 61) Schmidgall and Watson failed to cause AIPC to obtain proper information and to create appropriate written policies regarding capitalization of MIS related expenses, and they failed to implement appropriate procedures and controls in this area. These failures and other conduct by Watson and Schmidgall caused, permitted, or contributed to most or all of the improper capitalization of MIS related costs from fiscal 2002 through the second quarter of fiscal 2004.
- 62) Watson and Schmidgall also failed to appropriately inform or consult with AIPC's outside auditor regarding MIS capitalization.
- 63) Both Watson and Schmidgall knew or were reckless in not knowing that excessive capitalization of MIS expenses would improperly reduce operating expenses and increase net income.

**1. MIS Internal Labor**

- 64) In order to accurately determine the proper amount of internal MIS labor expense to capitalize under GAAP, it is necessary to track and consider the amount of time being spent on tasks related to capital projects, the nature of the tasks, the employees performing the tasks, and the related compensation rates. The actual capitalization recorded should be calculated considering these variables and be based upon actual events.
- 65) AIPC's MIS department operating expense budgets included a line item for capitalized internal MIS labor. The budgeted capitalized labor was not calculated considering anticipated capitalizable tasks, the hours those tasks would require, and the compensation rates of the employees that would perform the tasks. Rather, the budgeted capitalized labor was, in general, simply a percentage of total budgeted MIS department labor. Then,

during the year, contrary to GAAP, AIPC generally recorded internal MIS department labor capitalization based on its budget rather than calculating it based on tasks, hours, rates and actual events.

- 66) Watson knew or was reckless in not knowing that AIPC's budgeted capitalized internal MIS department labor was not calculated based on tasks, hours and rates, and that AIPC generally recorded internal MIS department labor capitalization based on its budget. Watson knew or was reckless in not knowing that the amounts of internal MIS department labor that were capitalized were not properly calculated, and were arbitrary and excessive.
- 67) When he began to take over responsibility for the MIS department in 2002, Schmidgall perceived that capitalized MIS labor had been too high in prior years. Schmidgall failed, however, to correct these prior year errors. He also failed to implement appropriate accounting procedures for the capitalization of internal MIS department labor, and largely perpetuated existing budgeting and capitalization practices.
- 68) Schmidgall knew or was reckless in not knowing that AIPC's budgeted capitalized internal MIS department labor was not calculated based on tasks, hours and rates, and that AIPC generally recorded internal MIS department labor capitalization based on its budget. Schmidgall knew or was reckless in not knowing that the amounts of internal MIS department labor that were capitalized were not properly calculated, and were arbitrary and excessive.
- 69) Among other things, in connection with preparation of the fiscal year 2003 budget and concerns expressed by AIPC's vice president of information technology ("MIS VP"),

Schmidgall acknowledged that the amount of capitalized internal MIS department labor that had been proposed for the budget was unreasonably high, and instructed the MIS VP to reduce it by approximately 50 percent or half. Nonetheless, as the budget process continued, Schmidgall permitted the budgeted capitalization to be increased back to the earlier, unreasonable level, and he knew or was reckless in not knowing that AIPC actually capitalized the budgeted amount.

70) The following year, AIPC's MIS VP attempted to calculate appropriate labor capitalization for her department. Although Schmidgall was provided with this information, he still allowed AIPC's budget for the corresponding period to include budgeted capitalized MIS department labor that was more than double the figure calculated by the MIS VP.

71) AIPC also improperly capitalized internal labor from other departments to MIS related assets.

## **2. Other MIS Expenses**

72) AIPC fraudulently and improperly capitalized numerous other MIS expenses, in addition to internal labor expenses.

73) In connection with preparation of the MIS department operating expense budget for fiscal 2003, Watson instructed AIPC's MIS VP to reduce expenses by adding more items of capitalization (in addition to MIS department labor) to the budget. None of this capitalization was appropriate under GAAP, and all of it was recorded as budgeted. Watson knew or was reckless in not knowing that these amounts would be capitalized, and that this capitalization was not appropriate under GAAP.

- 74) Schmidgall was aware of this capitalization, and knew or was reckless in not knowing that it was not appropriate under GAAP.
- 75) In connection with preparation of the MIS department operating expense budget for fiscal 2004, Schmidgall again added a number of items of capitalization (in addition to MIS department labor) to the budget. None of this capitalization was appropriate under GAAP, and all of it was recorded as budgeted. Schmidgall knew or was reckless in not knowing that these amounts would be capitalized, and that this capitalization was not appropriate under GAAP.
- 76) Additionally, Watson instructed the MIS VP that any external charge relating to construction in progress should be capitalized, and he failed to communicate to the MIS VP any necessary or appropriate exceptions to that broad general instruction under GAAP. Schmidgall knew or was reckless in not knowing of the broad general guidelines provided in this area, and similarly failed to communicate appropriate exceptions or detail.
- 77) Based on this broad instruction and approach, AIPC improperly capitalized certain software maintenance charges and items or amounts of consulting or outside labor. Watson and Schmidgall both knew or were reckless in not knowing that AIPC was, contrary to GAAP, improperly capitalizing such expenses. Schmidgall knew that AIPC capitalized software maintenance charges in connection with MIS capital projects and approved of this practice.

- 78) Watson and Schmidgall directed or caused the improper capitalization of non-hardware communications expenses, and both knew or were reckless in not knowing that AIPC was improperly capitalizing such expenses.
- 79) AIPC also improperly capitalized other costs involving MIS, including expenses related to training and routine services.

