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August 12, 2024

Ms. Phoebe Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 056

Dear Ms. Brown:

Deloitte & Touche LLP ("Deloitte," "we," or "our") appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB") on PCAOB Release No. 2024-006, *Proposing Auditing Standard – Designing and Performing Substantive Analytical Procedures and Amendments to Other PCAOB Standards* (the "Proposal," the "Release," or the "Project").

OVERALL SUMMARY

We support the PCAOB's ongoing efforts to modernize and clarify its standards, particularly the interim standards as adopted in 2003. We believe substantive analytical procedures (SAPs), when designed and executed appropriately, enable the auditor to obtain compelling audit evidence about assertions and accounts, including for accounts that consist of a high volume of transactions. SAPs often allow auditors to gather more persuasive audit evidence and deeper insights into an entire account balance than they could by performing "tests of details" on a limited selection of items within the testing population. While we are overall supportive of the proposed replacement of AS 2305, *Substantive Analytical Procedures* ("existing standard" or "existing AS 2305"), with a new standard, AS 2305, *Designing and Performing Substantive Analytical Procedures* ("proposed standard" or "proposed AS 2305"), we recommend certain clarifications and revisions. A brief summary of the matters that we have identified for additional consideration is as follows, with further detailed comments on the matters in the Appendix.

Requirement to Examine Information from External Sources

Proposed paragraph 40A of AS 2301, *The Auditor's Responses to Risks of Material Misstatement*, requires that when substantive procedures are applied to accounts or disclosures that depend on information received by the company from external sources, such procedures should involve examining relevant information from external sources (generally expected to involve tests of details on such information). This proposed requirement appears to suggest that solely using SAPs may not address risks of material misstatement (RoMMs) any longer. This would be a paradigm shift from historical practice and could lead to a reduced use of SAPs in favor of test of details, deviating from current auditing standards, which treat them as equivalent substantive responses to RoMMs. We would recommend the PCAOB clarify whether this was the intention.

We understand the PCAOB is seeking to mitigate the risk that an auditor relies on company-produced information without having the appropriate basis to do so. However, we are concerned that the proposed requirement may not align with the PCAOB's risk assessment standards, as it appears to treat all information used to record amounts and disclosures with a "fraud lens" where heightened procedures need to be performed irrespective of the assessed risk of material misstatement.

Determination of a Threshold for Evaluating Differences

We believe that the proposed requirement is not clear on how the auditor would apply the prescribed threshold in situations when the expectation is based on a ratio or when the auditor uses a combination of substantive procedures. Furthermore, the Proposal prescribing the threshold used by auditors when performing a substantive analytical procedure is inconsistent with a risk-based approach.

Definition of "Company's Amount"

Proposed AS 2305 introduces a new term, "company's amount"; however, it is unclear whether this term encompasses all amounts or balances that are derived from, or come from, the company's financial records, and whether the auditor is permitted to develop an expectation using audited information that is derived from company-produced information. We believe the term "company's amount" should be formally defined in the standard and should clarify that "company's amount" is the amount that the SAP is testing.

Identification of Sufficiently Plausible and Predictable Relationships

We agree with the PCAOB that the proposed standard should be risk-based and should not prescribe the nature, timing, and extent of audit procedures to be performed; however, to prevent misunderstandings and promote consistent application of the proposed standard, further implementation resources and examples are needed. Specifically, auditors would benefit from examples that demonstrate the spectrum of procedures the auditor can perform when complying with proposed AS 2305.05.

Need for Implementation Support

We believe stakeholders will benefit if the PCAOB engages in dialogue, including with the auditing profession, on implementation questions and resulting implementation resources. The PCAOB's engagement will help auditors better understand how to implement the proposed standard. It will also provide for more consistent application across the profession.

Need for Sufficient Implementation Time

We encourage the PCAOB to reconsider the proposed effective date. As currently proposed, the effective date for audits of financial statements with fiscal years beginning on or after December 15 in the year of approval by the SEC, may not provide public accounting firms sufficient time to update methodology, guidance, audit tools and software as well as train personnel on the enhanced requirements. We recommend an effective date for audits with fiscal years beginning no sooner than one year after the approval by the Securities and Exchange Commission (SEC) (or for audits of fiscal years beginning two years after the year of SEC approval if that approval occurs in the third or fourth quarter). We also ask that the PCAOB consider the impacts of other ongoing standard-setting projects[1] that are expected to be adopted and implemented over similar timeframes, and how it is critical that public accounting firms have sufficient time to appropriately and thoughtfully implement all new and amended rules and standards.

