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Agilent Technologies

November 20, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 008

Dear Board Members:

Thank you for the opportunity to comment on the Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of the Financial Statements*. We firmly believe that the PCAOB has an historic role to play in leading the reform of public companies' financial reporting processes, which should ultimately help to restore and increase investor confidence and security to new levels. As a public company, we depend on the Board to use care and a balanced approach to ensure that not only is the end goal achieved, but that no significant unintended consequences impede that goal. Agilent Technologies, Inc. (Agilent) is a global technology leader in communications, electronics, life sciences and chemical analysis. The company's approximately 29,000 employees serve customers in more than 110 countries. On behalf of Agilent, we offer the following comments with regard to the proposed standards for your consideration.

EXECUTIVE SUMMARY

1) Significant Deficiency and Material Weakness Definitions

We appreciate the Board's attention to the importance of clear definitions in the attestation process. However, the exposure draft has dropped the materiality threshold for what is considered to be a significant deficiency or a material weakness. Under the proposed rules, a shortcoming that is neither significant nor material can nevertheless qualify for one of these labels, with serious consequences.

The exposure draft states that a circumstance that creates more than a "remote" likelihood of a misstatement, which is more than "inconsequential" in amount, qualifies as a significant deficiency. The word "inconsequential" is not defined and will likely be interpreted differently. Many companies could point to a control activity failure that has a 10% probability of occurring and involves potential monetary amounts that are 5-10% of what those companies would consider "material." Although the likelihood of such an occurrence is small and the monetary amounts are not material, this, under example D-1, Scenario A, might be a significant deficiency.

If these definitions are retained, we ask the PCAOB to consider and clarify whether the relevant monetary threshold is the dollar impact that could reasonably occur, or the maximum financial impact under a worse case scenario. Currently, the PCAOB proposed definitions would include a number of scenarios from the worst case; ranging from more than remote likelihood with a material impact, to a probable likelihood with a very small impact. Is the intention of the PCAOB to cover this wide range of probability in required disclosures to the audit committee?

A review of the exposure draft examples reveals that the exceedingly low threshold proposed, exponentially increases the risk that companies will trigger multiple significant deficiencies; without regard to any compensating controls. Example D-1, Scenario A on its face seems to be an example of a deficiency, not a significant deficiency, especially given the compensating controls in place to catch material errors. The proposed standard will lead to disclosure of many significant deficiencies which may aggregate to a material weakness judgment and which may cause shareholders and third parties to consider the risk of material misstatement to be much greater than it actually is. This in turn may bring unwarranted volatility in a company's stock price. We are also concerned that the proposed standards will open the door for litigation against companies when an adverse internal control report is issued even though the company's financials are accurate and fairly presented.

2) Use of Internal Audit

With the statement that "the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.", the Board has wisely recognized the fiscal benefit to companies of a strong internal audit function. In other portions of the proposed standards, the exposure draft seems to move away from the above statement. While certain sections encourage the use of management, including internal audit, other provisions limit the circumstances in which internal audit may be used. The draft proposes that internal audit cannot be utilized for the following areas:

- Control environment, including fraud controls.
- Controls over period-end financial reporting process.
- Controls that have a pervasive effect on the financial statements, such as certain IT general controls on which the operating effectiveness of other controls depend.
- Walk throughs.

These prohibited functions are some of the key areas in which an internal audit group can provide significant insight and audit evidence based on its experience with the company. Public companies would not expect external auditors to rely solely on internal audit for 100% of testing, but to eliminate internal audit from these critical areas is a dramatic change from present accepted practices. In addition, this proposed point does not allow the external auditors latitude to use their own professional judgment.

We urge the Board to utilize the provisions of Statement of Auditing Standards No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which address the relationship of the internal audit function in the external audit of financial statements. Rather than redefining this relationship, it would seem that the Board's standard should extrapolate the SAS 65 standards to the audit of internal control over financial reporting especially given that external auditors are now required to perform an integrated audit of financial statements and internal control over financial reporting.

3) Scope of Procedures External Auditors Are Required To Perform

We are concerned that the exposure draft contains a dramatic increase in the number of procedures that external auditors are required, or are planning to, perform and document. Due to fears that their CPA firms may not pass a PCAOB quality audit, as well as mindful of the litigation that would follow, it is logical to assume that external auditors will feel required to perform every procedure in detail even when circumstances would not otherwise dictate such actions. Coupled with the requirement to seek out anything that is more than inconsequential, the proposed rules create an unprecedented amount of painstaking procedures. The exposure draft provides opportunities for assistance from internal audit functions but, as discussed above, these have been greatly reduced. For CPA firms to meet these very substantive new requirements, such firms are proposing to raise fees approximately 25 to100%.