**D. Obsolete and Missing Spare Parts**

- 80) For inventories such as AIPC's equipment spare parts inventory, GAAP generally requires that the value of the inventory include only items that exist and are available to the enterprise. Accordingly, if a count of the inventory indicates that parts formerly included or believed to be in inventory no longer exist, the missing parts should not be included in the value of the inventory under GAAP.
- 81) For inventories such as AIPC's equipment spare parts inventory, GAAP also generally requires that the value of spare parts be reduced or eliminated if the parts are discovered to be obsolete or used, or if their value to the business has otherwise been impaired or is less than the value assigned to them.
- 82) As spare parts are taken from inventory and used, the usage gives rise to expense that is properly recognized under GAAP. The expense created by the consumption of spare parts inventory will reduce net income under GAAP.
- 83) AIPC did not maintain an adequate system of internal controls with respect to its equipment spare parts inventory. In fiscal year 2002, AIPC retained an outside firm to manage the spare parts inventory at AIPC's Excelsior Springs, Missouri ("ES") plant. During fiscal year 2002, with assistance from AIPC personnel, the outside firm

- performed a physical count of the spare parts at the ES facility that indicated that the spare parts inventory on AIPC's records was overstated by approximately \$1 million.
- 84) The ES plant manager told Watson about the variance, including the amount, promptly after the count was completed. Watson refused to permit correction of the records and otherwise failed to take appropriate action in response to this information.
  - 85) Additionally, in fiscal 2002, Watson caused the ES spare parts inventory to be falsely increased for spare parts that had not been paid for or received. This caused an improper increase in spare parts inventory and a false reduction in repairs expense.
  - 86) Watson also directed that the cost of certain spare parts delivered to the ES plant be charged to the cost of constructing other facilities, which was improper under GAAP.
  - 87) Watson also failed to appropriately inform AIPC's outside auditor of the spare parts information brought to his attention or otherwise appropriately consult with AIPC's outside auditor regarding spare parts.
  - 88) Watson knew or was reckless in not knowing that AIPC's spare parts inventory was materially overstated, but he failed to take appropriate action to correct AIPC's financial information. Watson also knew or was reckless in not knowing that correcting AIPC's spare parts inventory records would reduce the carrying value of spare parts inventory and reduce net income.
  - 89) From approximately March through June 2003, AIPC employees counted the spare parts at the ES facility and segregated over \$1.4 million of worthless, obsolete, and missing spare parts. Although segregated and subtotaled, these entries continued to be included in the spare parts inventory total on AIPC's records.

- 90) This issue was conveyed to Schmidgall, but he failed to correct AIPC's records or otherwise take appropriate action in response to this information.
- 91) Then, in late 2003, AIPC engaged another outside consulting firm. In approximately February 2004, the consulting firm reported to AIPC that it appeared the spare parts inventory at ES was overstated by approximately \$1 to \$1.5 million. This information was promptly communicated to Schmidgall.
- 92) Then, in early May 2004, the consulting firm reported that it still appeared that \$1 million to \$1.5 million would be left unaccounted for or unidentified when initial cycle counting was completed and \$1 million to \$2 million was expected to be identified as obsolete. Again, these findings were promptly communicated to Schmidgall.
- 93) Nonetheless, Schmidgall failed to take appropriate action to cause the spare parts inventory records to be corrected.
- 94) Schmidgall also failed to appropriately inform AIPC's outside auditor of the spare parts information brought to his attention or otherwise appropriately consult with AIPC's outside auditor regarding spare parts.
- 95) Schmidgall knew or was reckless in not knowing that AIPC's spare parts inventory was materially overstated in the company's financial statements, but he failed to take appropriate action to correct AIPC's financial information. Schmidgall also knew or was reckless in not knowing that correcting AIPC's spare parts inventory records would reduce the value of spare parts inventory and reduce net income.

**E. The Gooch Foods Receivable**

- 96) On or around December 1, 2000, AIPC entered into a five-year agreement to supply pasta to Gooch Foods, Inc. ("Gooch"). Watson signed the agreement on behalf of AIPC and

was familiar with its provisions. The contract provided that Gooch would purchase a minimum of 18 million pounds of pasta during each twelve-month period or “term” (measured from December 1 to November 30) of the contract. The agreement further provided that if Gooch failed to purchase the contract minimum during any term, the price of pasta for the following term would automatically increase pursuant to a formula set forth in the contract.

- 97) During the third quarter of fiscal year 2002 (April through June), Watson and other AIPC employees predicted that Gooch’s purchases for the current contract term might not total 18 million pounds by November 30, 2002. Around the same time, Watson, Schmidgall, and AIPC’s CEO learned that AIPC faced a gap between its actual results and its earnings targets. In response, the three executives agreed that AIPC would recognize revenue and record a receivable for the third quarter of fiscal 2002 based on the potential price increase Gooch might pay in the next contract term. Schmidgall and Watson knew the next contract term would not begin until after the start of fiscal year 2003.
- 98) AIPC employees estimated the size of Gooch’s shortfall and then calculated what the future price increase would be if the estimate proved accurate. Based on these calculations, AIPC recorded \$302,000 of revenue for the third quarter of fiscal 2002 and a receivable in the same amount.
- 99) During the fourth quarter of fiscal 2002, AIPC increased its estimate of the size of Gooch’s purchase shortfall, recorded an additional \$81,000 of improper revenue, and increased the receivable by the same amount.

