
STANDING ADVISORY GROUP MEETING

RELATED PARTY TRANSACTIONS

SEPTEMBER 8-9, 2004

Introduction

The Standing Advisory Group ("SAG") will discuss the interim auditing standard of the Public Company Accounting Oversight Board ("PCAOB") on related parties, including addressing whether to revise that standard. Related parties and related-party transactions have proven difficult for auditors to audit, because such transactions are not always easily identifiable. The past several years have witnessed an increase in the reported instances of fraudulent financial reporting and misappropriation of assets facilitated by the use of undisclosed related parties. This paper provides members of the SAG with background information about related parties and current issues relevant to the auditor's obligation for the identification and disclosure of related parties and related-party transactions.

Generally accepted accounting principles define related parties and require certain disclosures regarding material related-party transactions, as well as the nature of control relationships that could result in operating results or financial positions significantly different from those that would have been achieved in the absence of such relationships, regardless of whether there were transactions between or among the related parties. The PCAOB interim auditing standard on related parties, Statement on Auditing Standards ("SAS") No. 45, *Omnibus Statement on Auditing Standards—1983* (AU sec. 334, *Related Parties*), sets forth certain procedures the auditor should consider to identify related-party relationships and transactions and requires auditors to examine whether such relationships and material transactions are properly accounted for and adequately disclosed in the financial statements.

<p>This paper was developed by the staff of the Office of the Chief Auditor in order to foster discussion among the members of the SAG. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or PCAOB staff.</p>
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Fraudulent Financial Reporting and Related Parties

In 1973, U.S. Financial Corporation ("USF") created sham transactions using subsidiaries and affiliates designed to create millions of dollars of phony profits and to inflate earnings per share and the company's stock price. In January 1974, USF filed for bankruptcy protection under Chapter 11, which was, at that time, the largest Chapter 11 bankruptcy in U.S. history.

In more recent times, Enron, one of the world's leading energy, commodities, and services companies, announced in November 2001 that it planned to restate its financial statements because of related-party transactions, among other things. Enron's Board of Directors appointed a special committee to review transactions between Enron and related parties. On February 1, 2002, Enron's Special Investigation Committee issued its findings in its "Report of Investigation by the Special Investigation Committee of the Board of Directors of Enron Corp." (the "Enron Report").^{1/} The Enron Report stated that "Enron, like all public companies, was required by the federal securities laws to describe its related-party transactions to shareholders and to members of the investing public in several different disclosure documents: the period reports filed with the SEC on a quarterly and annual basis, and the annual proxy solicitation materials sent to shareholders. We found significant issues concerning Enron's public disclosures of related-party transactions." The Enron Report also stated the following:

Overall, Enron failed to disclose facts that were important for an understanding of the substance of the transactions. The Company did disclose that there were large transactions with entities in which the CFO had an interest. Enron did not, however, set forth the CFO's actual or likely economic benefits from these transactions and, most importantly, never clearly disclosed the purposes behind these transactions or the complete financial statement effects of these complex arrangements. The disclosures also asserted without adequate foundation, in effect, that the arrangements were comparable to arm's-length transactions. We believe that the responsibility for these inadequate disclosures is shared by Enron Management, the Audit and Compliance Committee of the Board, Enron's in-house counsel, Vinson & Elkins, and Andersen.

^{1/} *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, dated February 1, 2002, can be obtained from Enron's Web site at <http://www.enron.com/corp/por/pdfs/PowersReport.pdf>.

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In December 2001, Enron, once ranked seventh among the Fortune 500, filed for bankruptcy protection under Chapter 11.

Section 704 of the Sarbanes-Oxley Act of 2002 (the "Act") directed the Securities and Exchange Commission ("SEC" or the "Commission") to study enforcement actions over the five years preceding its enactment to identify areas of issuer financial reporting most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management (the "SEC Study"). The SEC Study, issued on January 24, 2003, included the review of all of the Commission's enforcement actions filed during the period July 31, 1997, through July 30, 2002 (the "SEC Study period"), that were based on improper issuer financial reporting, fraud, audit failure, or auditor independence violations.^{2/}

During the SEC Study period, the Commission filed 515 enforcement actions for financial reporting and disclosure violations arising out of 227 Division of Enforcement investigations. The majority of the 227 enforcement matters involved improper conduct by senior management of the relevant issuers. The SEC Study cited that "Failure to disclose related-party transactions hides material information from shareholders and may be an indicator of weaknesses in internal control and corporate governance procedures. The Study found 23 enforcement matters included the failure to disclose such transactions. Of these, 12 issuers restated their financial statements."

