



# **Review of the Board of Directors' Report on Internal Control over Financial Reporting**

## **Suggested Recommendation**

7 June 2006



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## **Review of the Board of Directors' report on internal control over financial reporting**

### **Suggested recommendation**

#### **1. Introduction**

The Code Group (a special working group related to the Commission on Business Confidence) in December 2005 submitted a Swedish Code of Corporate Governance, SOU 2004:130 ("the Code"). The Code states that the Board of Directors (the board) is to submit a report annually on how internal control over financial reporting is organised and how well it has functioned during the most recent financial year ("internal control report"). The report is to be reviewed by the company's auditor. The Code also states that the board is to submit a special report on corporate governance issues ("corporate governance report") and that it shall be made apparent whether it is reviewed by the company's auditor.

The Association of Stock Market Companies and Stockholmsbörsen (the Stockholm Stock Exchange) have agreed to introduce the Code as a part of the rules of Stockholmsbörsen. This decision signifies that the Code is initially applicable to all Swedish companies on the A-list and to Swedish companies on the O-list with a market value in excess of SEK 3 billion with annual reconciliation on 31 May.

As an element in self-regulation, the Code forms part of the listing requirements of Stockholmsbörsen, that is to say the requirements which a company must comply with in order to be listed on Stockholmsbörsen. Foreign companies on the A- and O-lists have to follow the code applicable in the company's home country. If there is no code of corporate governance in place, the company is to follow the Swedish code.

In the long run the Code will apply to all listed companies, but the smaller companies are being given time to adapt. After a few years, when experience of practical application of the Code has been acquired and necessary modifications have been made, the Code is to cover all companies listed on the stock exchange. Companies not covered by the Code may decide to follow it voluntarily. Earlier affiliation to the Code, even by smaller companies, will increase the market's confidence in these companies.

Like the codes in most other countries, the Swedish Code is based on the "comply or explain" principle. This means that a company may deviate from the provisions of the Code without this signifying an infringement of the Code. A company intending to deviate from a particular provision of the Code must, however, explain why the deviation is made.

The Confederation of Swedish Enterprise and FAR in October 2005 published guidelines on the board's report on internal control ("the guidance").



The term internal control is used in this recommendation to designate internal control activities linked to financial reporting.

This recommendation is issued as guidance for those auditors who are engaged to examine the board's internal control report. The recommendation is also intended to provide support for companies which prepare the board's internal control report by describing the requirements which auditors must set for documentation. Furthermore, the recommendation describes the actions the company must take in order to be able to make their assessments and conduct their own review.

The recommendation does not cover a complete action programme for the auditor but instead focuses on the auditor's assessment of the board's processes in order to prepare the internal control report and be able to draw conclusions on how internal control has functioned during the year. The auditor does not draw any conclusions of his or her own, nor does the auditor express any opinion of his or her own on how internal control has functioned.

The auditor shall comply with applicable parts of Swedish Standards on Auditing (RS) during the review of the board's internal control report, for instance with respect to planning, materiality, risk, documentation and reporting.

## **2. Auditor's engagement**

### **2.1 Scope of the engagement**

This recommendation only covers the auditor's examination of the board's internal control report.

The Code does not specify what form of examination the auditor shall perform or how extensive the examination should be. The forms of examination which are available, and for which FAR has issued separate standards, are audit, review and agreed-upon procedures engagement. Audit and review are referred to as assurance engagements. It is characteristic for such engagements that the auditor expresses an opinion (conclusion) on what has been the object of examination (state of affairs). However, in agreed-upon procedures engagements the auditor is unbiased and reports only the actual observations of the examined material.

An assurance engagement requires, for instance, suitable and available criteria against which the auditor can gauge the state of affairs. Neither the Code nor the guidance for the board's reporting constitutes actual criteria or frameworks relating to internal control over financial reporting. Although the guidance refers to different frameworks for internal control, neither the guidance nor frameworks are mandatory for companies.

In companies where internal control is organised in accordance with either an internationally accepted framework, such as COSO, or a framework formulated by the company itself which is so well laid-out that it is judged capable of forming the basis of an examination, the auditor's assignment is to carry out an assurance engagement. The lowest level of this engagement is to conduct a limited assurance examination, i.e. a review.