- 100) Schmidgall and Watson knew or were reckless in not knowing that recognizing the \$302,000 of revenue in June 2002 based on predictions about Gooch's purchasing activity for the following five months was contrary to GAAP. Schmidgall and Watson also knew or were reckless in not knowing that recognizing the \$81,000 of revenue in September 2002 based on predictions about Gooch's purchasing activity for the following 2 months was contrary to GAAP. Under GAAP gains contingent on future events cannot be recognized as revenue.
- 101) Recognizing the \$383,000 as fiscal year 2002 revenue was contrary to GAAP for at least two additional reasons, both of which Schmidgall and Watson knew or were reckless in not knowing.
- 102) First, the contract provided for a price increase on sales in a future period. Under GAAP, such revenues may not be recognized until the product is delivered. None of the product giving rise to the revenue recorded could have been delivered in AIPC's 2002 fiscal year (which ended on September 27, 2002) because the price increase on which the purported revenue was based would not have started until December 2002.
- 103) Second, by or near the end October 2002, Watson had completed negotiations to acquire most of Gooch's pasta assets and knew that Gooch's parent company was planning to exit the pasta business in connection with the acquisition. Schmidgall was familiar with the status of Watson's negotiations with Gooch. Watson and Schmidgall therefore knew or were reckless in not knowing that the price increase for the December 2002 – November 2003 contract term would not occur.
- 104) Early in the first quarter of fiscal year 2003, AIPC completed its acquisition of the Gooch pasta assets. Instead of recording the elimination of the \$383,000 receivable as an

expense or as a reduction of revenue, AIPC accounted for it as a cost of the acquisition. Schmidgall and Watson knew or were reckless in not knowing that this accounting was improper under GAAP, which provides that only direct costs of an acquisition may be capitalized.

**F. The Gooch Foods Wheat Reserve**

- 105) During his negotiations with Gooch at the end of AIPC's fiscal year 2002, Watson learned that Gooch had not locked in a durum wheat price through forward contracts for 2003. Watson understood that AIPC would therefore have to pay current market prices, which had increased substantially by the end of fiscal year 2002, for the additional durum wheat it would need to produce Gooch brand pasta during fiscal year 2003.
- 106) Schmidgall, Watson, and AIPC's CEO discussed ways to prevent AIPC from recognizing in fiscal year 2003 the difference between the old and current durum wheat prices as an expense, as required by GAAP. Together they determined that AIPC would record a reserve as part of the acquisition cost and that the reserve would be used in fiscal year 2003 to reduce the wheat expense recognized by AIPC. Schmidgall and Watson knew or were reckless in not knowing that this accounting was fraudulent.
- 107) Watson caused language regarding AIPC's assumption of "[Gooch's] wheat price increase reserve payable to [AIPC]" to be added to the Gooch purchase agreement to facilitate AIPC's recording of the reserve. Watson knew or was reckless in not knowing that the language he added to the agreement lacked economic substance because it did not change the purchase price or any other substantive aspect of the agreement between AIPC and Gooch.

108) Based on the language Watson added to the contract, Schmidgall and Watson instructed AIPC's accounting personnel to add to the cost of the Gooch acquisition a \$500,000 reserve. As planned, during fiscal 2003, AIPC made entries to eliminate the reserve and reduce its fiscal year 2003 raw materials expense by \$125,000 per quarter.

**G. Specialty Pasta Business Round-Tripping Transactions**

- 109) During the relevant time period, the defendants also engaged in transactions involving reciprocal ("round-tripping") payment agreements for the purpose of recording improper income in AIPC's accounting records.
- 110) In February 2003, Watson negotiated on behalf of AIPC an asset purchase agreement with an independent manufacturer of specialty pasta owned by a husband and wife. Pursuant to the agreement, AIPC agreed to pay the owners 100,000 shares of AIPC stock, plus future cash payments (the "earnout payments") if the specialty pasta business met certain profitability thresholds. In or around February 2003, Watson and the former owners signed the agreement. Shortly thereafter, the former owners became employees of AIPC.
- 111) During the first six months after the acquisition, AIPC encountered difficulties with its integration of the specialty pasta business and the business generated less income than AIPC had predicted. In late August 2003, Watson asked the former owners to reimburse AIPC for certain unbudgeted costs associated with the acquired business. The former owners refused and asserted that AIPC's own failures were responsible for the business's lower than expected income.
- 112) When it became clear to Watson that he would be unable to convince the former owners to reimburse AIPC for the unbudgeted costs, Watson, Schmidgall and AIPC's CEO

agreed to find another way to offset the negative impact of the costs in AIPC's income statement for the fourth quarter of fiscal year 2003.

- 113) Around the same time, Watson and the CEO were negotiating the terms of Watson's departure from AIPC. Watson and the CEO agreed that Watson would be paid \$125,000 upon his departure from AIPC if Watson was successful in at least neutralizing the negative impact of the acquired business on AIPC's income statement.
- 114) In or around September 2003, Watson approached the former owners with two agreements that had been prepared at Watson's direction. One agreement provided that the former owners would reimburse AIPC for \$1.28 million of costs incurred by AIPC. The second agreement provided that AIPC would pay the former owners a \$1.3 million earnout payment. Watson and the former owners signed the reimbursement agreement and the earnout payment agreement which were dated, respectively, September 18, 2003, and September 19, 2003. Soon thereafter, AIPC made a payment to the owners that equaled the difference between the amounts in the two agreements, or approximately \$22,000.
- 115) Watson did not make any calculation of the earnout payment amount under the terms of the asset purchase agreement. Instead, the \$1.3 million amount Watson caused to be included in the September 19<sup>th</sup> earnout payment agreement was based on the amount by which Watson, Schmidgall, and AIPC's CEO wanted to inflate the company's income for the fourth quarter of fiscal year 2003. The acquired specialty business's fiscal 2003 financial results would not have triggered any earnout payment under the terms of the asset purchase agreement. Further, had an earnout payment been warranted, Watson could not have calculated its amount in September 2003 because AIPC's 2003 fiscal year

did not end until October 3, 2003. Watson and Schmidgall knew or were reckless in not knowing that the \$1.3 million earnout payment amount had no basis.