In the area of "walkthroughs" it is not clear if all processes in all locations (significant or otherwise) must have a "walkthrough." By way of example, Agilent, as other multinationals, has complex global operations with an extensive list of processes located in numerous geographies involving multiple sites. In addition, some financial transactions are performed in shared service centers while some are not. This leads to a complex environment that may have many different possible scenarios for walkthroughs. We believe the CPA firm should be allowed to use its judgment based on the specific circumstances of the company that it is evaluating to determine which "walkthroughs" are significant.

Sample sizes for testing of internal controls must also be taken into account. Multinational corporations with operations in multiple geographies could have a large number of immaterial entities and operations. If the company is required to view those immaterial operations together, this creates the potential for a material problem through the aggregation of these entities, only if they all in combination, have a problem. This is extremely unlikely. A careful reading of the exposure draft leads to the conclusion that a company's CPA firm or internal audit is obligated to test all of these small organizations yearly since in combination they could be material and since no rotation is allowed. While the chances of a material problem occurring are probably well below remote, large corporations, their internal audit functions and CPA firms will be forced to allocate time and shareholder dollars to these relatively insignificant operations rather than to significant operations. If a problem with a material operation is overlooked because of this allocation of resources, both the corporation and the investing public suffer.

4) Scope of Procedures Public Companies Are Required To Perform

We are concerned that the exposure draft is unclear as to the level of testing and documentation required by management. The proposed standards require external auditors to evaluate a number of proscribed procedures that a public company must perform in order to receive a "clean" opinion on their internal control over financial reporting from their auditors. If left unclarified, in light of the points mentioned in Item 3 above, external auditors can be expected to take a very conservative view of management testing and documentation. This would necessitate a considerable increase in the number of procedures that a public company would need to document and perform to avoid the external auditors declaring a significant deficiency or a material weakness. The type of evidence that a public company would be required to produce would far exceed the guidance currently given by the SEC to obtain reasonable assurance that a company's internal control over financial reporting is working effectively. For a public company of Agilent's size and complexity, the amount of documentation, evaluation and self-testing will be significant.

As stated before, Agilent has 5 main businesses, located in approximately 30 geographies with multiple sites, some of which may or may not be shared. In addition, some financial transactions are performed in shared service centers while some are not. Each of these different scenarios will need to be assessed by the company to determine what impact, if any, there could be to the internal control over financial reporting. In addition, this assessment will need to be reperformed throughout the year as a company of our size is not static. Then, the company will need to document the internal controls in those impacted areas and periodically test. In addition, the company will need to monitor and test, at an extremely low level, any changes that occur during the year to ensure that the internal controls are working effectively. This will require an incredible amount of effort to just provide adequate documentation, which will take away from the company's focus on those most significant and critical potential issue areas.

In addition, we believe that if a company is required to provide evidence of that control effectiveness to the extremely low level required by the proposed standards, the level of work performed by our external auditors will need to be at the same level or lower. Also, even though the internal control over financial reporting may be working effectively, if we are missing documentation around these controls or our self-testing, our external auditors may determine this situation is, at the minimum, a significant deficiency and potentially a material weakness. Again, the level of documentation, evaluation and testing by both the company and their external auditor may force the cost of implementing the proposed standards to exceed the benefit achieved by more effective internal control over financial reporting.

5) Service Providers

We respectfully request the Board to reconsider what companies must produce as required evidence of the internal controls of their service providers. Due to the potential impact and breadth of this issue, we believe that it may be best to defer the final rules effective date, in this area, for one year.

A SAS 70 report is an accepted United States standard, though it is a report that is expensive ($50,000 to $70,000) and time-consuming to produce. However, it may be considered reasonable to require a nationally-recognized service provider such as Fidelity or ADP to obtain a SAS 70 report yearly. But, as company fiscal years vary, will a CPA firm be allowed to rely on a 10-month old SAS 70 evaluation? If not, there will be a need to have service providers change their procedures and deliverables. Companies with non-standard fiscal calendars may not have the ability or the resources to pressure these service providers to deliver on the new requirements in time to meet their next SEC filing deadlines. Companies are also unlikely to have the contractual right to review any of the service provider's controls themselves. If there is no SAS 70 report the auditor will have to perform significant alternative procedures at a high cost to the public company. Add to this the complexity of using international service providers in dozens of countries. These service providers are not familiar with Sarbanes Oxley's Section 404 requirements and are naturally quite resistant to new requests to produce a detailed certification of their internal functions, utilizing a standard that may not comport with their local regulatory framework.

