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

12 August 2024

Re: PCAOB Rulemaking Docket Matter No. 056 — Proposed Auditing Standard — Designing and Performing Substantive Analytical Procedures and Amendments to Other PCAOB Standards

Dear Ms. Brown:

Ernst & Young LLP is pleased to provide comments to the Public Company Accounting Oversight Board (PCAOB or Board) on its proposal to replace Auditing Standard (AS) 2305, *Substantive Analytical Procedures*, with a new standard, AS 2305, *Designing and Performing Substantive Analytical Procedures*, and to amend other PCAOB standards (PCAOB Release No. 2024-006).

We support the Board's efforts to modernize the standards related to substantive analytical procedures (SAPs). As the Board noted in the proposing release, the use of technology by auditors to perform audit procedures, including SAPs, has significantly increased in recent years. This trend will likely accelerate as the use of technology expands and financial statement users expect auditors to utilize data and technology to obtain audit evidence more effectively and efficiently. Updating the standards to include flexible considerations and principles to support the rapid pace of change is essential to maintaining audit quality.

We agree that when designed and executed appropriately, SAPs can provide relevant and reliable audit evidence to respond to assessed risks of material misstatement. We also agree the increasing availability of comprehensive, detailed and disaggregated information can be used to design and execute a wider array of SAPs addressing a greater number of risks of material misstatement.

Well-designed substantive analytical procedures play a key role in the auditor's response to the assessed risks of material misstatement and, unlike tests of details, direct their testing objectives to the account balance as a whole rather than at individual transactions. As noted in paragraph .01 of the proposed standard and throughout the proposing release, SAPs can provide relevant and reliable audit evidence when performed alone or in combination with other audit procedures. In practice, we frequently observe that well-designed SAPs are performed in combination with tests of details to address identified risks.

While we are generally supportive of the proposed standard, we believe certain modifications and clarifications are essential for auditors to understand and consistently apply the principles of the proposed standard, avoid the potential unintended consequence of discouraging the appropriate use of SAPs and to achieve the Board's objective of improving audit quality.

We strongly encourage the Board to consider making the following adjustments to the proposed standard and related amendments.

Determining a threshold for evaluating differences

Paragraph .08 of the proposed standard requires that the threshold for evaluating the difference between the auditor's expectation and the company's amount be set at or below tolerable misstatement. While we believe there are instances where using a threshold at or below tolerable misstatement is appropriate (e.g., when a substantive analytical procedure represents the sole substantive procedure designed and performed in response to an assessed risk of material misstatement), this specific requirement is unnecessarily restrictive for SAPs designed and performed in combination with other substantive procedures to address assessed risks of material misstatement.

An important element in the appropriate use of substantive analytical procedures is the ability for the auditor to exercise professional judgment in determining an investigation threshold that is based on the level of evidence to be obtained from the SAP and other audit procedures to be performed in the area. This concept is consistent with the principles of paragraph .04 of the proposed standard. Under proposed AS 2305.04, the persuasiveness of audit evidence from a substantive analytical procedure takes into account the level of precision of the SAP, which is dependent on (i) the relevance of information used in designing and performing the procedure, (ii) the plausibility and predictability of the relationship on which the procedure is based, and (iii) the amount of the threshold for evaluating differences between the auditor's expectation and the company's amount. While the current proposal acknowledges that the precision of a SAP may vary, a requirement that SAPs must always use an investigation threshold at or below tolerable misstatement significantly reduces or eliminates that acceptable variation.

Specifically, as proposed, the requirement that a substantive analytical procedure must always use an investigation threshold set at or below tolerable misstatement could unintentionally discourage the appropriate use of SAPs in combination with other substantive audit procedures. This is based on the premise that, particularly in integrated audits, a SAP encompassing (i) relevant and reliable information, (ii) sufficiently plausible and predictable relationships and (iii) an investigation threshold at or below tolerable misstatement would in most cases provide the auditor with an overall persuasive level of audit evidence to address assessed risks of material misstatement. We are concerned that without an option to use professional judgment in determining an investigation threshold greater than tolerable misstatement, auditors will frequently limit their performance of SAPs to situations when such procedures, alone, provide sufficient appropriate audit evidence.