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We appreciate the opportunity to provide our perspectives on the proposed standard and the related amendments. We welcome the opportunity to engage in constructive discussions with the PCAOB on this important matter. If you have any questions or would like to discuss these issues further, please contact Bill Calder at (571) 766-7799, or Emily Fitts at (203) 423-4455.

Yours sincerely,

Deloitte + Touche LLP

Deloitte & Touche LLP

[1] For example, *Amendments Relating to the Supervision of Audits Involving Other Auditors* (effective for audits ending on or after December 15, 2024); AS 2310, *The Auditor's Use of Confirmation* (effective for audits ending on or after June 15, 2025); AS 1000, *General Responsibilities of the Auditor in Conducting an Audit* (effective for audits starting on or after December 15, 2024); QC 1000, *A Firm's System of Quality Control* (effective as of December 15, 2025); *Amendments Related to Aspects of Designing and Performing Audit Procedures That Involve Technology-Assisted Analysis of Information in Electronic Form* (effective for audits starting on or after December 15, 2025); Proposed AS 2405, *A Company's Noncompliance with Laws and Regulations; Proposed Firm and Engagement Metrics*.

APPENDIX

This Appendix provides additional context on the matters where we believe further outreach prior to the finalization of the project is necessary. This Appendix also includes matters for which we suggest additional alternatives, clarifications, or implementation resources are needed to prevent misunderstandings and promote consistent application of the proposed standard.

Requirement to Examine Information from External Sources

We are concerned that the combination of the proposed requirement in AS 2301, paragraph 40A, and the PCAOB's recently approved new requirement in AS 1105, *Audit Evidence*, paragraph 10A[2] may have far-reaching implications that should be considered further.

The amendments to AS 2301 in paragraph 40A state: "When the auditor's substantive procedures are applied to accounts or disclosures that depend on information the company received from one or more external sources, such procedures should involve examining relevant information that the company received, or that the auditor obtained directly, from the external source(s)." We believe the proposed requirement is contrary to the risk-based approach contained in the PCAOB's risk assessment standards. It may also result in the auditor performing unnecessary work when the substantive procedure designed by the auditor does not depend upon the external information as audit evidence.

> ***For example***, cost of sales is recorded based on vendor invoices (i.e., external information). The auditor has tested the operating effectiveness of controls related to costs of sales, and designs and performs an SAP to respond to the identified risks of material misstatement. Assume the auditor identifies a sufficiently plausible and predictable relationship using revenue and examined external information as part of performing the tests of details on revenue. Further, no other information from external sources is used to determine that the relationship was sufficiently plausible and predictable. In addition to performing the SAP (which is designed to obtain sufficient and appropriate audit evidence for the identified risks of material misstatement related to cost of sales), the proposed requirement in AS 2301.40A would result in the auditor also being required to make a selection of cost of sales expenses and obtain third-party vendor invoices to validate the recorded expense. In other words, in performing the SAP the auditor would de facto have to also perform tests of details, which may call into question the acceptance of SAP as a sufficient substantive testing technique on its own. The use of SAP may provide deeper insights across the population as a whole than making a selection of individual transactions, but going forward auditors may choose to perform only the latter since the weight of the proposed standard is on tests of details as an accepted sole substantive test.

To further demonstrate our understanding of the proposal, we've included the following two examples. These examples represent common approaches used when performing substantive analytical procedures to test revenue in a ship-and-bill environment. For both examples, the recording of revenue is dependent on information the company received from external sources (e.g., contracts, purchase orders, or shipping/delivery documents).

Example 1 – SAP where the auditor's expectation is **not dependent** on information from external sources

Information from external sources used to	Auditor's Expectation

[2] See PCAOB Release No. 2023-004, *Proposed Amendments Related to Aspects of Designing and Performing Audit Procedures that Involve Technology-Assisted Analysis of Information in Electronic Form* ("TAA Amendments").