The end result for a U.S. corporation might be the need to terminate a beneficial relationship with a foreign service provider who will not, or cannot, meet the Board's requirements. The detrimental effect to the U.S. company is clear, as operations would need to be transitioned, workers terminated and new workers hired and trained, with the attendant legal complications, loss of local beneficial arrangements, and perhaps lawsuits or penalties. As the U.S. economy teeters on the edge of recovery, with the fate of U.S. companies hanging on the balance, locating a new service provider who can meet the PCAOB requirements as well as the corporation's requirements in a short period of time is very risky. These risks directly impact the ability of a company such as Agilent to produce quality products and services and our ability to generate profit.

6) Evaluating the Effectiveness of the Audit Committee

We believe that more guidance is necessary to understand the extent of the Board's requirements for evaluating the effectiveness of the audit committee. In the infamous Enron audit committee failure, it should have been clear to Enron's external auditors what the relative levels of effectiveness were for each member of the committee. As a result of the PCAOB proposed standards, CPA firms are now planning significant audit procedures -- including lengthy surveys and interviews with the audit committee -- to fulfill the evaluation requirement. In reality, after working with the audit committee for a year, an external auditor should be able to determine rather quickly if the audit committee is effective. The added benefit of surveys and interviews at the end of the year appears to be quite small, while the detriment is a procedural burden for audit committee members whose time is better spent on their other duties. While the ability to oversee the preparation of audited financials and disclosure is a key function of an audit committee, this is not the only role that it plays. We question whether external auditors are the proper arbiters of the overall effectiveness of an audit committee. Ultimately, the company must make that decision. In addition, there is an inherent conflict of interest in asking the external auditors to evaluate the audit committee.

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Agilent supports what we initially perceived Section 404 to be: A primer on what proper level a company's internal controls system should be operating at, which would provide a reasonable basis of assurance that material errors would be prevented and detected prior to being included in the financial statements. We have seen Section 404 evolve into an attempt to go from reasonable assurance to almost absolute assurance. The average industry process relies on an approximately 95-97% confidence level that things will perform as planned. The cost to increase a percentage point of confidence is not a linear increase but rather an exponential increase. In judging the effect of the proposed regulations, to move from 96 to 97% does not equal one percentage point of additional effort, but rather might be 100 to 500% more effort and cost. At Agilent, we believe that strong internal controls pay for themselves, but the suggested level of analysis, disclosure, documentation and assurances proposed to implement Section 404 exceed what is reasonably required and will force companies to spend significantly beyond any type of benefit. The impact of this will be the loss of productivity and company jobs, lower R&D spending and innovation, and a diminished focus on customers and industries by top managers. We urge the Board to consider that the external auditor's attestation is not an independent test of management's assessment of internal controls, but rather is part of an integrated review with the financial statement audit, which views internal controls as a network of many procedures and compensating controls.

We would hope that you will take into account the concerns above when you review our list of prioritized concerns on the exposure draft.

Thank you for your consideration and as always, please do not hesitate to contact us for clarification or follow-up questions.

Sincerely,

Adrian Dillon
CFO
Agilent Technologies, Inc.

EXHIBIT A
Selected Responses To PCAOB Questions

Question regarding the audit of internal control over financial reporting:

5. Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.

No. We do not see a need to devise new measures beyond the existing competence and training standards. As professional firms, external auditors have always been required to be competent in the areas in which they provide services. They should be able to determine the training necessary to execute the attestation in accordance with PCAOB's framework.

Questions regarding evaluation of management's assessment:

6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?

We agree that the scope might be appropriate, in that the auditor may need to obtain certain evidence directly. However, the depth and extent of testing suggested is beyond a reasonable cost-benefit to an average shareholder. We urge the Board to allow the external auditors to exercise judgment and utilize their comprehensive audit knowledge about the risks and control environment at each company. The auditors should be able to use discretion to determine the appropriate level of testing required to gain comfort on the internal controls over financial reportings.

7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?

We believe the guidance is fine, but as stated above, the standard should leave room for the external auditor's professional judgment.

Questions regarding obtaining an understanding of internal control over financial reporting:

9. Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?

10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

We believe there is value in performing walkthroughs. Wherever possible, walkthroughs should be conducted in conjunction with the financial statement audit. The auditors need to have the freedom to determine what walkthroughs are necessary. They should not be required to perform a walkthrough for every process at every location or site or in future years be required to repeat walkthroughs if those processes have not changed. We also believe that internal audit should be able to participate under the direction of the auditor in these procedures.

<u>Questions regarding using the work of management and others:</u>

12. To what extent should the auditor be permitted or required to use the work of management and others?

13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?

14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?

15. Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?