Under existing auditing standards, the auditor's appropriate use of professional judgment to determine an investigation threshold that is greater than tolerable misstatement can provide some, but not all, substantive audit evidence for an assessed risk of material misstatement. Specifically, a SAP designed with an investigation threshold greater than tolerable misstatement reduces the probability that a material misstatement is not identified by the auditor's other substantive procedures to address the same risk of material misstatement. For example, a SAP designed and executed to detect misstatements using an investigation threshold greater than tolerable misstatement would limit the remaining risk of material misstatement to those that are individually, or in the aggregate, greater than tolerable misstatement but less than the investigation threshold used.

The academic literature and other auditing standards, many of which are cited in the proposing release, support the auditor's use of professional judgment to determine an investigation threshold greater than tolerable misstatement but still allowing for the SAP to provide some, but not all, substantive audit evidence for an assessed risk of material misstatement. For example:

- As acknowledged in the proposing release, academic literature[1] suggests that performing certain SAPs using an investigation threshold exceeding an auditor's materiality can still provide audit evidence that, in combination with other SAPs, is sufficient to respond to a risk of material misstatement.

- A more principles-based and less restrictive requirement for SAPs designed to provide some, but not all, audit evidence toward an assessed risk of material misstatement is consistent with the principles of AS 2301.37, which states that for individual assertions "different combinations of the nature, timing and extent of testing might provide sufficient appropriate evidence to respond to the assessed risk of material misstatement," and AS 2301.39, which states that "some types of substantive procedures, by their nature, produce more persuasive evidence than others."

- The concept that SAPs may provide some, but not all, audit evidence toward a relevant assertion is consistent with Table 2 of the Appendix to AS 2315 which illustrates, in the context of the auditor determining a sufficient test of details, that the auditor considers that SAPs (or other substantive tests) can contribute varying degrees of audit evidence.

Based on the observations above, we recommend the Board consider modifying paragraph .08 of the proposed standard as follows (hereinafter, any reordered proposal text is marked in *italics*, additions are marked as <u>underlined</u> and deletions are ~~struck through~~):

> .08 The auditor should determine a threshold for evaluating the difference between the auditor's expectation and the company's amount, *taking into account the nature of the account or disclosure or, where applicable, the component of the account or disclosure,* <u>tolerable misstatement and the desired level of precision</u>. ~~The amount of the threshold should be set at or below tolerable misstatement, taking into account the nature of the account or disclosure or, where applicable, the component of the account or disclosure.~~ 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. <u>When the substantive analytical procedure is the only substantive audit procedure responsive to an assessed risk of material misstatement for an assertion,</u> *the amount of the threshold should be set at or below tolerable misstatement*.

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1 *See* Steven M. Glover, Douglas F. Prawitt, and Michael S. Drake, *Between a Rock and a Hard Place: A Path Forward for Using Substantive Analytical Procedures in Auditing Large P&L Accounts: Commentary and Analysis,* Auditing: A Journal of Practice & Theory 164 (2015), which states "The requirement to strictly limit the size of the tolerable threshold to less than materiality for SAPs is sensible if the SAP is intended to provide a high level of assurance that an account is not materially misstated by itself."

Definition of "company's amount"

Paragraph .07 of the proposed standard specifies that the auditor may not develop an expectation using the "company's amount or information that is based on the company's amount." While we support the Board's objective to address the risk of circular auditing, the term "company's amount" as used in the proposed standard may be misunderstood and unintentionally preclude common and appropriate substantive analytical procedures from being performed.

In the proposing release, examples referencing the "company's amount" suggest this term only refers to a current period financial balance recorded by a company (or an amount derived directly from such amount) that is being subjected to audit by a SAP. However, we believe auditors will interpret the "company's amount or information that is based on the company's amount" and the related restriction on using such amount, to include amounts other than the recorded amount being tested, such as:

- Comparable amounts audited in prior periods used to set expectations for disaggregated trend analyses, predictive ratios or statistical regression

- Other "company's amounts" recorded in the current year (different from and not derived from the company's amount being tested) (e.g., using current year revenue to develop an expectation for the recorded amount of cost of goods sold)

- Nonfinancial information provided by the company, such as payroll headcount data, that is used to set expectations for ratio analyses

These represent examples of amounts commonly used in developing expectations of appropriate substantive analytical procedures that are not circular in nature but are developed based on the relationships identified in paragraphs .05 and .06 of the proposed standard. As a result, we believe clarification of the term "company's amount" is necessary and propose the following edits to paragraph .07 of the proposed standard:

> .07 The auditor should develop an expectation of the company's amount based on the relationship(s) identified pursuant to paragraphs .05 and .06. The auditor may not develop the expectation <u>on a circular basis</u> using the company's amount <u>(i.e., the amount to which the expectation will be compared)</u> or information that is based on the company's amount.