In companies where internal control is not organised in accordance with an internationally accepted framework or another well-defined framework, the auditor cannot conduct any examination which is meaningful to the recipient of the auditor's reporting. No review is thus to be performed in these cases.

## **2.2 FAR's considerations on the review approach**

This recommendation covers the auditor's review procedures, questions regarding materiality and the scope of the review and how deviations are to be reported and how the reporting can be formulated. In addition, the recommendation specifies what documentation the auditor is to expect from the company in order to be able to conduct an appropriate review and reporting. If appropriate documentation of how the company's internal control is organised, performed and assessed is not in place, the auditor will not be able to submit any report from his or her review.

The internal control report is intended to describe both how the company has organised its internal control and how the board has monitored that internal control is appropriate for the company and group. In making this assessment, the board must consider what risks there are of misstatements in the financial reporting, how internal control has been organised to deal with these risks, and how internal controls have functioned during the most recent financial year. The company, the board and the auditor shall also consider which framework the formulation and function of internal control shall be evaluated upon. If deficiencies are discovered, the board must take necessary measures in order to limit the deficiencies so that no material errors can affect the financial reporting. The auditor assesses whether the board has been able to ensure that internal controls have functioned as intended. Therefore, internal control activities performed in the company, and the work which the board performs to organise and follow up the internal control must therefore be so well-documented that such an assessment is possible. It must be possible to demonstrate that the board has a solid basis for its position on internal control.

The board has responsibility for the contents of the internal control report but can choose to delegate responsibility to perform certain parts of the internal control activities to other officers within the company.

The review work, which is additional to the review of the internal control report and the documents supporting it, is a random-sample verification that the internal control system is appropriate and functions well in relation to the risk assessment made by the board. In addition, the auditor should verify and through samples ensure that the feedback-system to the board regarding internal control information is appropriate and provides a correct basis for the board's position on the functioning of internal control.

According to the guidance, the internal control report should be formulated on the basis of overall requirements that the information in the report describes in a true and fair and materiality-oriented manner, circumstances of significance in the assessment of the company's organisation of internal control and how well it has functioned. The reporting should be characterised by openness and by being formulated on the basis of the company's specific circumstances. If the auditor considers these overall principles not to be met or the board's report to lack substance, the



auditor should not submit any report from the review, since such a report risks being difficult for the reader to interpret.

### **3. Assurance engagement**

#### **3.1 Auditor's examination**

##### **3.1.1 Purpose of the examination**

In an assurance engagement, great demands are made on the work of the board on internal control and in particular the documentation the board uses as the basis for its internal control report. The company's application of a framework for internal control, either an established one or a framework which the company has laid out itself and documented, is essential if the auditor is to be able to carry out an assurance engagement. The board must submit a complete internal control report, in which all parts of the framework used for internal control are commented upon. The board in other words cannot, if it requests the auditor to carry out an assurance engagement, formulate an internal control report which only encompasses certain parts of what is covered by the framework used for internal control.

The review is intended to conclude that the board has made sufficient efforts to be able to state on a sound basis whether internal control has functioned well or not during the most recent financial year. This means that the auditor first needs to establish that the board's report is complete and adequate in relation to the framework the company applies for its internal control. The auditor then examines the documentation which verifies that the board's assertions and statement in the internal control report are well-founded and therefore true and fair. The auditor can then express his or her opinion on the board's internal control report.

The review work which the auditor should perform in order to be able to assess the board's statement on how well internal control has worked during the most recent financial year is discussed in sections 3.2.1 to 3.2.6 which comprise the greater part of this review recommendation. The auditor's review and assessment of the contents of the internal control report, i.e. the board's description of how internal control is organised, are only discussed in section 3.2.7.

##### **3.1.2 Scope and orientation of the examination**

The auditor's examination of the board's internal control report includes studying the contents of the report and the statement made by the board on how well internal control has functioned during the most recent financial year.