- 116) This transaction was a circular transaction. GAAP requires that the accounting for such circular transactions reflect their substance over their legal form. Contrary to GAAP, Schmidgall directed AIPC personnel to reduce operating expenses by \$1.28 million in the fourth quarter of 2003 based on the reimbursement agreement. Watson and Schmidgall knew or were reckless in not knowing that this accounting was fraudulent.
- 117) At or around the beginning of the first quarter of fiscal year 2004 (November 2003), Watson and AIPC's CEO agreed that AIPC should terminate the employment of the former owners and negotiate a buyout agreement with them. Watson negotiated a deal with the former owners under which AIPC was to pay them \$7 million in exchange for the return of their AIPC stock and the cancellation of AIPC's earnout payment and other obligations under the parties' original asset purchase agreement.
- 118) Watson, Schmidgall, and AIPC's CEO discussed the \$7 million buyout price Watson had negotiated and together the three executives agreed to incorporate into the final documents for the transaction an incremental reimbursement payment from the former owners to AIPC to further fraudulently reduce AIPC's reported expenses.
- 119) On or about December 12, 2003, the former owners received from AIPC a term sheet that increased the buyout price they had negotiated with Watson to \$7.5 million and included a \$500,000 reimbursement payment from them to AIPC.
- 120) When the former owners sought an explanation for the new buyout price and for the reimbursement payment, Watson explained that the offsetting \$500,000 amounts were

necessary for AIPC's internal accounting purposes and stressed that the former owners would still net \$7 million. AIPC's CEO and the former owners signed the term sheet on or about December 12, 2003.

- 121) On or about December 23, 2003, the former owners received from AIPC an unsigned buyout agreement that provided for the \$7.5 million buyout price and \$500,000 reimbursement payment. The former owners signed the agreement and returned it to AIPC.
- 122) On about January 2, 2004, Watson called the former owners and told them that the amount of the buyout price and the amount of reimbursement payment were each being increased by another \$500,000 and that AIPC would send the former owners a new buyout agreement to sign with a buyout amount of \$8 million and a reimbursement amount of \$1 million. Watson again stressed that the former owners would still net \$7 million.
- 123) Watson knew or was reckless in not knowing that the purpose of the offsetting \$1 million amounts was to increase AIPC's first quarter income by \$1 million. Watson also knew or was reckless in not knowing that this accounting was fraudulent because the offsetting \$1 million amounts had no economic substance.
- 124) On or about January 2, 2004, Watson instructed AIPC's counsel to revise the buyout agreement to reflect the \$8 million buyout and \$1 million reimbursement amounts that Watson had described orally to the former owners.
- 125) On or about January 6, 2004, Schmidgall received the revised agreement reflecting the \$8 million buyout and \$1 million reimbursement amounts from AIPC's counsel. The same

day, Schmidgall sent an email to the former owners attaching the revised agreement and confirming that the reimbursement amount had been increased to \$1 million.

- 126) On or about January 6, 2004, Schmidgall, on behalf of AIPC, and the former owners executed the revised buyout agreement with the \$8 million buyout and \$1 million reimbursement amounts. Soon thereafter, AIPC paid the former owners \$3 million in cash and gave them a \$4 million promissory note.
- 127) Based on the revised buyout agreement, Schmidgall instructed AIPC's accounting department to make entries to record \$8 million as an asset and reduce expense for the first quarter of fiscal year 2004 by \$1 million. Schmidgall knew or was reckless in not knowing that this accounting was fraudulent.

#### **H. Atkins Receivable**

- 128) At the end of fiscal year 2003, Watson negotiated an agreement for AIPC to produce new low-carbohydrate pasta products for Atkins Nutritionals, Inc. ("Atkins").
- 129) During the first quarter of fiscal year 2004, Watson, Schmidgall, and AIPC's CEO learned that costs in the plant where the new Atkins products were being manufactured were higher than the amounts that AIPC had budgeted. The three executives attributed the excess costs to problems associated with producing the Atkins products and together they agreed to record a \$1 million receivable to offset the impact of the excess costs on AIPC's first quarter income statement. Watson and Schmidgall knew or were reckless in not knowing that Atkins had not agreed to reimburse AIPC for higher than expected production costs and therefore knew or were reckless in not knowing that AIPC's recording of the receivable was fraudulent.

- 130) In or around December 2003, AIPC's auditor learned that the company had recorded the \$1 million receivable. A senior member of the audit team contacted Watson and questioned him about the basis for the receivable. Watson assured the senior auditor that Atkins had orally communicated to him a firm commitment to reimburse AIPC for \$1 million of research and development costs and that a written agreement between AIPC and Atkins to that effect would be signed shortly.
- 131) Watson had no basis for representing that Atkins had made a firm commitment to reimburse AIPC for \$1 million of costs. Watson made the misrepresentation to AIPC's auditor to facilitate AIPC's fraudulent inflation of fiscal 2004 first quarter income by \$1 million.
- 132) In or around March 2004, AIPC and Atkins amended their original agreement to allow AIPC to sell low carbohydrate pasta to third parties. The amended agreement stated explicitly that Atkins had no obligation to reimburse AIPC for any research and development costs incurred by AIPC. Schmidgall received a copy of the agreement and knew or was reckless in not knowing that it contradicted AIPC's assertion to its auditors about the basis for the receivable. Schmidgall withheld the amendment from AIPC's auditor and did not disclose to the auditor its content. Schmidgall also permitted AIPC to leave the false receivable on its records until the end of fiscal year 2004.

#### **I. Trade Promotional Liability**

- 133) From fiscal year 2001 through fiscal year 2003, AIPC acquired several large pasta brands such as Mueller's, Golden Grain, and Anthony's. Unlike AIPC's private label business, sales of branded pasta required AIPC to incur trade promotion costs, which included product discounts, promotions, advertising, and volume rebates.