Proposed amendment to AS 2301, *The Auditor's Responses to the Risks of Material Misstatement* and recent amendment to AS 1105, *Audit Evidence*

We appreciate the Board's efforts to consider clarifications to the auditor's responsibilities regarding information the company receives from external sources, and we support the development of standards that are well-suited to respond to the continued expansion of technology-assisted auditing techniques. However, we have significant concerns that the requirements in new proposed paragraph AS 2301.40A and the recent amendments to AS 1105.08 through .10 (including new paragraph AS 1105.10A) would (i) appear to be in conflict with one another, (ii) introduce unclear testing requirements and (iii) significantly expand the required auditor procedures related to establishing the reliability (including authenticity) of information the company receives from external sources. Such an expansion of auditor procedures, without measurably enhancing audit quality in a cost-beneficial manner, would not be in line with the Board's stated objectives. Further, absent modification, proposed AS 2301.40A and recently passed AS 1105.10A will require extensive new audit procedures related to external information used by the company irrespective of the auditor's risk assessment and professional judgment related to the possibility that such external information is not reliable or authentic or whether the auditor intends to use such external information as part of its audit procedures.

Accordingly, we recommend the Board eliminate paragraph AS 2301.40A from the proposed amendments. We believe the expanded requirements could be costly and unnecessary given the extant requirements of AS 1105, which provides a sufficient model for the evaluation of this external information. However, if such requirements are determined to be insufficient, we recommend the Board consider further amendments to AS 1105 to make those requirements clearer. Further, we recommend the Board consider amending AS 1105.10A(b) such that the requirements are first subject to the auditor's evaluations in paragraphs 1105.08 through .10A(a).

Proposed amendment AS 2301.40A

We outline in further detail our concerns with respect to proposed AS 2301.40A as follows:

- When performing substantive audit procedures on accounts or disclosures that depend on information the company received from external sources, AS 2301.40A requires the auditor to "examine" relevant information from the external sources. However, when the auditor uses information from external sources as part of their audit, existing AS 1105 paragraphs .08 through .10 (including recently passed AS 1105.10A) would be applicable and the auditor would be required to evaluate the relevance and reliability of the information. Accordingly, depending upon which procedures the auditor chooses to perform to evaluate the relevance and reliability of external information under AS 1105, proposed AS 2301.40A would be either redundant (e.g., when "examining" the information involves procedures equivalent to those performed by the auditor to evaluate the reliability of such information pursuant to AS 1105) or incremental (e.g., when "examining" the information involves substantive audit procedures related to the reliability of such external information that go beyond AS 1105's requirements for performing an appropriate combination of risk assessment, control and/or substantive procedures when considering the reliability of audit evidence).

- For accounts or disclosures that depend on information the company received from external sources, AS 2301.40A goes further than AS 1105 by requiring the auditor to perform substantive procedures related to relevant information from external sources regardless of whether the auditor otherwise plans to use such information as audit evidence. When the auditor would not otherwise be planning to use the information from external sources that is referenced in proposed AS 2301.40A as audit evidence, we do not believe the auditor's substantive procedures should be required to involve "examining" such information.

- Based on the examples provided in the proposing release of accounts or disclosures that may depend on information the company received from external sources (e.g., "accounts involving transactions with third parties or assets held by third parties"), combined with the examples of information a company receives from external sources (e.g., "customer payments" or "supplier invoices" as noted in the proposing release, or "cash receipts, shipping documents, and purchase orders" provided in footnote 3B of recently passed AS 1105.10A), it appears that substantially all accounts or disclosures could be subject to proposed AS 2301.40A.

Notwithstanding our above recommendations, we also believe the requirements of proposed AS 2301.40A would lack the necessary clarity for auditor implementation. Specifically, "examine" or "examining" is not defined in either AS 1105 or AS 2301, and we do not believe there is sufficient clarity on the nature, timing and extent of procedures that "examining" would entail under proposed AS 2301.40A. Further, proposed AS 2301.40A would apply to all accounts or disclosures that "depend on" information the company received from external sources, with examples indicating a broad spectrum of potential information from external sources that companies depend on. However, proposed AS 2301.40A requires auditors only to examine "relevant" information from external sources while not articulating in what context relevancy would apply. With no clear framework, explanation or examples to support this requirement, this would result in a wide range of inconsistent practice that could be contrary to the Board's objectives.