On the basis of the contents of the internal control report, the auditor reviews the material which the board presents as support for the contents of the internal control report and the statement on internal control. It should be apparent from this material that the formulation and function of internal control is based on the framework the company applies for its internal control. *Formulation* ("appropriateness") signifies how systems for internal control are formulated to



prevent and/or identify and rectify materially incorrect information, and *function* is understood to mean that the system exists and has functioned satisfactorily.

The auditor studies material that describes the framework the company has used in evaluating and in comparing with the existing internal control. This may be either what is known as an established framework or a framework defined by the company itself. If the company uses an internally defined framework, the auditor evaluates whether this provides a sufficient basis to constitute an appropriate framework for internal control over financial reporting. This evaluation is made by the auditor on the basis of the established framework COSO.

The auditor should examine documentation which supports the work undertaken in the company to plan, prioritise and implement efforts to substantiate the statement in the internal control report.

The review includes a verification and examination of the material on which the internal control report is based in order to ensure that it includes the claimed substance. This implies that the auditor makes assessments on the formulation of internal control and verifies on a random sample basis that material controls have functioned during the most recent financial year in consideration of the risks identified.

The scope of the auditor's verification work depends on various circumstances, such as the scope of the company's own internal control work, how well-structured the work has been, the complexity of the company's operations and the auditor's own risk assessment. The auditor takes these and other circumstances into account and adapts the work accordingly. The auditor should ensure that the controls have functioned during the most recent financial year.

The scope of the review of the internal control report is also affected by the auditor's examination of the company's annual accounts, the accounting records and the administration of the board. As a result, the auditor has established an understanding of the company and its environment. This understanding makes it possible for the auditor to focus the review procedures, which he or she intends to carry out in a review of the internal control report in areas where there is a risk of material errors.

The scope of the auditor's review is limited to the auditor only having to verify the formulation and function of certain controls with the aim of judging the quality of the board's material and not having to express an opinion on how well the internal control over financial reporting has worked during the most recent financial year.

## **3.2 Auditor's review**

### **3.2.1 Review of the board's risk assessment**

The overall objective of a company's external financial reporting is that it should be reliable and prepared in accordance with generally accepted accounting principles, applicable laws and ordinances and any other requirements, for example requirements to be met by listed companies.



A structured and conscientious risk assessment makes it possible to identify the material risks which may affect how well this objective is met. As part of the risk assessment, it is also identified where these risks exist at company, business unit, function or process level.

- The auditor judges whether the board has a structured and documented risk assessment which makes it possible to identify the material risks that affect internal control over financial reporting.
- When the auditor assesses the formulation of the company's risk assessment, he or she considers whether the board has identified and documented risks with an impact on the financial reporting and whether the board has judged the significance of these risks and the probability of them leading to material errors in the financial reporting.
- The auditor judges whether the board's documented risk assessment
  - o covers material financial items, such as income statement and balance sheet items, as well as material notes to the accounts
  - o considers both quantitative and qualitative factors (for example the complexity of the financial item, history of errors, extent of assessments in determination of size, volatility etc.)
  - o pays special attention to the risk of, and any knowledge of, fraud and improper favouring of another party at the company's expense as well as the risk of loss or misappropriation of assets
  - o determines whether the identified material risks are to be classified as company, business unit, function or process level risks
  - o considers any occurrence of outsourcing of processes that affects the financial reporting
  - o covers the most material business units in consideration of both quantitative and qualitative factors (for example units which are financially material, units posing special risks, units with particularly complex processes, units in which material controls are carried out etc.)
  - o covers unusual or complex events that may have affected the internal control, such as company acquisitions, implementation of new systems etc.
  - o covers the IT-environment and the information systems that affect financial reporting.



- The auditor evaluates whether the board's risk assessment is relevant in consideration of the auditor's knowledge of the operation and hence judges whether the risk assessment has had an impact on the scope of the company's work on internal control over financial reporting.
- The auditor evaluates whether the board's risk assessment of material financial items, material processes and material business units is sufficiently extensive as a basis for the board's statement on how well the internal control over financial reporting has functioned during the most recent financial year.

### **3.2.2 Review of company-wide controls**

Company-wide controls are used to a varying extent to manage the risks the board has identified regarding internal control over financial reporting. The company-wide controls which the company decides to rely upon should be documented. This can be done in many different ways, for example in a questionnaire structured according to each COSO component (framework component), where the control is described and where evidence that the control is in place is also documented.