## **1. AIPC's Trade Promotion Accounting Practices**

- 134) In accordance with GAAP, AIPC accounted for its trade promotion spending by recognizing a promotional expense and accruing a corresponding liability at the time of sale and then reducing the liability when AIPC paid its customer for the promotion. AIPC's payment for promotions generally took the form of deductions by its customers from their payments to AIPC. AIPC based the promotional expense and liability accrual at the time of sale on its annual promotional spending estimate. The expense and liability were to be "trued up" if actual promotional spending for the year differed from the estimate.
- 135) During fiscal years 2002 and 2003, AIPC did not have adequate internal controls with respect to its accounting for trade promotions. During the same time period, AIPC's actual promotional spending consistently outpaced its estimated promotional spending and, as a result, the promotional liability reflected in the company's books and records was consistently too low.
- 136) Schmidgall knew or was reckless in not knowing that AIPC did not have adequate internal controls with respect to its accounting for trade promotions. Instead of permitting AIPC to recognize expense to eliminate the liability shortages, Schmidgall repeatedly caused AIPC to improperly record offsetting increases to various assets and otherwise caused AIPC to understate its promotional expense. In total, from fiscal year 2002 through the end of fiscal year 2003, AIPC fraudulently understated its promotional expense by more than \$10 million.

## 2. Examples of Fraudulent Failures to Record Trade Promotion Expense

- 137) In early fiscal year 2002, the company's promotional liability was deficient by approximately \$2.9 million. In response, Schmidgall directed AIPC accounting personnel to capitalize \$1.1 million of promotional spending to the cost of the company's acquisition of the Mueller's pasta brand. Schmidgall knew or was reckless in not knowing that this accounting was fraudulent. AIPC's auditor told Schmidgall that this accounting was incorrect, but Schmidgall refused to correct it.
- 138) Schmidgall also established an improper plan to make three "catch-up" accruals from fiscal year 2002 through fiscal year 2004 to eliminate the remaining \$1.8 million of the liability deficiency. Schmidgall did not disclose to AIPC's auditor that the company's trade promotion liability was deficient or the company's catch-up plan.
- 139) At the end of the first quarter of fiscal year 2003, AIPC's promotional liability was deficient by approximately \$5.6 million. At the beginning of the fourth quarter of fiscal year 2003, the liability deficiency had grown to approximately \$8 million. Schmidgall did not disclose to AIPC's auditor the full extent of the company's liability deficiency. Instead, at Schmidgall's direction, AIPC repeatedly gave the auditor an inaccurate view of the promotional liability that reflected a significantly smaller deficiency.
- 140) In response to the increasingly deficient liability, Schmidgall and AIPC's CEO organized a review of all company promotional spending prior to August 2002, ostensibly to identify promotional deductions that had been improperly taken by AIPC's customers and for which AIPC could therefore attempt to seek reimbursement. Schmidgall and the CEO had instructed that the review should "target identification of \$3 to \$4 million."

- 141) The goal of the review was to justify the recording of a receivable to reduce the promotional liability shortage. An internal memorandum generated during the review that Schmidgall received, however, estimated that the success rate for obtaining reimbursement from customers would be very small, and stated that AIPC should not record a receivable for potentially improper deductions.
- 142) An internal October 2003 memorandum and table summarizing the review results, which Schmidgall received, reflected that only \$941,000 of deductions had been improperly taken and estimated that AIPC could potentially recover about \$679,000 of this amount.
- 143) Schmidgall disregarded these results and instead, contrary to GAAP, directed AIPC's accounting personnel to record a fraudulent \$3.4 million receivable.
- 144) In November 2003, another AIPC internal report, which Schmidgall received, indicated that the original \$679,000 recovery estimate was too high and predicted instead that no more than \$500,000 could be collected. Nevertheless, Schmidgall permitted AIPC to include the fraudulent \$3.4 million receivable in its fiscal year 2003 Form 10-K that it filed at the end of December 2003. Schmidgall also falsely asserted in a memorandum to AIPC's auditor that the \$3.4 million receivable was a "reasonable estimate" and that AIPC managers were "confident in their ability to recover this amount."
- 145) During the fourth quarter of fiscal 2003, at Schmidgall's direction, AIPC also fraudulently capitalized, contrary to GAAP, an additional \$1.5 million of promotional spending to the cost of AIPC's fiscal year 2001 Mueller's brand acquisition. Schmidgall knew or was reckless in not knowing that this accounting was fraudulent.

**J. AIPC Customer Round-Tripping Transaction**

- 146) Beginning in 2001, AIPC requested the U.S. Department of Commerce (“DOC”) to conduct a three-year review for the purpose of removing AIPC, through its Italian subsidiary Pasta Lensi S.r.l. (“Lensi”), from DOC’s anti-dumping requirements. Pasta exported from Italy to the U.S. is subject to a DOC antidumping duty order. The purpose of the antidumping order, generally, is to discourage pasta sales in the U.S. at below market rates (“dumping”) by foreign exporters. Under Schmidgall’s supervision of the process, AIPC met the removal requirements for the first two years of review, for the periods ended June 30, 2001 and 2002.
- 147) In November 2003, Schmidgall learned that AIPC had sold Lensi pasta to a customer at prices below its production cost during the review period ended June 30, 2003. Therefore, AIPC faced a DOC finding that the company (a) had dumped pasta on the U.S. market; (b) was not entitled to a return of the full amount of the company’s anti-dumping deposits; and (c) would have to begin a new three-year review period.
- 148) Schmidgall and AIPC’s CEO agreed that AIPC should seek from the customer a retroactive price increase amounting to \$345,774 in order to pass the DOC review, and in exchange offer \$400,000 to the customer in the form of promotional spending. The customer accepted the proposal.
- 149) On December 18, 2003, the customer paid to AIPC \$345,774. Thereafter, by two separate checks in January and February 2004, AIPC paid the customer a total of \$400,000.

- 150) Schmidgall knew that the customer's agreement to pay the \$345,774 price increase was entirely contingent on the \$400,000 promotional payment from AIPC. Schmidgall knew that AIPC's promotional payment was in reality a repayment to the customer of the price increase plus an incentive.
- 151) Contrary to GAAP, in the first quarter of fiscal year 2004 AIPC recorded as revenue the \$345,774 payment and failed to expense the \$400,000 so-called promotional payment. Schmidgall directed this accounting and knew or was reckless in not knowing that it was fraudulent.