Amended AS 1105.10A

As acknowledged above, auditors performing substantive analytical procedures would need to comply with proposed AS 2301 as well as AS 1105, which was recently amended as part of the Board's amendments related to aspects of designing and performing audit procedures involving technology-assisted analysis of information in electronic form. Such amendments include a new provision in paragraph AS 1105.10A(b) related to the auditor's required testing of certain information from external sources to determine the information has not been modified by the company. Specifically, when the auditor uses information in electronic form that the company received from one or more external sources (identified in footnote 3B as encompassing information such as "cash receipts, shipping documents and purchase orders"), AS 1105.10A(b) requires the auditor to perform procedures to establish reliability by either "testing the information to determine whether it has been modified by the company" or "testing controls over the receiving, maintaining, and processing the information."

In evaluating new paragraph AS 1105.10A(b), including how it would interact with the proposal to replace AS 2305, we outline in further detail our concerns as follows:

- AS 1105.10A(b), absent further amendments or interpretive guidance, could be construed to conflict with AS 1105 paragraphs .08 and .09 and significantly expand the scope of the auditor's required procedures to address the risk of evidence modification and develop and implement an appropriate audit response. For example:

    - Paragraph .08 establishes that the reliability of evidence depends on the nature and source of the evidence and the circumstances under which it is obtained. Paragraph .09, importantly, acknowledges that the auditor is not expected to be an expert in document authentication but "if conditions indicate that a document may not be authentic or that the terms in a document have been modified but that the modifications have not been disclosed to the auditor," the auditor should modify their planned audit procedures. As a result, the new requirement in AS 1105.10A(b) could be viewed to differ from the principles and risk-based approach outlined in paragraphs .08 and .09 of AS 1105 related to the reliability of audit evidence.

- If new paragraph AS 1105.10A(b) is not subject to the principles and risk-based approach outlined in paragraphs .08 and .09 of AS 1105, we are concerned that AS 1105.10A(b) effectively establishes a presumption (regardless of their nature, source and circumstances) that the information provided to the auditor in electronic form has been modified, which must always be overcome by the auditor's testing (either controls or substantive procedures). Given the routine nature of the types of information contemplated by AS 1105.10A (e.g., cash receipts, shipping documents, purchase orders), in combination with routine company practices to receive and store such information electronically by digitizing the related information, we believe in most instances the presumption that such underlying source evidence has been modified by the entity is inconsistent with the nature, source and use of such information in practice.

- We also believe AS 1105.10A(b), absent further amendments or interpretive guidance, lacks sufficient clarity for auditor implementation. As mentioned above, companies commonly digitize the source information referred to in footnote 3B of AS 1105.10A. In many circumstances, issuers do not consider the risk of subsequent modification of such information as a risk of material misstatement. Therefore, such digitization controls are not designed and executed in the normal course of their internal control over financial reporting. Additionally, in many cases the underlying source documentation is disposed of once the information is digitized. As a result, should the auditor now be required to either test controls over the digitization, maintenance and storage of such information or directly test that such information received in electronic form has not been modified by the company, it is unclear how the Board expects auditors to comply with the new requirement in all circumstances.

Based on the above, we recommend the Board consider amending AS 1105.10A as follows:

> .10A The company may provide to the auditor information in electronic form that the company received from one or more external sources.[3B] When using such information as audit evidence, the auditor should evaluate whether the information is reliable for purposes of the audit by:
>
> > a. Obtaining an understanding of (i) the source from which the company received the information; and (ii) the company's process by which such information was received, maintained, and, where applicable, processed, which includes understanding the nature of any modifications made to the information before it was provided to the auditor; and
> >
> > b. Subject to the auditor's evaluations in paragraphs .08, .09 and .10A(a) above, assessing the need for additional procedures such as: (i) ~~T~~ testing the information to determine whether it has been modified by the company and evaluating the effect of those modifications; or (ii) testing controls over receiving, maintaining, and processing the information (including, where applicable, information technology general controls and automated application controls).

[3B] Such information includes, for example, cash receipts, shipping documents, and purchase orders.