Since the company-wide controls often have a great impact on the controls at process level, the auditor should initiate his or her review by acquiring an understanding of the company-wide controls before a more detailed examination is carried out at process level.

Company-wide controls can occur in the following framework components: control environment, risk assessment, information & communication and monitoring. Company-wide controls include for example:

- o controls including those which relate to "tone at the top", established policies and guidelines, documented job descriptions etc.
- o controls to identify risks of material errors in the financial reporting (for a more detailed description of the board's process for risk assessment, see section 3.2.1)
- o controls to ensure the quality of underlying data for the financial reporting
- o controls to ensure that deficiencies in the internal control are reported to the person responsible.
- The auditor evaluates whether the company-wide controls
  - o are well-documented and make it possible to identify which company-wide controls the company decides to rely upon - the documentation should demonstrate how the company has assessed the formulation of the controls,



contain evidence that the controls are in place and indicate the extent of company-wide controls in the framework component in question.

- o take into account the risks the board has identified in its risk-assessment process
- o include the business unit level to an adequate extent.
- The auditor also assesses the design of the company-wide controls. The scope of the auditor's work depends on his or her preliminary assessment of the board's process, how complex the operations are and the auditor's own risk assessment. The auditor's actions to obtain evidence that material controls have been designed and implemented may include enquiries, observation of how a particular control is performed or inspection of documents and reports. Enquiries alone are not sufficient to be able to make an assessment of the design of a control and whether it has been implemented.
- The auditor assesses the occurrence of company-wide controls and whether those controls that occur are designed to manage the company's material risks to an adequate extent and whether they substantiate the board's statement on how well the internal control over financial reporting has functioned during the most recent financial year.

### **3.2.3 Review of controls at process level**

Based on the company's risk assessment regarding material items in the income statement, balance sheet and notes to the account, the auditor assesses whether the company has documented and evaluated internal controls at the process level to an adequate extent. The auditor should consider in this assessment the occurrence of company-wide controls and their effect. The auditor should also assess whether relevant processes and controls have been selected with regard to the financial items in the income statement, balance sheet or note disclosures which the company has judged to be material. The processes which may be relevant are processes with a material impact on material financial items and note disclosures.

The company can document risks and controls at process level in many different ways. A common way of documenting risks, process activities and controls at process level is through risk and control matrices and flow-charts and/or descriptions of process activities and controls. The company does not need to prepare any detailed documentation for processes and controls over financial reporting and note disclosures judged to be not material.

The auditor assesses whether the company's documented evaluation of controls at process level contains:

- Adequate and relevant descriptions of risks of material errors in the processes that affect the material financial items and note disclosures identified by the company.



- Adequate and relevant descriptions of the preventive and detective control activities (manual controls, IT-dependent manual controls and application controls) which have been implemented and which the company relies upon to mitigate the identified risks in the processes linked to the concerned material financial items in the income statement, balance sheet or note disclosure. The company's evaluation and documentation of controls at process level should demonstrate that reasonable links exist between the controls at process level and the identified risks.
- An evaluation of the design of the controls at process level which the company relies upon and which minimise the risk of material errors with respect to financial statement assertions, such as Existence, Occurrence, Completeness, Valuation, Measurement, Rights and Obligations and Presentation and Disclosure. The evaluation should, in consideration of the fact that certain financial statement assertions for various financial items in some cases can be attained through strong company-wide controls, demonstrate that all relevant financial statement assertions for each material financial item or note disclosure are attained through the implemented controls. The auditor should ensure in the assessment that the company's controls at process level cover all types of material transactions and material transaction flows for the material financial item in question.

The company should be able to demonstrate evaluations at process level that verify that the board has considered an adequate proportion of all material financial items and note disclosures in its assessment of the formulation of the controls at process level, taking account of company-wide controls that occur in the company or, when applicable, in the group, and their effect.