The Commission highlighted two cases in the SEC Study, as follows:

- Adelphia Communications Corporation ("Adelphia") – The Commission alleged that Adelphia engaged in numerous undisclosed related-party transactions with board members, executive officers, and entities they controlled. These transactions resulted in the channeling of company funds and stock into entities controlled by senior management, the payment for timber rights that reverted to senior management, the construction of a golf course on land owned or controlled by senior management, and the payment of personal loans. The Commission alleged that Adelphia failed to disclose the existence of these transactions or misrepresented their terms in its financial statements. Over \$300 million of company funds were diverted to senior management without

^{2/} The SEC's Study titled "Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002" can be found on the SEC's Web site at <http://www.sec.gov/news/studies.shtml>.

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adequate disclosure to investors. On June 25, 2002, the company and certain of its subsidiaries filed for bankruptcy.

- Rite Aid Corporation ("Rite Aid") – The Commission alleged, among other things, that the CEO sought to enrich himself at the expense of shareholders by failing to disclose both his personal interest in leased property for Rite Aid store locations and several transactions where he funneled \$2.6 million from Rite Aid to a partnership that he and a relative controlled. On three separate occasions during 1999 and 2000, Rite Aid filed amended financial statements relating to this matter.

Related-party Disclosure Requirements

Public companies must provide financial statements in periodic quarterly and annual SEC filings. Statement of Financial Accounting Standards No. 57, *Related Party Disclosures* ("FASB Statement No. 57"), sets forth the requirements under generally accepted accounting principles concerning disclosures of transactions between related parties. Essentially, the financial statements must disclose material related-party transactions and must disclose information about:

- The nature of the relationship(s) involved;
- A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements;
- The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period; and
- Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.

SEC Regulation S-X, sec. 4-08(k), provides that "[r]elated party transactions should be identified and the amounts stated on the face of the balance sheet, income

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statement, or statement of cash flows." These disclosures are typically provided in a footnote to the consolidated financial statements.

FASB Statement No. 57 also states that "Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related-party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated."

Auditing Related Parties and Related-Party Transactions

Paragraph 4 of SAS No. 45, *Related Parties* (AU sec. 334), states that "an audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related-party transactions will be discovered. Nevertheless, during the course of his audit, the auditor should be aware of the possible existence of material related-party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB Statement No. 57 requires disclosure even though there are no transactions." (See Appendix for a summary of the auditing procedures in SAS No. 45.)

In October 2002, the AICPA's Auditing Standards Board issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316). This standard superseded SAS No. 82, of the same title, to provide for expanded guidance for detecting material fraud. SAS No. 99 states that:

During the course of the audit, the auditor may become aware of significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment. The auditor should gain an understanding of the business rationale for such transactions and whether that rationale (or lack thereof) suggests that the transactions may have been entered into to engage in fraudulent financial reporting or conceal misappropriation of assets.

SAS No. 99 further states that in understanding the business rationale for the transactions, the auditor should consider the following:

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- Whether the form of such transactions is overly complex (for example, involves multiple entities within a consolidated group or unrelated third parties);
- Whether management has discussed the nature of and accounting for such transactions with the audit committee or board of directors;
- Whether management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
- Whether transactions that involve unconsolidated related parties, including special purpose entities, have been properly reviewed and approved by the audit committee or board of directors; and
- Whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

On October 22, 2002, the Quality Control Inquiry Committee ("QCIC") of the AICPA's SEC Practice Section ("SECPS") issued a report titled, "Recommendations for the Profession Based on Lessons Learned from Litigation" (the "QCIC Report").^{3/} The QCIC's primary objective was to conduct investigations when allegations of an audit failure were made public against a SECPS member firm with respect to an audit of an SEC registrant and with certain other entities. The investigations were conducted to determine whether there were any deficiencies in the firm's system of quality control, in its compliance with that system, or in its application of professional standards.

The QCIC Report was based on the QCIC's analysis of more than 200 cases closed from December 1997 to October 2002 in order to identify problem areas and trends that may have needed to be addressed to further improve financial reporting and audit quality. The QCIC report included the following recommendation for the AICPA's Auditing Standards Board ("ASB") with respect to related-party transactions:

^{3/} The QCIC Report can be obtained from the AICPA's Web site at <http://www.aicpa.org/centerprp/managepartnerletters.htm>. On December 31, 2003, the SECPS discontinued the activities of the QCIC in recognition that firms registered with the PCAOB, including its associated persons, are subject to investigation and discipline by the PCAOB.

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The QCIC recommends that the auditing standard covering related parties should be expanded. The existing standard primarily requires auditors to identify and ensure disclosure of related-party transactions, with an underlying acceptance that not all related-party transactions may be discovered and, that regardless, such transactions are presumed to be in the "ordinary course of business" absent contrary evidence. The QCIC recommends that the required audit procedures be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions. New ideas for identifying difficult to find related-party transactions should be investigated and guidance issued. The auditor should perform procedures to identify all parties involved in the transactions, and to confirm transactions and agreement terms with financing parties. Further, auditors should be required to consider the need to design any additional procedures to be performed by themselves or other auditors with respect to related-party entities or transactional counterparties.

