

# SEC Charges Executive Officers with Fraud and Violations of Sarbanes-Oxley

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On July 30, 2014, the Securities and Exchange Commission (the "SEC") announced enforcement actions against Marc Sherman and Edward Cummings, CEO and former CFO, respectively, of QSGI, Inc., a publicly traded computer equipment company ("QSGI"), for misrepresenting to external auditors and the investing public the state of its internal controls over financial reporting.

The enforcement proceedings stem from actions alleged to have occurred during 2008 and the first quarter of 2009, during which time QSGI was a reseller of and a maintenance services provider for used computer equipment. The SEC orders allege that during this time period company personnel would ship or remove inventory without making appropriate entries in the books and records of the company, thus resulting in the falsification of QSGI's books and records. Company management, including Messrs. Sherman and Cummings, were aware of the deficiencies in internal controls and in 2008 attempted to introduce new controls into its operations. However, the SEC alleges that the new controls were designed without taking into account the existing control environment, including the qualifications and experience level of persons employed to handle accounting. Furthermore, the training of company personnel was either inadequate or did not take place at all. Accordingly, the new controls were widely ignored, and the company's attempt to monitor compliance was inadequate.

In addition, the orders allege that during this same time period, weekly calculations performed by a QSGI employee and required under QSGI's revolving credit facility would often indicate that the company had exceeded its borrowing limit or would not be able to borrow enough funds to continue its operations for the next week. When this occurred, Messrs. Sherman and/or Cummings would direct the employee not to report the calculations to the creditor and would direct accounting personnel to improperly accelerate recognition of accounts receivable and/or receipt of inventory on QSGI's books and records. They would then direct the employee to recalculate the borrowing base using the improperly recognized figures.

Despite knowing of the ongoing deficiencies in and circumvention of the internal controls relating to inventory and the improper acceleration of recognition of accounts receivable and/or receipt of inventory on QSGI's books and records, Messrs. Sherman and Cummings:

- Did not disclose, or direct anyone else to disclose, to QSGI's external auditors the ongoing deficiencies regarding inventory controls and, in fact, affirmatively stated in management representation letters provided to the external auditors in connection with the fiscal 2008 audit and review of the first quarter 2009 financials that either there were no significant deficiencies or that all such deficiencies had been disclosed.
- Signed and filed reports with the SEC (the Form 10-K for 2008, as well as an amendment thereto, and the Form 10-Q for the first quarter of 2009) that contained clean management reports on internal control over financial reporting as required under Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX").
- Signed and filed certifications under SOX Section 302 in connection with the Form 10-K for 2008, as well as an amendment thereto, and the Form 10-Q for the first quarter of 2009, which among other things certified as to the financial statements contained in the filings, the adequacy of internal controls, and the disclosure of any significant deficiencies therein to the external auditors and the audit committee.

Based on the foregoing, the SEC alleged the following violations by Messrs. Sherman and Cummings:

- violation of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 thereunder;
- that they caused QSGI's violations of Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B), which require reporting issuers to make and keep accurate books and records and devise and maintain effective internal accounting controls, respectively;
- a violation of Section 13(b)(5) of the Exchange Act, which prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly

- falsifying any book, record, or account subject to Exchange Act Section 13(b)(2);
- a violation of Rule 13b2-1 under the Exchange Act, which prohibits any person from, directly or indirectly, falsifying or causing to be falsified any book, record, or account subject to Exchange Act Section 13(b)(2);
- a violation of Rule 13b2-2 under the Exchange Act, which prohibits any director or officer of an issuer from, directly or indirectly, (a) making or causing to be made a materially false or misleading statement; or (b) omitting or causing another person to omit to state a material fact 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 financial statement audits, reviews, or examinations or the preparation or filing of any document or report required to be filed with the SEC; and
- a violation of Rule 13a-14(a) under the Exchange Act, which requires that an issuer's principal executive officer and principal financial officer, or person's performing similar functions, certify each periodic report containing financial statements filed by an issuer pursuant to Section 13(a) of the Exchange Act.

Without admitting or denying the SEC's allegations, Mr. Cummings agreed to settle the charges, agreeing to a cease and desist order, a \$23,000 penalty, a five-year bar from serving as a director or officer of a public company and a five-year bar on practicing before the SEC as an accountant. As of the date of this alert, Mr. Sherman has not agreed to a settlement with the SEC.

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In the press release issued by the SEC announcing the enforcement proceedings against Messrs. Sherman and Cummings, Scott W. Friestad, Associate Director of the SEC's Enforcement Division stated, "Corporate executives have an obligation to take the Sarbanes-Oxley disclosure and certification requirements very seriously. Sherman and Cummings flouted these regulatory requirements and misled investors and external auditors in the process."

While the actions of Messrs. Sherman and Cummings as alleged in the SEC orders are certainly egregious and deserving of the actions brought by the SEC, we believe that these charges should serve as a cautionary tale for all public company executives that disclosure with respect to SOX requirements and the certifications made with respect to every SEC periodic report should not be taken lightly.

## Authors