### **3.2.4 Review of the management's evaluation of general IT-controls**

The way in which the company manages IT and its information systems is of significance to internal control. General IT-controls provide the foundation for controls in computerised information systems, which in turn support the company's processes. These systems are to a great extent integrated into the process stages of initiation, approval, book-keeping, processing and reporting of financial transactions upon which financial reporting is based. The need for and adaptation of general IT-controls differs considerably from company to company depending on the extent of and dependence on IT in the operation. Hence, the company concerned should assess the need for general IT-controls, their nature and extent, so that it in its turn is able to assess the internal control over financial reporting.

General IT-controls, which cover areas such as software development, software changes, computer operation and access to software and data, support the function of controls related to the computerised information systems and are consequently closely linked to financial reporting. There are specific control objectives for general IT-controls that support the function of other controls, specially formulated to manage identified risks in the business processes.

The board should, in the internal control report, give an account of the internal control over financial reporting. This includes general IT-controls upon which other controls in the processes



rest. In order for the company to give details about this part of the internal control, the company needs to map the IT-systems that support the financial reporting. The company needs to identify risks related to these IT-systems and formulate and introduce control activities to manage the identified risks. The company needs to continuously ensure that the general IT-controls are relevant and that they are maintained and amended if necessary.

The auditor assesses whether general IT-controls are in place to mitigate the risks relevant to the company. This implies that the auditor assesses whether the board's documented description and evaluation of the general IT-controls over the computerised information systems that support the processes for the company's financial reporting demonstrate that they fulfil the following criteria:

- o Controls exist for software development and software changes. Here is included that there are controls for development, installation and maintenance of computerised information systems.
  - The company's controls ensure that the development and maintenance of software meet the requirements of the operation and that the software is installed in the correct manner and at the right time. A lack of suitable controls for newly developed or modified software may result in incorrect calculations, incomplete recordings, incorrect cut-offs or other misstatements in the financial accounts.
- o Controls are in place for computer operation containing controls on monitoring and maintenance of computer operation (contingency planning can be excluded).
  - Controls for computer operation are supposed to provide planned, supervised and secure operation of information systems that satisfy the user's needs concerning availability, support and problem management. If there are no controls for this, software may terminate in an abnormal manner, which may result in transactions not being recorded completely or correctly.
- o Controls should exist to manage access to software and data. These controls comprise design, implementation and maintenance of information security, both physical and logical security, with regard to access to software and data.
  - The company describes controls linked to the company's assessment and prioritisation of security risks with regard to access to software and data. This work includes appointing an information owner, classification of information from a security perspective and the selection and introduction of security tools and security routines. If no controls are implemented to ensure suitable access to software and data, information can be altered or deleted by unauthorised individuals. In addition, information may be lost and consequently not be available when needed.

The auditor evaluates whether the board's description and assessment of the general IT-controls is correct and properly substantiated. In the evaluation, the auditor considers whether the scope



and function of the general IT-controls are adequate to support the controls in the substantial processes on which the financial reporting is based and whether the general IT-controls substantiate the board's statement on how well internal control over financial reporting has functioned during the most recent financial year.

### **3.2.5 Review of the company's evaluation of functionality**

A documented evaluation of how internal control has worked during the most recent financial year should provide a basis upon which the board could make a properly founded statement on internal control. The company needs to verify that the controls upon which the company principally relies have worked, and have been carried out as intended, during the most recent financial year.

The auditor should test the functionality of certain controls in order to verify the company's assessments and gain an understanding of the major types of activities the company uses to monitor internal control. The auditor should early in his or her review assess the company's work on evaluating the formulation and function of company-wide controls, as this then has an impact on the scope of the auditor's continued review of the controls at process level.

- The auditor evaluates whether the company's work on evaluating the functionality of controls
  - o is structured and documented in such a way that the execution, results and conclusions of the verification work are clear
  - o covers material company-wide controls, general IT-controls and controls at process level
  - o considers both quantitative and qualitative factors (for example how often a control is performed, the complexity of a financial item etc.) in designing the verification work
  - o covers the most material business units
  - o covers activities for follow-up of internal control over financial reporting.
- The auditor should verify the quality of the company's evaluation of functionality by verifying on a random-sample basis the function of certain material controls. To obtain audit evidence of the function of controls the auditor's review activities may consist of enquiries, inspection of relevant documentation, observation of how a certain control is carried out or testing certain control elements. The scope depends on the auditor's assessment of the work performed by the company, the characteristics of the control and how often it is carried out, the complexity of the operation and the auditor's own risk assessment.