SAS No. 45, *Related Parties* (AU sec. 334), has not been revised subsequent to the QCIC's recommendation.

Current Issues Relevant to the Auditor's Obligation for the Identification and Disclosure of Related Parties and Related-Party Transactions

Related parties and related-party transactions have proven difficult for auditors to audit, because such transactions are not always easily identifiable. The auditing interpretation to SAS No. 45 states that the "auditor's procedures should be sufficient to provide reasonable assurance that related-party transactions are adequately disclosed and that identified related-party transactions do not contain material misstatements that, when aggregated with misstatements in other balances or classes of transactions, could be material to the financial statements taken as a whole....The risk associated with management's assertions about related-party transactions is often assessed as higher than for many other types of transactions because of the possibility that the parties to the transaction are motivated by reasons other than those that exist for most business transactions." The auditing standard on related parties states that "Experience has shown, however, that business structure and operating style are occasionally deliberately designed to obscure related-party transactions." While the auditing standard and related auditing interpretation encourage the auditor to evaluate related-party transactions as a high risk area, in practice, auditors often rely primarily upon

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management and principal owners to identify related parties and related-party transactions.

A new standard on related parties may provide direction that is clear and focused on related-party issues to help ensure that auditors perform procedures sufficient to provide reasonable assurance that related-party transactions are adequately disclosed and that identified related-party transactions do not contain misstatements that, when aggregated in other balances or classes of transactions, could be material to the financial statements taken as a whole. Further, a new standard may help ensure that auditors consider the risk associated with management's assertions about related-party transactions to be higher than the risk for many other types of transactions because of the possibility that the parties to the transaction are motivated by reasons other than those that exist for most business transactions. Accordingly, in connection with the development of a potential new standard on related parties, the input and advice of the SAG is sought in the areas described in the following sections of this paper.

Overall Scope

SAS No. 45, *Related Parties* (AU sec. 334), states that "an audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related-party transactions will be discovered."

Discussion Questions –

1. Is it appropriate to assume that an audit cannot be expected to provide assurance that all related-party transactions will be identified and discovered?
2. If not, what type of assurance should the auditors provide with respect to identification of related parties and related-party transactions?

Definition of Related Parties

The definition of "related party" in footnote 1 of paragraph 1 of SAS No. 45 on related parties is the same as its definition in the accounting literature. The definition is as follows:

- Affiliates of the enterprise;

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- Entities for which investments are accounted for by the equity method by the enterprise;
- Trusts for the benefit of employees, such as pension and profit sharing trusts that are managed by or under the trusteeship of management;
- Principal owners of the enterprise;
- Management;
- Members of the immediate families of principal owners of the enterprise and its management; and
- Other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

Another party is also a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Discussion Question –

3. For auditing purposes, is the current definition appropriate? Are there other relationships that pose similar roles (e.g., sales to suppliers, round-trip transactions)?

Examining Identified Related-Party Transactions

SAS No. 45, *Related Parties* (AU sec. 334), states that once related parties are identified, the auditing procedures that should be considered include the following:

- Obtain an understanding of the business purpose of the transaction;
- Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents;

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- Determine whether the transaction has been approved by the board of directors or other appropriate officials;
- Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements;
- Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related-party transactions by the auditors for each of the parties, with appropriate exchange of relevant information; and
- Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

SAS No. 45 also states that when necessary to fully understand a particular transaction, the auditor should consider the following procedures, which might otherwise be deemed necessary to comply with generally accepted auditing standards:

- Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction;
- Inspect evidence in possession of the other party or parties to the transaction;
- Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction;
- Refer to financial publications, trade journals, credit agencies, and other information sources when there is a reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance; and
- With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction.

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One of the QCIC's recommendations was that the auditing procedures should be broadened to help ensure the auditor gains a more complete understanding of related-party transactions, including the business aspects of the transactions.

Discussion Questions –

4. Should the auditor be required to understand the business purpose of the transaction from the perspective of both the company being audited and the related party?
5. The procedures listed in SAS No. 45, *Related Parties* (AU sec. 334), are illustrative and do not represent required auditing procedures. Should any procedures listed in SAS No. 45 be required? For instance, should an auditor be required to confirm amounts with related parties? Should an auditor be required to inspect evidence in possession of the other party? Are there other procedures the auditor should be required to perform?