record revenue	
▪Customer contracts ▪Customer purchase orders ▪Shipping/delivery documents provided by the customer or third-party shipper	Prior year(s) gross margin percentage (calculated using prior year audited revenue and cost of sales) applied to current year cost of sales
Example 1 - Implementation challenges with proposed AS 2301.40A	
The auditor has identified a sufficiently plausible and predictable relationship between historical gross margin and current year cost of sales, to develop an expectation for revenue. To determine that the relationship is plausible and predictable in accordance with proposed AS 2305.05 and .06, the auditor takes into account all relevant information they are aware of, including information to support the auditor's determination that there have been no changes in the current year impacting the relationship (e.g., examination of vendor agreements and product sales pricing). However, as the auditor's expectation is not dependent on the information from the external sources (e.g., customer purchase orders, shipping/delivery documents), under existing AS 2305 such information would likely not be examined when testing revenue or evaluating the information used in the performance of the SAP. The proposed requirements would require the auditor to obtain and examine information from external sources, even though such information would not contribute to the auditor obtaining sufficient appropriate audit evidence nor would it be used to (i) determine the relationship is plausible and predictable or (ii) to evaluate the reliability of the information used in the SAP. Such additional procedures would be additive and not contribute to the effectiveness of the SAP designed by the auditor.	

<u>**Example 2 –** SAP where the auditor's expectation **is dependent** on information from external sources</u>

Information from external sources used to record revenue	**Auditor's Expectation**
▪Customer contracts ▪Customer purchase orders ▪Shipping/delivery documents provided by the customer or third-party shipper	Prior year recorded revenue, adjusted for changes in internally prepared information dependent on external sources (e.g., sales volumes, sales prices)
Example 2 - Implementation challenges with proposed AS 2301.40A	
The auditor has identified a sufficiently plausible and predictable relationship between historical revenue, change in shipping volumes, and changes in sales prices, to develop an expectation for revenue in the current period. The information used by the auditor in developing the expectation includes company-produced information that is dependent on information from external sources. *For example: Sales Volumes from shipped quantities report are dependent on information from third-party shippers; sales prices from the approved price list are dependent on customer contracts agreed to by the external customers.* In accordance with AS 1105.06, the auditor evaluates the relevance and reliability of such information (as further emphasized by proposed AS 2305.04). Procedures may include examining information from external sources on which the revenue account depends (e.g., testing the accuracy of the sales volume	

information may include examining shipping documents from the third-party shipper). However, to test the reliability of the approved sales price list, the auditor may not need to examine individual customer contracts (e.g., the auditor may choose to test controls over the reliability of a sales price list).

In applying the requirements of proposed AS 2301.40A to this example the auditor would be required to examine information from external sources. While it is likely that the auditor will examine some information from external sources as part of performing the SAP, it is unclear when applying proposed AS 2301.40A whether (1) the auditor would be expected to examine each type of information obtained from external sources (i.e., customer contracts, customer purchase orders, and shipping/delivery documents), for which the company's account is dependent upon, or (2) the procedures performed to determine if information used in the SAP was reliable would satisfy the requirement in paragraph 40A, including when the auditor chooses to test controls over the accuracy and completeness of certain information used in performing the SAP.

If the intent of paragraph 40A is to direct the auditor to design separate procedures to examine information from external sources in addition to those performed when satisfying the requirements of AS 1105 or when relevant controls have been tested, such procedures would be additive and not contribute to the effectiveness of the SAP designed by the auditor.

While not an all-inclusive list, below are additional examples where a significant account is dependent on information the company received from external sources, but the auditor may identify a sufficiently plausible and predictable relationship that is not dependent on such external information when performing SAPs.

Significant account	Information the company received from external sources on which the significant account depends	Auditor's expectation based on:
Other operating expenses (e.g., rent, utilities, repairs & maintenance)	•Vendor contracts, vendor invoices •Rental agreements •Utilities invoices	Prior year, adjusted for changes in number of operating facilities
Selling expense	•Vendor invoices	Prior year(s) ratio of selling expense to revenue, applied to current year revenue
Fixed asset depreciation expense	•Vendor contracts •Vendor invoices	Prior year(s) ratio of fixed asset depreciation expense to fixed assets, adjusted for changes in depreciation rates

We recommend that before finalizing this Proposal the PCAOB engage with relevant stakeholders on the proposed requirement in AS 2301.40A and the intersection with the requirement in AS 1105.10A.