- The auditor determines whether the company's work has been structured and to a adequate extent demonstrates the functionality of the controls to be able to substantiate the board's statement on how well internal control over financial reporting has functioned during the most recent financial year.

### **3.2.6 Review of the company's evaluation of internal control**

The company's work results in a combined evaluation of material controls at company-wide level and at process level as well as the general IT-controls based on the risk assessment made. The evaluation forms an important part of the board's basis of assessment and analysis and also the foundation for the board's statement on how internal control has functioned during the most recent financial year.

- The auditor assesses whether the company's evaluation of internal control over financial reporting
  - o is structured and covers all material controls and business units
  - o is documented so that it substantiates the description and the conclusion in the internal control report
  - o has considered all the material risks that have emerged in the board's risk assessment process
  - o indicates measures which will be taken for any deficiencies noted in the internal control and information on when the measures will be implemented.

### **3.2.7 Review of the contents of the internal control report**

The auditor's review work and assessments are finally put in relation to the board's internal control report. The auditor considers whether any circumstances have arisen which give him or her reason to believe that the report, in all material aspects, does not give a true and fair view of how internal control over financial reporting is organised and how well it has functioned during the most recent financial year in accordance with the framework applied. Here it is important that consideration is also given to the result of the audit of accounts and any material misstatements noted there.

### **3.2.8 The board's evaluation of the need for an internal audit function**

In companies which do not have a separate internal audit function, the work of which includes review of internal control over financial reporting, the board annually assesses the need for such a function. The board states its conclusion from this evaluation and gives reasons for its position. The auditor has to respond to the board's statement, based on the auditor's knowledge of the



company and its internal control which the auditor has acquired through the audit of the annual reports and the administration as well as through the review of internal control over financial reporting.

#### **4. Auditor's reporting**

The guidance stipulates that the board's internal control report should be based on overall requirements that the information in the report describes in a fair and materiality-oriented manner circumstances of significance in the assessment of the company's organisation of internal control over financial reporting and how well it has functioned. The reporting should be characterised by openness and reflect the company's specific circumstances. Based on the review evidence gathered, the auditor uses his or her professional judgement to establish whether the board's process has given the board a reasonable basis for its statement on how well internal control has functioned. If the auditor considers that these overall principles to a great extent have not been met or that the board's report lacks substance, the auditor shall not submit a review report at all as there is a risk that readers find such a review report difficult to interpret.



## **Appendix 1 – Auditor’s report on the board's report on internal control over financial reporting**

To the general meeting of the shareholders of ABC company

### *Introduction*

I (we) have reviewed the board of directors' report on internal control over financial reporting for ABC company for the year YYYY (the financial year ...). It is the responsibility of the board of directors to prepare a true and fair internal control report. My (Our) responsibility is to express an opinion on this internal control report based on my (our) review.

### *Scope and orientation of the review*

I (We) conducted my (our) review in accordance with FAR’s suggested recommendation on review of the board of directors’ report on internal control over financial reporting. The review has consisted of an examination of documentation that relates to how internal control is organised and conducted, enquiries - primarily to persons who are responsible for financial and accounting issues, as well as additional review procedures. A review has a different orientation and is considerably limited in scope compared with an audit in accordance with Swedish Standards on Auditing (RS) and good auditing practice in general. The procedures carried out during the review do not make it possible for me (us) to obtain such assurance that I (we) become aware of all important circumstances which might have been identified if an audit had been conducted. Subsequently, an opinion which is based on a review does not have the same degree of assurance as an opinion based on an audit.

### *Conclusion*

Based on my (our) review, no circumstances have emerged which give me (us) cause to consider the board of directors' report on internal control over financial reporting not, in all material aspects, to have been prepared in accordance with the “Guidance on the Swedish Code of Corporate Governance” or to consider that the board of directors does not have a reasonable basis for its statement on how internal control over financial reporting has functioned during the most recent financial year.

Place and date

AA  
(Authorized/Approved Public Accountant)