

**SEC Open Meeting on SEC's Proposed Management Guidance  
for Section 404 of the Sarbanes-Oxley Act and the  
PCAOB's Proposed Revisions to Auditing Standard No. 2  
Remarks of Jeffrey C. Steinhoff  
Managing Director, Financial Management and Assurance  
U.S. Government Accountability Office  
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Chairman Cox and Members of the Commission:

I am pleased to be here today to discuss the Commission's proposed guidance for Section 404 of the Sarbanes-Oxley Act and the PCAOB's proposed revisions to Auditing Standard No. 2.

Let me say at the outset that we support the thrust of the current proposals by the Commission and the PCAOB. Also, I support Chairman Olson's comments earlier today. These proposals are responsive to the recommendations in our April 2006, report on the application of the Sarbanes-Oxley Act to smaller companies. In that report, we recommended that the Commission do three things. First, assess the sufficiency of internal control guidance for smaller public companies. Second, coordinate with the PCAOB to ensure consistency of Section 404 auditing standards with any additional internal control guidance for public companies. And finally, if further relief is deemed appropriate, to analyze the unique characteristics of smaller companies and their investors to ensure that the objectives of investor protection are met and any relief provided is targeted and limited.

Investor protection is the heart of what we are speaking about today and my remarks that follow will address not only smaller companies, but all companies because we think the manner in which Auditing Standard No. 2 was applied added burdens to all companies.

Today I would like to briefly highlight three issues that are critical to effective implementation of Section 404, which we continue to strongly support, and the current proposals of the Commission and the PCAOB.

First, we strongly support the emphasis on using a top-down, risk-based approach in both management's evaluation of internal control over financial reporting and in the audit of management's evaluation. We were doing this prior to Sarbanes-Oxley. This is the approach we use at GAO in our financial statement audits, which provide an opinion on internal control and include the consolidated financial statements of the U.S. government, the IRS, the Bureau of Public Debt, the FDIC, and the SEC.

We urged use of a top-down, risk-based approach when the current Auditing Standard No. 2 was first considered and continue to strongly believe that this approach, if done properly, —and I emphasize if done properly— can maximize efficiency and effectiveness in the assessment of internal control. Such an approach provides needed flexibility for both management and auditors to make informed decisions based on relative risk and cost-benefit considerations versus having overly prescriptive “one-size-fits-all” requirements.

As the Commission and the PCAOB move in this direction, the challenge will shift to the need to properly implement this approach and to hold company management and its auditors accountable for doing so. Effective implementation of a top-down, risk-based approach requires the involvement of highly knowledgeable senior management and audit professionals in order to make sound judgments about the risk of material financial statement misstatements. Reaching the proper balance is challenging but very achievable if the assessment is approached with a goal of protecting the investor and with the right amount of expertise and professional skepticism going in.

If a top-down, risk-based approach is not properly implemented by company management and/or the auditors, its effectiveness can be compromised. Therefore, if the proposed changes are adopted, it will be critical that the Commission and the PCAOB closely monitor implementation. In the case of the PCAOB, it can use its inspection program to monitor auditor implementation. Again, we're very supportive of a risk-based approach. We think it can be effective and efficient, but it must be done in a proper manner.

Second, the Commission and the PCAOB should continue to emphasize management and auditor responsibilities related to fraud. Management's evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity. The auditors' responsibility for detecting and reporting fraud overlaps with their responsibility for reporting on internal control over financial reporting under Section 404

since effective internal control generally serves as a first line of defense in preventing and detecting fraud. These things are intertwined.

This is where professional skepticism becomes paramount in the auditors' work. In assessing fraud risk, auditors have to be inquisitive and vigilant. Auditors must not just ask basic questions, such as whether management has in place a comprehensive fraud program that includes continuous fraud oversight. They must dig deeper if things do not look right or if there is a risk of material financial statement misstatement, whether caused by error or fraud. Really, this whole thing is about substance over form. We need to look at the substance of what's going on versus having a checklist mentality where every control is reviewed, every control is documented. This has to be raised up to where you are looking at risk and you're doing that for the purpose of protecting the investor against those things that are significant and those things that are important.

Third, coordination among regulators and standard-setters is very important. Continued coordination such as today between the Commission and the PCAOB will be needed to monitor the implementation of Section 404 and to identify any additional ways for achieving economical, effective, and efficient implementation. It will be important that company management and its auditors agree on what is expected and resolve any implementation problems early in the process. They need to have a dialogue. Again, this shouldn't be viewed as just a compliance approach on both sides; it should be focused and tailored.

Also important is the need for the PCAOB to continue to coordinate with the other U.S. audit standard-setters—GAO and the AICPA—and with international standard setters on key issues, such as the terminology and definitions used to communicate internal control deficiencies. At this time, all the U.S. auditing standards setters are in sync and have adopted consistent definitions of a material weakness and a significant deficiency. Everyone will be best served by having standard setters develop consistent core auditing standards and, where there are any differences, to articulate why there is a difference or a need in the particular environment we're in. Inconsistencies in such core standards can increase audit costs and lead to potential confusion among management, users, and auditors. In this context, the U.S. audit standard-setters meet roughly three times a year collectively. We had a meeting a couple weeks ago which David Walker hosted at the GAO and we're very appreciative of the very open environment that the PCAOB has fostered.

In closing, we support the efforts of the Commission and the PCAOB to address Section 404 implementation issues. Public companies must be able to strike an appropriate

balance between costs and benefits, while at the same time achieving an appropriate level of internal control and strong investor protection. At the end of the day, public companies need to have the right controls, in the right place, at the right time. We view this as a basic management responsibility, irrespective of Section 404. At the same time, auditors also have an important role. They must be vigilant but practical, which a top-down, risk-based approach provides for, and must always maintain independence and professional skepticism in doing their work.

It will be very important that the Commission and the PCAOB continue to reinforce the overarching goal of investor protection, as well as the principles I have just highlighted in order to achieve sensible, effective, and responsible implementation of Section 404 and to ensure that investors never again suffer from another Enron or Worldcom

Mr. Chairman, Members of the Commission, thank you again for inviting me and for permitting GAO to participate in this forum.