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To: Arthur Levitt, Jr. (Co-Chair)

Donald T Nicholaisen, Co-Chair

Advisory Committee on the Auditing Profession

Department of the Treasury

From: Ashwinpaul (Tony) C. Sondhi, Ph. D.

My comments are based on my experience as an educator, management advisor, standard-setter, and most importantly as a user of financial statements in every sphere of my professional activities.

User Information Needs and the Roles of Preparers and Auditors

Why do investors and other users of financial statement information need financial statements and, more specifically, why do they ask for audited financial statements? I believe that an understanding of this need is critical to resolving many of the issues relevant to this Committee and to our markets.

Preparers and auditors treat financial statements as a compliance exercise rather than as a means of communicating vital information about an enterprise to providers of capital. This compliance perspective dominates accounting education in universities, training of accountants at auditing firms and the preparation of financial statements at reporting enterprises.

Disclosures

As a user, I am also concerned with the compliance approach to financial statement disclosures. Standard setters, educators, preparers, and the auditors give short shrift to disclosures. The increasing complexity of business transactions should lead to better disclosures. Preparers and auditors should use disclosures to communicate the complex and unique nature of their operations rather than merely seek to "comply" with the basic requirements.

The Use of IFRS

Recent decisions by the SEC tell us that U.S. companies may soon be able to report using IFRS and it is likely that IFRS will eventually replace U.S. GAAP. I strongly believe that IFRS are not widely understood by U.S. accountants (preparers as well as auditors). The diverse versions of IFRS in use today suggest that IFRS are not well understood elsewhere in the world.

Do we know whether IFRS (regardless of version used) can be enforced if it is unclear whether the standards are well understood by preparers and auditors? I believe that international auditing standards and enforcement institutions need to be better prepared to manage this movement toward the expanded use of IFRS.

Accounting Education and Academic Accountants

The increasing complexity of business transactions (consider, for example, stock options and securitizations) has resulted in similarly complex accounting standards, and has increased the need for internal controls and other types of regulation. In order to comprehend accounting, we need to better understand these business transactions. The increased emphasis on principles based accounting standards also puts a premium on the ability of preparers and auditors to exercise judgment. Accounting education and training, with their emphasis on compliance, are at odds with these changes in our world.

Over the past thirty years, academic research in accounting has become less practice oriented, with fewer papers examining accounting alternatives, the effects of new standards, and the impact of financial statement information on financial markets (Even less is researched and known about the impact of IFRS on financial markets). This situation reflects the criteria used by major academic journals and those used to hire and promote faculty. It is imperative that those who train the next generation of accountants have a working knowledge of financial reporting.

Audit Quality and Competence of Audit Staff

The well publicized problems at Enron, Waste Management, Tyco, Adelphia, and Parmalat, and the recent problems with securitizations of sub-prime mortgages, and the accounting for structured investment vehicles have raised our awareness of the need for high quality audits and competent audit staff. Preparers need the same qualities of ethics and competence. I believe that users of financial statements also need to improve their ability to ask critical questions rather than accept financial statements at face value.

Auditors also need to remain independent of their clients in order to question reporting choices made by management. Auditors must have the ability to stand up to long-standing clients, the largest firms in an industry, or clients in industries with other regulators (for example, banks and insurance companies).

However, I do not believe that a limitation on auditor liability and a tacit acceptance of the inability of auditors to detect fraud is the appropriate response to these problems. The answer may lie in a radical rethinking of how auditors are trained, compensated, and rewarded.