**K. Revenue Recognition Prior to Shipment**

- 152) Schmidgall knew that AIPC had a practice of recognizing current period revenue on pasta shipped after the end of the period. Schmidgall knew or was reckless in not knowing that this practice was contrary to GAAP.
- 153) At the end of fiscal year 2003, AIPC's sales outlook deteriorated in step with the steadily contracting pasta market. In response, AIPC engaged in a sales push by offering aggressive quarter-end promotional discounts to retailers in a process that was known internally as "quarter-end loading."
- 154) Because of the magnitude of the sales push, AIPC was unable to ship by the last day of the fiscal year approximately \$3.2 million worth of pasta ordered by its customers. Contrary to GAAP, AIPC fraudulently recognized the \$3.2 million as fiscal year 2003 revenue.

155) In or around the first week of the fiscal year 2004, the head of AIPC's logistics and operations department met with Schmidgall and told him that a substantial amount of revenue for the fourth quarter of fiscal year 2004 had been recognized on orders that had not shipped by year end. The head of AIPC's logistics/shipping department further explained to Schmidgall that some of this pasta had still not shipped but was sitting in trailers outside AIPC's distribution centers. Schmidgall failed to take any action to correct the improperly recognized revenue.

**L. Durum Wheat Purchase Price Variance**

156) AIPC used a standard cost accounting system to value its pasta inventory and to compute its cost of goods sold. Under this system, AIPC created during its annual budget process standard manufacturing costs for each type of pasta based on the manufacturing expenditures it expected to incur, which included the cost of the durum wheat that would be used to manufacture the pasta.

157) In fiscal year 2003, AIPC paid less for durum wheat than was budgeted in its standard manufacturing costs, such that the company's fiscal year 2003 year-end inventory balance (which was valued at standard costs) was overstated by more than \$1 million. Schmidgall met with AIPC accounting personnel regarding the variance and instructed them not to adjust the value of the inventory. AIPC's auditors disagreed with this accounting, but Schmidgall refused to correct it.

**M. Elimination of Compensated Absence Liability**

158) Prior to 2004, AIPC's compensated absence (or vacation) policy allowed employees to carry over 80 hours of unused time-off from one year to the next. During fiscal year 2003 and prior fiscal years, AIPC maintained, as required by GAAP, a liability at the end

of each reporting period for unused compensated absences that employees could use in the future.

- 159) For fiscal year 2004, Schmidgall budgeted the elimination of the liability based on a plan to adopt a “use-or-lose” compensated absence policy that did not permit any carryover of unused time-off. Instead of implementing the use-or-lose policy, AIPC allowed employees to carry over up to 40 hours of unused compensated absences into fiscal year 2005. Schmidgall knew that AIPC did not implement a use-or-lose policy.
- 160) In the first quarter of 2004, Schmidgall instructed AIPC’s accounting personnel to eliminate the full amount of the liability and thereby reduce expenses and increase income by \$670,000. Because the policy implemented allowed employees to carry over unused time-off into fiscal year 2005, AIPC should have only eliminated approximately \$84,000 of its liability in the first quarter of fiscal year 2004.
- 161) Schmidgall knew or was reckless in not knowing that AIPC’s elimination of the full amount of the compensated absences liability in the first quarter of fiscal 2004 was contrary to GAAP.
- 162) Further, AIPC failed to disclose the one-time \$670,000 benefit in its Form 10-Q for the first quarter of fiscal year 2004. Schmidgall was involved in the preparation of AIPC’s first quarter 2004 Form 10-Q, and knew or was reckless in not knowing that AIPC fraudulently failed to disclose in that document the one-time benefit from eliminating the compensated absences liability.
- 163) Schmidgall falsely represented to AIPC’s independent auditor that AIPC had adopted a “use-or-lose policy” during the first quarter of 2004.

**N. The Packaging Products Receivable**

- 164) Prior to fiscal year 2002, Schmidgall learned that packaging materials AIPC had purchased from Packaging Products Corporation (“PPC”), one of its suppliers, were defective. Schmidgall permitted AIPC to record a receivable and related income based on the prospect of recovering damages from PPC. This accounting was contrary to GAAP because GAAP prohibits recognizing contingent gains as income. Schmidgall knew or was reckless in not knowing that recording the receivable based on the uncertain outcome of AIPC’s lawsuit was contrary to GAAP.
- 165) In or around the third quarter of fiscal year 2002, AIPC filed a lawsuit against PPC to compel PPC to pay AIPC damages. In April 2003, AIPC and PPC agreed to settle the lawsuit for a \$300,000 cash payment to AIPC. In addition, PPC granted AIPC an option to enter into a supply agreement, on or before May 2004, whereby PPC would sell packaging material to AIPC at a five percent discount over a three-year period, up to a maximum benefit to AIPC of \$300,000.
- 166) AIPC left approximately \$332,000 of the receivable on the company’s records based on the prospect of entering into the supply agreement and taking advantage of the discount. Schmidgall knew or was reckless in not knowing that it was improper under GAAP to maintain the receivable given the uncertainty of AIPC’s future purchases from PPC.
- 167) On or before January 2004, AIPC determined not to purchase any packaging material from PPC. Schmidgall knew about this decision but decided to have AIPC amortize the \$332,000 receivable over two years instead of writing it off to expense immediately. Under GAAP, the receivable should have been written off to expense immediately.

Schmidgall knew or was reckless in not knowing that there was no basis under GAAP to amortize the receivable.