Determination of a Threshold for Evaluating Differences

We agree with the improvements in the proposed standard to clarify auditors should determine a threshold to evaluate differences when performing SAPs. By doing so, we believe that the proposed standard will improve consistency in practice and alleviate the concerns observed by the PCAOB during its oversight activities as noted in the Release. However, we have concerns related to the PCAOB prescribing the threshold used by auditors be set at or below tolerable misstatement. Specifically, we believe that paragraph .08 of the proposed standard:

- *Is inconsistent with other auditing standards and a risk-based approach relating to the design and performance of further audit procedures.* For example, existing auditing standards do not prescribe minimum sample sizes when using audit sampling for substantive purposes or tests of controls, but rather describe the factors the auditor considers when forming their professional judgment on the extent of testing necessary to provide sufficient appropriate audit evidence. Prescribing the threshold to be set at or below tolerable misstatement unnecessarily limits the auditor's ability to apply professional judgment.
- *Does not contemplate the auditor's use of a combination of substantive procedures in response to identified risks of material misstatement.* When using a combination of substantive procedures to address the same risk of material misstatement, it may be appropriate for the auditor to perform less precise substantive analytical procedures.
- *Is unclear how to apply the prescribed threshold that cannot exceed tolerable misstatement when the auditor develops an expectation for an amount derived from a recorded amount (e.g., a ratio), rather than the recorded amount itself.* The use of tolerable misstatement may be irrelevant if the auditor is developing an expectation for something other than a recorded amount.

While we agree that tolerable misstatement is an important factor the auditor considers when determining an appropriate threshold, we do not believe it should be a bright-line requirement. Rather than prescribe a threshold amount, the standard should describe the factors that influence the auditor's professional judgment, including tolerable misstatement, the nature of the account being tested, and other qualitative factors. The proposed language in paragraph .08 only allows the auditor to exercise professional judgment when determining if a threshold below tolerable misstatement would be necessary. However, the factors noted in proposed paragraph .08[3] do not solely have a reducing effect and may also lead to circumstances where a threshold above tolerable misstatement may be appropriate.

Furthermore, footnote 6 attached in proposed paragraph .08 states that "[t]he auditor may perform a substantive analytical procedure for a component of a significant account or disclosure because the component might be subject to significantly differing risks." We agree this is one example of when an auditor may design an SAP at a more disaggregated level; however, we believe there are other situations that may lead to disaggregation, including the identification of a more precise plausible and predictable relationship at a disaggregated level. For example, when using an SAP to test revenue, the auditor may disaggregate (e.g., by product or service type, subsidiary, physical location, some combination thereof) to develop a sufficiently precise expectation that considers the variability in the relationship. When an auditor designs an SAP at a disaggregated level, it is important to recognize that the threshold is also applied at that disaggregated level.

Therefore, we recommend the PCAOB:

1. Remove the prescriptive requirement regarding the threshold amount and instead identify the factors the auditor is required to consider when forming their professional judgment, including the nature and materiality of the amount being tested, and the level of disaggregation at which to perform the SAP.

2. Remove the footnote and the phrase "component of the account or disclosure" as it leads to

[3] "…taking into account the nature of the account or disclosure or, where applicable, the component of the account or disclosure."

confusion on the level at which the threshold is applied when the SAP is designed at a disaggregated level.

We suggest the following edits to paragraph .08 for the PCAOB's consideration:

.08 The auditor should determine a threshold for evaluating the difference between the auditor's expectation and the company's amount. The amount of the threshold should ~~be set at or below tolerable misstatement,[5] taking~~ take into account tolerable misstatement and the nature of the company's amount being tested. ~~account or disclosure or, where applicable, the component of the account or disclosure.[6]~~ When determining the threshold, the auditor should address the risk that the difference between the auditor's expectation and the company's amount represents a misstatement that would be material to the financial statements, individually or in combination with other misstatements within the account or disclosure, considering the possibility of undetected misstatements.

Footnotes

[5] *See paragraph .08 of AS 2105,* Consideration of Materiality in Planning and Performing an Audit. *"The auditor should determine tolerable misstatement at an amount or amounts that reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements would result in material misstatement of the financial statements."*

~~[6] The auditor may perform a substantive analytical procedure for a component of a significant account or disclosure because the component might be subject to significantly differing risks. See AS 2110.63.~~

Definition of "Company's Amount"

We understand that the PCAOB's objective to incorporate the new term, "company's amount", into the standard is to reflect the broader range of comparisons used by auditors when performing SAPs, as well as to prevent the use of "circular auditing." We agree with both of those objectives but believe the term "company's amount" needs to be formally defined within the standard to avoid misinterpretation.

We believe the intent is for "company's amount" to refer to the amount that the SAP is testing. Without a formal definition it is unclear if the PCAOB intended "company's amount" to encompass all amounts or balances that are derived from, or come from, the company's financial records or rather if "company's amount" is limited to the amount or balance that is the subject of the SAP. It is not clear whether the term is intended to prevent an auditor from developing an expectation using audited information that is derived from company-produced information, examples of which include:

- Revenue amounts to develop an expectation of cost of sales.
- Sales amounts to develop an expectation for sales commission expense.
- Prior-year fixed expense amount to develop an expectation for the fixed expense in the current year.
- Hotel occupancy rates and room rates to develop an expectation for hotel revenue.
- A company-developed budget to develop an expectation for research and development costs.
- Interim income statement amounts to develop an expectation for the remaining period.