Search for Undisclosed Related Parties

Paragraph .08 of SAS No. 45, *Related Parties* (AU sec. 334), provides guidance rather than mandatory procedures for both "identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships." Those suggested procedures are as follows:

- Provide audit personnel performing segments of the audit or auditing and reporting separately on the accounts of related components of the reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits;
- Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorized or discussed at their meetings;
- Review proxy and other material filed with the Securities and Exchange Commission and comparable data filed with other regulatory agencies for information about material transactions with related parties;

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- Review conflict-of-interests statements obtained by the company from its management;
- Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders for indications of previously undisclosed relationships;
- Consider whether transactions are occurring, but are not being given accounting recognition, such as receiving or providing accounting, management or other services at no charge or a major stockholder absorbing corporate expenses;
- Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period;
- Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties;
- Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related parties or related-party transactions; and
- Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

One of the QCIC's recommendations was that the auditor should perform procedures to identify all parties involved in the transaction. The QCIC also suggested that new ideas for identifying difficult-to-find related parties should be investigated and that related guidance should be issued.

Discussion Questions -

6. Should the procedures in SAS No. 45, *Related Parties* (AU sec. 334), for identifying transactions with related parties be mandatory rather than suggested guidance? Are there other procedures auditors can perform to help identify difficult-to-find related parties?

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7. Should information be obtained about all material transactions to determine whether a related-party transaction exists? Such information might include:
 - a. Identification of the transaction;
 - b. Identification of the parties known to the transaction;
 - c. The nature of already known related-party involvement;
 - d. The nature and amount of the transaction and effect on income, if determined;
 - e. The effect of the transaction on the balance sheet for all balance sheets to be reported upon; and
 - f. The terms of the transaction and how they were established, and changes in terms during the period.

Related-Party Transactions in the Ordinary Course of Business

SAS No. 45 on related parties states that "In the absence of evidence to the contrary, transactions with related parties should not be assumed to be outside the ordinary course of business." That standard, however, does state that the auditor should be aware of the possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions such as lack of sufficient working capital, desire for a continued favorable earnings records, declining industry, excess capacity, among others.

Discussion Question –

8. Is it an appropriate assumption that transactions with related parties are in the ordinary course of business? If not, how should the auditor view related parties and related-party transactions?

Representations from Management

SAS No. 85, *Management Representations* (AU sec. 315)), requires the auditor to obtain written representations from management and provides guidance concerning the representations to be obtained. With respect to related parties, SAS No. 85 requires

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obtaining a representation that the following issues have been properly recorded or disclosed in the financial statements:

- Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties;
- Guarantees, whether written or oral, under which the company is contingently liable; and
- Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Discussion Questions -

9. Should any additional representations be obtained from management with respect to related parties?
10. How much reliance should the auditor place on representations from management?

Arm's-Length Equivalency

SAS No. 45, *Related Parties* (AU sec. 334), states that:

Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions...If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality.

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The standard implies that the auditor should substantiate management's representations, although this idea is not explicitly stated.

A footnote disclosure in Enron's financial statements for the year ended December 31, 2002, stated the following:

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

Discussion Questions -

11. Should the auditor be required to verify any representation made by management that a related-party transaction is substantially equivalent to an arm's-length transaction?
12. If so, what procedures should the auditor perform to accomplish this objective?

Other Practice Issues

Discussion Question -

13. Are there other practice issues that should be addressed in an auditing standard on related parties?

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APPENDIX

Summary of SAS No. 45 Auditing Procedures

The following list is a summary of the auditing procedures in paragraphs .05 and .07 of SAS No. 45, *Related Parties* (AU sec. 334), to be performed by the auditor in the area of related parties and related-party transactions:

- Obtain an understanding of management responsibilities and the relationship of each component to the total entity.
- Consider controls over management activities and consider the business purpose served by the various components of the entity.
- Place emphasis on testing material transactions with parties known to be related to the reporting entity. Determining the existence of others requires the application of specific audit procedures, which may include the following:
 - Evaluate the company's procedures for identifying and properly accounting for related-party transactions.
 - Request from appropriate management personnel the names of all related parties and inquire whether there were any transactions with these parties during the period.
 - Review filings by the reporting entity with the SEC and other regulatory agencies for the names of related parties and for other businesses in which officers and directors occupy directorship or management positions.
 - Determine the names of all pension and other trusts established for the benefit of employees and the names of their officers and trustees.
 - Review stockholder listings of closely held companies to identify principal stockholders.
 - Review prior years' working papers for the names of known related parties.

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- Inquire of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement of material transactions.
- Review material investment transactions during the period under audit to determine whether the nature and extent of investments during the period create related parties.
- After identifying related-party transactions, apply procedures considered necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management.
- When necessary to fully understand a particular transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered:
 - Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
 - Inspect evidence in possession of the other party or parties to the transaction.
 - Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
 - Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
 - With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction.

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- For each material related-party transaction that requires disclosure, consider whether sufficient competent evidential matter has been obtained to understand the relationship of the parties and, for related-party transactions, the effects of the transaction on the financial statements.

Evaluate all information available concerning the related-party transaction or control relationship and become satisfied on the basis of professional judgment that the related-party transaction or control relationship is adequately disclosed in the financial statements.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.