**O. Bay State Milling Revenue**

- 168) In March 2002, AIPC and Bay State Milling Company (“Bay State”) entered into a 10-year agreement for the supply of durum flour to one of AIPC’s manufacturing plants. The supply agreement required Bay State to pay AIPC a \$1 million “marketing payment.”
- 169) Contrary to GAAP, Schmidgall instructed AIPC’s accounting personnel to record the \$1 million payment as revenue for the second quarter of fiscal year 2002. GAAP requires that such payments must be recognized as a reduction of cost of goods sold over the term of the contract. Schmidgall knew or should have known that AIPC’s accounting was improper.

**P. General Mills Supply Agreement and Shortfall**

- 170) In fiscal year 2002, AIPC entered into a five-year agreement to supply pasta to General Mills, Inc. (“GM”). The agreement covered AIPC’s fiscal years 2003 through 2007.
- 171) The agreement with GM provided that upon execution AIPC would pay a \$2 million “signing incentive” to GM. AIPC initially determined to amortize the incentive on a straight-line basis, but switched to a different method in connection with its fiscal year 2003 budget. The new amortization schedule delayed the expense, with recognition heavily weighted to the later years of the contract.
- 172) This treatment was contrary to GAAP because (a) the contract contemplated relatively constant volume over its term with only modest price increases (roughly a few percentage points per year) in years three through five and (b) the terms of the contract provided that

GM would in some circumstances acquire the right to keep the incentive as it purchased the volumes contemplated by the contract.

- 173) The delayed amortization improperly reduced expenses by over \$300,000 through 2003 and over \$450,000 through the second quarter of 2004.
- 174) Schmidgall was familiar with the new amortization approach, and he approved of or did not object to or prevent AIPC from using this new method to amortize the signing incentive.
- 175) Schmidgall knew or was reckless in not knowing that the new amortization treatment was contrary to GAAP.
- 176) Further, during fiscal year 2003, GM did not order the minimum amount of pasta contemplated by the contract. As a result, GM agreed to pay AIPC a price increase of \$.004/pound on the next 80 million pounds GM purchased for a total of \$320,000 (the “shortfall amount”). GM did not pay \$320,000 to AIPC in 2003; it merely agreed to a higher price beginning in 2004.
- 177) Under GAAP, AIPC should have recognized the shortfall amount in future (post-fiscal year 2003) periods as the sales occurred, but AIPC fraudulently recognized the entire \$320,000 as revenue in the last quarter of fiscal year 2003.
- 178) Schmidgall knew or was reckless in not knowing that GM did not pay \$320,000 to AIPC in 2003, and that it merely agreed to a higher price beginning in 2004. He also knew or was reckless in not knowing that AIPC recognized the shortfall amount as revenue in the last quarter of fiscal year 2003.

- 179) Schmidgall approved of or did not object to or prevent AIPC from recognizing the shortfall amount as revenue in the last quarter of fiscal year 2003.
- 180) Schmidgall knew or was reckless in not knowing that recognizing the shortfall amount as revenue in fiscal 2003 was contrary to GAAP.

**Q. Depreciation Delays**

- 181) Under GAAP, operating assets must be depreciated. AIPC's depreciation policy called for depreciation of assets to begin after they were completed and ready for their intended use. Specifically, under AIPC's policy, depreciation of assets that became ready for their intended use during a given quarter was to begin on the first day of the following quarter.
- 182) During his tenure as CFO, Schmidgall was responsible for the implementation of AIPC's depreciation policy. During fiscal years 2002 and 2003, Schmidgall facilitated AIPC's improper reduction of depreciation expense by delaying the depreciation start dates of manufacturing-related assets and MIS-related assets.
- 183) For example, during the preparation of the fiscal 2002 budget, one of Schmidgall's subordinates told him that to reduce depreciation expense, AIPC would not start depreciation of any new MIS-related capital projects during fiscal year 2002 regardless of when the capital projects were completed. Schmidgall knew or was reckless in not knowing that these depreciation start date delays were part of a fraudulent scheme to improperly reduce depreciation expense by \$500,000 during fiscal year 2002.
- 184) During his tenure as CFO, Schmidgall took no meaningful steps to ensure that AIPC started depreciation of assets that became ready for their intended use during a given quarter on the first day of the following quarter.

**R. Quantitative Materiality**

185) As a result of the practices described above, AIPC overstated its pre-tax net income earnings per share by the amounts reflected in the table below.

	Pre-Tax Income Overstatement*	Pre-Tax Income Overstatement in Percentage Terms	EPS Overstatement	EPS Oversatement in Percentage Terms
Q1-02	\$ 1,360	11%	\$0.05	12%
Q2-02	\$ 3,839	34%	\$0.14	34%
Q3-02	\$ 2,068	14%	\$0.10	15%
Q4-02	\$ 4,256	33%	\$0.15	33%
<b>Fiscal 2002 Total</b>	<b>\$ 11,523</b>	<b>23%</b>	<b>\$0.41</b>	<b>23%</b>
Q1-03	\$ 974	8%	\$0.04	7%
Q2-03	\$ 3,379	34%	\$0.13	25%
Q3-03	\$ 2,197	14%	\$0.08	14%
Q4-03	\$ 13,126	219%	\$0.48	220%
<b>Fiscal 2003 Total</b>	<b>\$ 19,676</b>	<b>45%</b>	<b>\$0.77</b>	<b>41%</b>
Q1-04	\$ 4,366	56%	\$0.16	59%
Q2-04	\$ 723	7%	\$0.04	8%
<b>10 Quarter Total</b>	<b>\$ 36,288</b>	<b>32%</b>		

\*In Thousands

#### S. Internal Controls Deficiencies

186) As AIPC's CFO, Schmidgall was responsible for devising and maintaining a system of internal controls sufficient to ensure that transactions were recorded such that AIPC's financial statements could be prepared in conformity with GAAP. During the time period fiscal year 2002 through the second quarter of fiscal year 2004, Schmidgall knew or was reckless in not knowing that AIPC's internal controls were inadequate with respect to capitalization, spare parts usage, promotional spending, depreciation, and other areas. Schmidgall failed to take sufficient steps to devise and maintain adequate internal controls.