> *For example*, the auditor performs a test of details over maintenance expense recorded for the first nine months of the year. The auditor designs an SAP to extend the substantive procedures over the remaining period by developing an expectation for the last three months of the year based on the average monthly expense recorded for the first nine months of the year (a sufficiently plausible and predictable relationship based on the audited nine-month expense).

We believe that using company-produced information in the manner described above is appropriate when the auditor has considered and adjusted for any changes to the relationship when developing the expectation and evaluated the reliability of the information used under AS 1105. If the PCAOB agrees that it was not their intent to limit such applications of SAPs, that intent could be clarified by defining that the "company's amount" is intended to reflect the amount to which the expectation will be compared. This definition would then allow for using company-produced information to develop an expectation if that information is separate and distinct from the amount being tested (and appropriate audit procedures have been applied to such information).

Furthermore, proposed AS 2305.07 states that an auditor may not develop an expectation using the company's amount. While we fully support the PCAOB's intent to avoid "circular auditing," there are circumstances where we believe the company's amount may be used when testing a balance sheet account as of an interim date and then extending the audit conclusion to period-end through an SAP.[4]

> *For example*, after considering the factors outlined in AS 2301.44, the auditor determines it appropriate to perform substantive procedures as of an interim date (September 30) to test the accounts receivable (A/R) balance. The auditor then designs audit procedures to extend the audit conclusions reached as of September 30 to period end (December 31) in accordance with AS 2301.45. Such procedures include designing and performing an SAP over the remaining period. The auditor develops an expectation for A/R as of December 31 based on the relationship between A/R and revenue as of September 30, which was determined to be sufficiently plausible and predictable (i.e., the auditor's expectation of December 31 A/R is equal to September 30 A/R as a percentage of September 30 quarter to date (QTD) audited revenue amount multiplied by actual December 31 QTD audited revenue).

The distinction in this example compared to "circular auditing" is that the interim amount used in the period-end expectation is audited, as a conclusion is reached on the balance sheet account as of the interim date. While we don't believe it was the PCAOB's intent to limit the use of such SAPs when extending audit conclusions from interim to the period-end, without further clarification the proposed standard may be misinterpreted in this manner. This has the potential to cause auditors to avoid interim testing, which could have a negative impact on audit quality due to the volume of audit effort that would be moved to the end of the audit.

Identification of Sufficiently Plausible and Predictable Relationships

We are supportive of clarifying the auditor's responsibilities associated with identifying the scope of procedures to be performed in determining whether a relationship that will be used in forming the auditor's expectation of a recorded amount is a plausible and predictable relationship. While we agree that the proposed standard itself should not prescribe the nature, timing, and extent of such procedures, we believe further implementation resources and examples are needed to address the spectrum of

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[4] AS 2301.45 states, "When substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, or substantive procedures combined with tests of controls, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end."

procedures the auditor can perform to comply with proposed AS 2305.05, including the nature and extent of procedures to be performed. For example, for straightforward relationships used to develop SAP expectations, the auditor will often use their understanding of the company, experience from historical auditing procedures, and understanding of the macroeconomic environment, along with the relevant information gained from the items highlighted in paragraph .06 of proposed AS 2305, to assess the plausibility and predictability of the relationship; it is unclear from the proposal as to whether this is sufficient.

We recognize the PCAOB discussed the scalability of the requirement, including through the examples in the Release on page 24, which highlights that "some relationships may require more extensive procedures than for others," but the PCAOB stopped short of providing any examples of the additional procedures the auditor may perform. We recommend the PCAOB provide implementation resources, including complete examples that describe the determinations made and procedures performed related to the plausibility and predictability, such as demonstrated in the following.

> *For example*, assume a company has not issued any new debt and existing debt instruments have fixed interest rate terms that the auditor validated at the time of issuance. The auditor concludes that the prior-year ratio of the outstanding debt balance to interest expense is a plausible and predictable relationship for the current-year interest expense. To determine that the relationship is plausible and predictable, the auditor understands (through inquiry of management) that no new debt has been issued and they corroborate their inquiry with a review of the board of directors' minutes (i.e., inspection).