Overall, we believe the proposed standard can be a critical step in improving the quality of substantive analytical procedures and is beneficial to the audit profession. The Appendix contains our responses to selected questions from the proposing release where we have recommendations or specific feedback.

*   *   *   *   *

We would be pleased to discuss our comments with members of the PCAOB or its staff at your convenience.

Sincerely,

Ernst + Young LLP

Appendix

3. Does the proposal adequately describe the extent and frequency of auditors' use of substantive analytical procedures in audits? Please provide supporting information, such as the types of accounts generally tested using substantive analytical procedures and other relevant data.

Yes. In addition, the following are examples of types of accounts frequently tested using substantive analytical procedures:

- Revenue — either directly (e.g., revenue per unit of sale, revenue disaggregated by time period, regression analysis of revenue transactions by store), for accounts derived from revenues (e.g., sales taxes, sales commissions) or for accounts with a plausible and predictable relationship to revenues (e.g., sales discounts, cost of sales or gross margin, selling expenses)

- Other significant income statement accounts, such as payroll expense (frequently based on average wages per employee), depreciation expense (frequently based on property, plant and equipment values and related useful life assumptions) and interest expense (based on long-term debt balances and associated relevant interest rates)

- Certain balance sheet accounts, based on corresponding transaction activity and related terms (e.g., days sales outstanding of accounts receivable, inventory turnover, prepaid expenses, deferred revenue, compensation-related liabilities)

6. Are the factors that affect the persuasiveness of audit evidence provided by substantive analytical procedures, specifically the precision of the procedure and the reliability of the information used in it, clear and appropriate? If not, how should they be clarified? Are there other factors that affect the persuasiveness of audit evidence provided by substantive analytical procedures? If so, what are they?

Yes, we agree that more persuasive audit evidence is obtained from a substantive analytical procedure when the procedure is more precise and uses more reliable information. However, we also observe in practice that many SAPs are performed in combination with other substantive procedures to address risks of material misstatement. In these cases, we believe the required persuasiveness of audit evidence provided by the SAPs can be less than those cases where the SAP is the sole substantive procedure to address a risk of material misstatement.

7. Are the factors that affect precision clear and appropriate? If not, how should they be clarified? Are there other factors upon which a substantive analytical procedure's level of precision depends? If so, what are they?

We believe that the level of disaggregation is a factor affecting the precision of the procedure that should be clearly stated and included in the proposed standard.

Notwithstanding the fact that AS 1105.07, as amended, states that the relevance of audit evidence depends on "the level of disaggregation or detail of information necessary to achieve the objective of the audit procedure," because the majority of substantive analytical procedures are performed on a disaggregated basis in practice, we recommend the Board specifically highlight the level of disaggregation in its definition of precision in paragraph .04. Specifically, we respectfully recommend the Board consider the following adjustment to proposed paragraph .04:

> .04 Under AS 2301, in designing and performing audit procedures, the higher the auditor's assessment of risk, the more persuasive audit evidence the auditor should obtain. More persuasive audit evidence is obtained from a substantive analytical procedure when the procedure is more precise and uses more reliable information. The precision of a substantive analytical procedure depends on (i) the relevance of the information used in designing and performing the procedure, <u>including the level of disaggregation at which the procedure is performed</u>, (ii) the plausibility and predictability of the relationship on which the procedure is based, and (iii) the amount of the threshold for evaluating differences between the auditor's expectation and the company's amount.

In the proposing release, the Board acknowledges that disaggregated data "can improve the precision of the substantive analytical procedure (e.g., by improving the precision of the auditor's expectation)," and therefore, we believe expressly incorporating the level of disaggregation as a component of precision as recommended would be appropriate.

Additionally, we acknowledge the Board's notation that technology-assisted analysis has enabled auditors to design and perform SAPs on a more disaggregated basis, and that the greater availability of disaggregated data through the use of technology-assisted analysis to analyze that data enables the auditor to develop more precise expectations, including those for all individual items within an account or disclosure (e.g., individual lease contracts or individual loans).

10. Is the proposed requirement that the auditor identify the relationship or relationships to use in the substantive analytical procedure and determine whether each such relationship is sufficiently plausible and predictable clear and appropriate? If not, how should it be clarified?