With the statement that "the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.", the Board has wisely recognized the fiscal benefit to companies of a strong internal audit function. In other portions of the proposed standards, the exposure draft seems to move away from the above statement. While certain sections encourage the use of management, including internal audit, other provisions limit the circumstances in which internal audit may be used. The draft proposes that internal audit cannot be utilized for the following areas:

- Control environment, including fraud controls.
- Controls over period-end financial reporting process.
- Controls that have a pervasive effect on the financial statements, such as certain IT general controls on which the operating effectiveness of other controls depend.
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These prohibited functions are some of the key areas in which an internal audit group can provide significant insight and audit evidence based on its experience with the company. Public companies would not expect external auditors to rely solely on internal audit for 100% of testing, but to eliminate internal audit from these critical areas is a dramatic change from present accepted practices. In addition, this proposed point does not allow the external auditors latitude to use their own professional judgment.

We urge the Board to utilize the provisions of Statement of Auditing Standards No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, which address the relationship of the internal audit function in the external audit of financial statements. Rather than redefining this relationship, it would seem that the Board's standard should extrapolate the SAS 65 standards to the audit of internal control over financial reporting especially given that external auditors are now required to perform an integrated audit of financial statements and internal control over financial reporting.

<u>Questions regarding evaluating results:</u>

17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?

18. Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?

We appreciate the Board's attention to the importance of clear definitions in the attestation process. However, the exposure draft has dropped the materiality threshold for what is considered to be a significant deficiency or a material weakness. Under the proposed rules, a shortcoming that is neither significant nor material can nevertheless qualify for one of these labels, with serious consequences.

The exposure draft states that a circumstance which creates more than a "remote" likelihood of a misstatement, which is more than "inconsequential" in amount, qualifies as a significant deficiency. The word "inconsequential" is not defined and will likely be interpreted differently. Many companies could point to a control activity failure that has a 10% probability of occurring and involves potential monetary amounts that are 5-10% of what those companies would consider "material." Although the likelihood of such an occurrence is small and the monetary amounts are not material, this, under example D-1, Scenario A, might be a significant deficiency.

If these definitions are retained, we ask the PCAOB to consider and clarify whether the relevant monetary threshold is the dollar impact which could reasonably occur, or the maximum financial impact under a worse case scenario. Currently, the PCAOB proposed definitions would include a number of scenarios from the worst case; ranging from more than remote likelihood with a material impact, to a probable likelihood with a very small impact. Is the intention of the PCAOB to cover this wide range of probability in required disclosures to the audit committee?

A review of the exposure draft examples reveals that the exceedingly low threshold proposed, exponentially increases the risk that companies will trigger multiple significant deficiencies; without regard to any compensating controls. Example D-1, Scenario A on its face seems to be an example of a deficiency, not a significant deficiency, especially given the compensating controls in place to catch material errors. The proposed standard will lead to disclosure of many significant deficiencies which may aggregate to a material weakness judgment and which may cause shareholders and third parties to consider the risk of material misstatement to be much greater than it actually is. This in turn may bring unwarranted volatility in a company's stock price. We are also concerned that the proposed standards will open the door for litigation against companies when an adverse internal control report is issued even though the company's financials are accurate and fairly presented.

20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?

No. We believe all substantial and significant deficiencies should be escalated based on the auditor's judgment. By requiring all deficiencies to be reported to management, you have several unintended consequences.

1. This will create debate and animosity between the process owners and the external auditors. There will be great debate on what is a deficiency versus a decision by management to have a higher level compensating control in place to catch material issues or a decision by management that the costs far outweigh any risk of loss or exposure for the company.
2. Companies are not static and systems technology and people change. Companies are continually adapting their controls to their business environment. The proposal to communicate all internal control deficiencies would inundate management, potentially reducing their time to review, or causing them to lose focus on, more significant control issues.
3. With the increased pressure and exposure that audit committees are facing, audit committees will feel obliged to review the list of deficiencies presented to management. This will force audit committees to spend significant time reviewing these deficiencies even though they did not reach the level of a significant deficiency.

22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?

23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?

We believe that more guidance is necessary to understand the extent of the Board's requirements for evaluating the effectiveness of the audit committee. In the infamous Enron audit committee failure, it should have been clear to Enron's external auditors what the relative levels of effectiveness were for each member of the committee. As a result of the PCAOB proposed standards, CPA firms are now planning significant audit procedures -- including lengthy surveys and interviews with the audit committee -- to fulfill the evaluation requirement. In reality, after working with the audit committee for a year, an external auditor should be able to determine rather quickly if the audit committee is effective. The added benefit of surveys and interviews at the end of the year appears to be quite small, while the detriment is a procedural burden for audit committee members whose time is better spent on their other duties. While the ability to oversee the preparation of audited financials and disclosure is a key function of an audit committee, this is not the only role that it plays. We question whether external auditors are the proper arbiters of the overall effectiveness of an audit committee. Ultimately, the company must make that decision. In addition, there is an inherent conflict of interest in asking the external auditors to evaluate the audit committee.

24. If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?

No, we do not believe this would be an appropriate response and believe that this material weakness should be treated no differently than any other identified material weakness.