**FIRST CLAIM FOR RELIEF**

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

15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5

- 187) Paragraphs 1 through 186 are hereby realleged and incorporated by reference.
- 188) Each of Schmidgall and Watson directly and indirectly, with scienter, in connection with the purchase or sale of AIPC securities, by use of the means or instrumentalities of interstate commerce or by use of the mails, has employed devices, schemes, or artifices to defraud; has made untrue statements of material fact or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or has engaged in acts, practices, or courses of business which have been and are operating as a fraud or deceit upon the purchasers or sellers of such securities.
- 189) By reason of the foregoing, each of Schmidgall and Watson violated and unless restrained and enjoined will violate Section 10(b) of the Exchange Act and Rule 10b-5.

**SECOND CLAIM FOR RELIEF**

(Section 13(b)(5) of the Exchange Act and Rule 13b2-1)

15 U.S.C. § 78m(b)(5) and 17 C.F.R. § 240.13b2-1

- 190) Paragraphs 1 through 186 are hereby realleged and incorporated by reference.
- 191) Each of Schmidgall and Watson falsified or caused to be falsified records, records or accounts of AIPC and knowingly circumvented or knowingly failed to implement a system of internal accounting controls.
- 192) By reason of the foregoing, each of Schmidgall and Watson violated and unless restrained and enjoined will violate Section 13(b)(5) of the Exchange Act and Rule 13b2-1.

**THIRD CLAIM FOR RELIEF**  
(Rule 13a-14 of the Exchange Act)  
17 C.F.R. § 240.13a-14

- 193) Paragraphs 1 through 186 are hereby realleged and incorporated by reference.
- 194) Schmidgall certified falsely that to the best of his knowledge there were no untrue statements of material fact or omissions of a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading in reports filed by AIPC under Section 13(a) of the Exchange Act.
- 195) By reason of the foregoing, Schmidgall violated and unless restrained and enjoined will violate Rule 13a-14 of the Exchange Act.

**FOURTH CLAIM FOR RELIEF**  
(Rule 13b2-2)  
17 C.F.R. § 240.13b2-2

- 196) Paragraphs 1 through 186 are hereby realleged and incorporated by reference.
- 197) Each of Schmidgall and Watson made or caused to be made materially false or misleading statements to an accountant in connection with audits, reviews or examinations of AIPC financial statements or in the preparation or filing of AIPC documents or reports required to be filed with the Commission; or omitted to state, or caused another person to omit to state, material facts necessary in order to make statements made, in light of the circumstances under which such statements were made, not misleading, to an accountant in connection with audits, reviews or examinations of financial statements or in the preparation or filing of AIPC documents or reports required to be filed with the Commission.

198) By reason of the foregoing, each of Schmidgall and Watson violated and unless restrained and enjoined will violate Rule 13b2-2 of the Exchange Act.

**FIFTH CLAIM FOR RELIEF**

(Sections 13(a) and 13(b)(2)(A) of the Exchange Act and  
Rules 12b-20, 13a-1, 13a-11, and 13a-13)

15 U.S.C. §§ 78m(a) and 78m(b)(2)(A) and 17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11,  
and 240.13a-13

199) Paragraphs 1 through 186 are hereby realleged and incorporated by reference.

200) AIPC violated Sections 13(a) and 13(b)(2)(A) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13 (15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B) and 17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, and 240.13a-13). By engaging in the conduct described above, each of Schmidgall and Watson knowingly substantially assisted and therefore aided and abetted AIPC's violations pursuant to Section 20(e) of the Exchange Act [15 U.S.C. §78t(e)].

201) By reason of the foregoing, unless restrained and enjoined, each of Schmidgall and Watson will in the future aid and abet violations of Exchange Act Sections 13(a) and 13(b)(2)(A) and Rules 12b-20, 13a-1, 13a-11, and 13a-13.

**SIXTH CLAIM FOR RELIEF**

(Section 13(b)(2)(B) of the Exchange Act)  
15 U.S.C. § 78m(b)(2)(B)

202) Paragraphs 1 through 186 are hereby realleged and incorporated by reference.

203) AIPC violated Section 13(b)(2)(B) of the Exchange Act (15 U.S.C. § 78m(b)(2)(B)). By engaging in the conduct described above, Schmidgall knowingly substantially assisted and therefore aided and abetted AIPC's violations pursuant to Section 20(e) of the Exchange Act [15 U.S.C. §78t(e)].

204) By reason of the foregoing, unless restrained and enjoined, Schmidgall will in the future aid and abet violations of Section 13(b)(2)(B) of the Exchange Act.

### **PRAYER FOR RELIEF**

WHEREFORE, the Commission respectfully requests that the Court:

#### **I.**

Find that Schmidgall and Watson committed the violations alleged.

#### **II.**

Enter an Injunction, in a form consistent with Rule 65(d) of the Federal Rules of Civil Procedure, permanently restraining and enjoining Schmidgall and Watson, their agents, servants, employees, and attorneys-in-fact, and all persons in active concert or participation with them, from violating, directly or indirectly, the provisions of law and rules alleged in this complaint.

#### **III.**

Order that each of Schmidgall and Watson pay disgorgement, including pre-judgment and post-judgment interest.

#### **IV.**

Order each of Schmidgall and Watson to pay civil penalties, including pre and post-judgment interest, pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)] in an amount to be determined by the Court.

#### **V.**

Order that each of Schmidgall and Watson be permanently prohibited from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of

the Exchange Act [15 U.S.C. § 78l] or that is required to file reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)].

VI.

Grant such other relief as this Court may deem just or appropriate.

Dated: September 15, 2008

Respectfully submitted,

/s/ Nancy J. Gegenheimer  
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