We believe auditors would benefit from further clarification or implementation guidance on the definition of "sufficiently" plausible and predictable that goes beyond the reference "to achieve the objective of the procedure" included in proposed paragraph .06. In our view, it will otherwise be unclear to auditors whether "sufficiently" plausible and predictable relationships are intended to describe, for example, a minimum (or baseline) level of plausibility and predictability that allows the analytical procedure to provide some substantive evidence (after which, an acknowledged spectrum from lower to higher plausibility and predictability would exist) or whether "sufficiently" plausible and predictable relationships to "achieve the objective of the procedure" refers to the overall persuasiveness of audit evidence the auditor intends to obtain through the procedure (e.g., using existing AS 2305 language, the auditor's planned "level of assurance").

Additionally, paragraph .05 of the proposed standard states that "making this determination should extend beyond inquiry." This proposed language infers that additional procedures are always required to determine whether the relationship is plausible and predictable. However, the nature, timing and extent of such additional procedures are not specified. We believe there are some circumstances in which inquiry related to the account, its relationships, or the company's business activities, combined with the auditor's understanding of the entity, industry and accounts from a historical perspective may be sufficient for determining whether the relationship is plausible and predictable. It is unclear whether these procedures would be considered "beyond inquiry" when they may not constitute the specific other types of audit evidence contemplated in AS 1105, such as observation, inspection, reperformance or recalculation. Accordingly, we recommend the Board consider revising this paragraph .05 requirement to specify the sufficiency of procedures contemplated by proposed paragraph .06, or issue further implementation guidance to avoid inconsistencies in practice.

11. Is the proposed requirement that the auditor take into account all relevant information of which the auditor is aware when determining whether a relationship is sufficiently plausible and predictable clear and appropriate? If not, how should it be clarified?

Yes, we agree that the auditor should take into account all relevant information of which the auditor is aware when determining whether a relationship is sufficiently plausible and predictable.

12. Are the examples of events, conditions, and company activities that are included in proposed paragraph .06 described clearly and appropriately? Are there additional events, conditions, or company activities that may affect the plausibility and predictability of a relationship that should be included in the proposed standard as examples? If so, what are they? If the examples of events and conditions are not clear, how should they be clarified?

With respect to the relevant information the auditor should take into account when determining whether a relationship is sufficiently plausible and predictable, we agree with the proposed paragraph .06 factors of (a) the auditor's understanding of the company and its environment and (b) other procedures performed in the audit and in reviews of interim financial information. However, we recommend adding an additional criterion to paragraph .06 (in between current proposed factors (a) and (b)) that is related to the auditor's consideration of the characteristics of the account or disclosure and its relevant assertions.

When determining whether a relationship is sufficiently plausible and predictable, we believe the relevant account and assertion characteristics represent an important consideration related to both the plausibility (e.g., whether the analytical procedure is suitable for the intended assertion) and predictability of the relationships identified. If these characteristics are included in paragraph .06, we would also recommend adding references to applicable AS 2110 paragraphs (e.g., AS 2110.60).

14. Is the proposed change specifying that the auditor may not develop the expectation using the company's amount or information that is based on the company's amount clear and appropriate? If not, what changes should be made?

As discussed above, the terms "company's amount" and "information based on the company's amount" are not clearly defined in the words of the standard and should be revised to avoid variability of application in practice. Further, while the proposing release provides some examples of "information based on the company's amount," we believe further discussion and additional examples of what information could encompass "information based on the company's amount," as well as when such information is considered circular, is necessary for a consistent auditor implementation.

16. Is the proposed requirement that the auditor determine a threshold to evaluate the difference between the auditor's expectation and the company's amount clear and appropriate? If not, what changes should be made?

As discussed above, we believe it is not appropriate to restrict the threshold to an amount at or below tolerable misstatement in all cases where a substantive analytical procedure is performed. We believe this would limit the auditor's use of substantive analytics that are designed in combination with other audit procedures that address the same account and assertion, which would reduce audit quality where SAPs would otherwise provide appropriate audit evidence.

Notwithstanding the discussion above, we believe the proposed standard could go further in addressing the appropriate threshold to use when substantive analytical procedures are designed using disaggregated information (e.g., by time or other relevant categorical information). The Board acknowledges that a lower threshold may be necessary when performing a SAP over disaggregated amounts, but that concept is not clearly articulated in the proposed standard.

