SIMPSON THACHER MEMORANDUM

SEC Charges CEO and Former CFO With Misrepresenting Internal Controls Over Financial Reporting

August 22, 2014

On July 30, 2014, the Securities of Exchange Commission ("SEC") charged the CEO and former CFO of QSGI, Inc., a computer equipment company, with misrepresenting to the company's outside auditors and investors the condition of the company's internal controls over financial reporting ("ICFR").[1]

The SEC alleged that CEO Marc Sherman and former CFO Edward L. Cummings were aware that QSGI was experiencing recurring inventory control problems that "resulted in the falsification of QSGI's books and records relating to QSGI's inventory." In particular, the SEC stated that Sherman and Cummings knew that company personnel removed component parts from the company's inventory without recording such removal, resulting in "the Company's books and records incorrectly reflect[ing] certain components in inventory and operating systems as intact systems." According to the SEC, Sherman and Cummings were also aware that QSGI's efforts to strengthen internal controls in 2008 largely failed, as company personnel continued to regularly circumvent controls and the company's efforts to monitor compliance were inadequate. Moreover, the SEC found that Sherman and Cummings participated in the improper acceleration of "recognition of accounts receivable and/or the receipt of product into inventory on QSGI's books and records" in order to increase the company's borrowing base.

The SEC found that despite knowing of the company's internal control problems and its decision to accelerate the recognition of accounts receivable, Sherman and Cummings did not "disclose, or direct anyone else to disclose, to QSGI's external auditors the foregoing inventory and accounts receivable issues and the resulting falsification of QSGI's books and records." "To the contrary," Sherman and Cummings made material misrepresentations and omissions to the company's external auditors regarding "the design, maintenance, and operation of internal controls." Specifically, Sherman and Cummings allegedly omitted mention of significant deficiencies in the company's ICFR and affirmatively represented to the auditors either that there were no significant deficiencies in the company's internal controls or that they had disclosed all such deficiencies to the auditors. According to the SEC, had Sherman and Cummings "disclosed to the external auditors the deficiencies in and the circumvention of

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[1] *See* U.S. Securities and Exchange Commission, *In the Matter of Marc Sherman*, Release No. 72723, File No. 3-15992 (July 30, 2014); U.S. Securities and Exchange Commission, *In the Matter of Edward L. Cummings, CPA*, Release No. 72722, File No. 3-15991 (July 30, 2014); U.S. Securities and Exchange Commission Press Release, "SEC Charges Company CEO and Former CFO With Hiding Internal Controls Deficiencies and Violating Sarbanes-Oxley Requirements" (July 30, 2014). Former CFO Edward L. Cummings agreed to settle the SEC's charges against him, without admitting or denying the SEC's findings; the SEC's case against CEO Marc Sherman is expected to be litigated in an administrative proceeding.

inventory controls and the improper acceleration of accounts receivable and inventory recognition . . . , the auditors would have changed the nature, timing, and extent of their procedures in conducting the audit of the financial statements" for the 2008 fiscal year and the review of the financial statements for the following quarter.

In addition to misleading QSGI's external auditors, the SEC found that Sherman and Cummings, who signed QSGI's Form 10-K and/or 10-K/A for the fiscal year at issue, falsely represented in the management's report on ICFR that the company's management, with the participation of the company's CEO and then-CFO, had assessed the effectiveness of QSGI's ICFR using a specified framework. The SEC indicated that in fact, the CEO "did not participate in any evaluation and was unfamiliar with the referenced framework." Furthermore, the SEC found that the discussion on critical accounting policies in QSGI's Forms 10-K and 10-K/A included false statements regarding QSGI's recognition of revenue and management's monitoring of inventory.

Finally, the SEC asserted that Sherman and Cummings signed false certifications required by Sarbanes-Oxley Act Section 302 and Securities and Exchange Act Rule 13a-4, and which were attached to QSGI's public filings. According to the SEC, Sherman and Cummings falsely certified that they "had disclosed, based on their 'most recent evaluation of [ICFR],' to QSGI's external auditors all significant deficiencies, 'in the design or operation of [ICFR] which are reasonably likely to adversely affect [QSGI's] ability to record, process, summarize and report financial information.'" Additionally, the certification improperly omitted the confirmation that Sherman and Cummings "had been responsible for establishing and maintaining ICFR and designing, or supervising others in the design of, ICFR" and that they "had designed, or caused to be designed, such ICFR."

SIGNIFICANCE OF THE SEC'S CHARGES

At the heart of the SEC's administrative orders are several crucial disclosure principles applicable to public companies and their management. The SEC's charges underscore the importance of:

- honesty and transparency in management's communications with the company's audit committee and external auditors;
- ensuring that disclosures in management's report on ICFR, which tend to be viewed as boilerplate, are truthful; and
- having thoughtful procedures in place to ensure accurate and complete Sections 302 and 906 certifications.

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If you have any questions or would like additional information, please do not hesitate to contact Yafit Cohn at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Executive Compensation and Employee Benefits Practice or Public Company Advisory Practice, including:

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