For example, it is unclear whether, in a disaggregated analytical procedure (e.g., a monthly analysis of payroll expense), the auditor could reasonably apply proposed paragraph .07 to use an investigation threshold amount below tolerable misstatement (e.g., 20% of tolerable misstatement per month) when investigating differences between expected and actual monthly payroll expense, when the summation of individual investigation thresholds over each of the 12 months of disaggregated analytical procedures may exceed tolerable misstatement (e.g., 20% of tolerable misstatement per month x 12 months = ~2.4x tolerable misstatement in the aggregate). We believe paragraph .07 and the principles-based discussion in the proposing release would appropriately allow for such judgment, particularly when the SAP is performed in combination with other substantive audit procedures. However, we encourage the Board to clarify the interaction between the use of disaggregated data and the threshold used to evaluate differences to avoid inconsistencies in practice.

17. Are the proposed requirements for evaluating the difference between the auditor's expectation and the company's amount clear and appropriate? If not, what changes should be made?

We agree with paragraph .09 of the proposed standard, which states the auditor should evaluate the difference between the auditor's expectation and the company's amount. If, after evaluating the difference, the auditor is unable to (1) determine whether there is a misstatement or (2) find new information that would require an update to the substantive analytical procedures' expectations, we agree with paragraph .11 of the proposed standard that additional audit procedures should be performed to obtain sufficient audit evidence to address the risk of material misstatement for the relevant assertion. However, we encourage the Board to clarify that the auditor cannot rely on the SAP to reduce the nature, timing and extent of the additional audit procedures in response to the "failed" SAP.

22. The proposed amendment specifies 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 the external sources. Is this proposed amendment clear and appropriate? If not, what changes should be made?

We do not believe the amendment is clear for the reasons provided above. Further, the concept of accounts or disclosures that "depend on" information received from the company from external sources could create an unclear categorization instead of applying generally to external information provided by the company used as audit evidence. The proposal provides an example to illustrate the difference between the determination of depreciation expense in the year of acquisition being dependent on external information and the subsequent measurement of depreciation expense dependent on internal information. However, we believe this example could cause confusion because the depreciation expense in subsequent years is still dependent, at least in part, on the external information used to record the asset.

36. Should proposed AS 2305 explicitly address aspects of the use of technology when designing and performing substantive analytical procedures, including situations where the use of technology might improve the quality of audit evidence obtained from such procedures? If so, how?

Yes. Similar to the PCAOB staff, we have also observed that "the use of technology-based tools can enable auditors to disaggregate data to a level where the most plausible and predictable relationships are more readily identified, which in turn can improve the precision of the substantive analytical procedure …".[2] If technology can be used to improve the quality of SAPs, especially when tests of detail may not identify potential misstatements, we suggest the Board more directly encourage the appropriate use of technology. This could be done by providing examples throughout the standard where technology is used to perform highly disaggregated or statistical SAPs (e.g., linear regression).

As previously stated, SAPs play an essential role in supporting audit quality, and we have observed they are frequently performed in combination with other substantive procedures. By their nature, SAPs are typically directed at the entirety of an account balance and not just a sample of individual transactions. Given the importance of their role in promoting audit quality, we also encourage the Board to add the following language based on extant AS 2305.12 to proposed AS 2305.01:

> .01 … When designed and performed appropriately, substantive analytical procedures can provide relevant and reliable audit evidence. <u>Such procedures may effectively and efficiently respond to potential misstatements that would not be apparent from an examination of the detailed evidence, or when detailed evidence is not readily available. For example, a statistical comparison of monthly aggregate payroll expense with the number of personnel may indicate unauthorized payments that may not be apparent from testing individual items.</u>

[2] PCAOB Release No. 2024-006, Page 38

38. Would the proposed effective date present challenges for auditors? If so, what are those challenges, and how should they be addressed?

Yes. An effective date of less than a year from issuance would present challenges to audit firms, since they need sufficient time to properly (1) update their audit methodology to conform with the new standard, (2) update forms and templates, including examples, (3) update software audit tools and automated techniques and (4) train auditors on how to apply the new standard. Further, we believe the Board should consider the significant changes from other standards going into effect in 2026 when setting the timing for adoption. For example, audit firms will need appropriate time to comply with QC 1000, *A Firm's System of Quality Control*, which will heighten the requirement for audit firms to perform quality controls over the implementation of new audit standards. At a minimum, the Board should consider deferring the effective date by an additional year. This would also afford the Board an opportunity to gain insightful feedback from both auditors and issuers prior to implementation of a final standard.