

Due Diligence: Problematic Aspects of a Modern Auditing Service

Antonova N.A.

Kalinina str, 1-15-9, 350039, Krasnodar, Russia

e-mail: antonova_n@list.ru

Abstract—This paper presents the author view on problematic aspects of the due diligence procedure as a modern auditing service. Conducting the due diligence involves an investment research. The results of this research include identification of risks, that can make influence on a proposed capital market transaction, and the design of risk management techniques. The author notes one important problem – currently there are no professional audit standards and methodological recommendations in Russian legislation governing the process of organization and conducting of the due diligence procedure. The objectives of this article are to synthesize the results of earlier studies and to determine the key elements of the concept needed to develop the working technique of conducting the due diligence in Russia. In this paper tasks are determined as the presentation of an algorithm for risk assessment for the due diligence, the proposal of the draft due diligence standard, the formation of a glossary of terms for the working technique of the due diligence. The relevance of the topic is determined by the necessity of the innovative development of theoretical and methodological bases of auditing in Russia. The conditions for further improvement of professional practices should be made to provide high-level audit related and other audit services to meet today's information needs of investors, who make decisions in changing and risky economic conditions.

Keywords—auditing activities, auditing companies, audit related services, due diligence, risks, investment.

I. INTRODUCTION

Nowadays among auditing professional services the due diligence procedure is gaining popularity. For scientists engaged in the studies of problems in the fields of auditing, accounting, financial analysis, and for specialists provided auditing services some questions are still relevant. These questions are: issues regarding the development of clear, applicable and useful due diligence procedure that meets the requirements of the economy conditions and the needs of users of accounting and analytical and other financial information; development of the standard or guidelines on how to conduct the due diligence procedure; searching for new methods of analytical procedures including identification of risk and risk assessment.

II. REVIEW OF PRIOR LITERATURE

The works of foreign authors are devoted to the study of questions of the theory and practice of due diligence, in particular: R. Bell [1], G. Bing [2], W. Davis [3], D. Denison [4], J. Duffy [5], W. Gole [6], W. Grilly [7], T. Mullins [8], A. Reed [9], A. Rosman [10], A. Sherer [11], S. Simmonds [12], J. Sinkin [13], A. Sherman [14], J. Woods [15]. For the last ten years papers of Russian scientists such as A. Gerasimo-

va [16], Yu. Guzov [17], V. Kerimov [18] have also appeared. In addition, it should be noted that in the international multidisciplinary bibliographic and abstract databases there are a lot of materials about due diligence, for example, about 18,000 articles are presented in the Science Direct electronic library, about 22,000 articles are presented in the Wiley online library. While the national bibliographic database of scientific citation "RINC" presents about 200 works of Russian scientists and practitioners. This is almost 100 times less than the number of foreign publications. Therefore, research on the topic of due diligence seems appropriate from the point of view of the fact that it allows to expand knowledge about due diligence, to provide a better understanding of existing problems in the field of due diligence, to create conditions for implementation new ideas for improving theory and practice of auditing in this field. International auditing companies (EY, PwC, KPMG, Deloitte) also make a great contribution to the development and improvement of due diligence methods and "know-how" techniques [19,20,21,22]. These international companies have their own methods for conducting the due diligence procedure. It is important to note that in Russia due diligence is only gaining popularity among professional services due to the changes in the capital market. But due diligence as a professional service is not regulated by law strictly. Therefore, there is a need to develop clear and applicable techniques of due diligence. This will help to control the quality of due diligence service rendered to investors.

III. THE PURPOSE OF THE STUDY

Due diligence is a less standardized form of audit activity. Special standards or instructions developed by methodologists of audit companies are not disclosed to a wide range of people. Therefore, there are difficulties in understanding the process of conducting the due diligence procedure under investigation, as well as in understanding how the planning of due diligence is carried out. In this regard, the purpose of this study is to reveal the specifics of the process of performing due diligence and to propose its working technique.

IV. THEORETICAL ASPECTS

There are some similarities (methods, information basis, subjects, etc.) between audit and due diligence. But at the same time, there are much more differences. Therefore, due diligence should not be equated with audit. When analyzing IASB 4400, attention is drawn to paragraph 13, on the issue of planning agreed procedures. In point 13 of IASB 4400 only one sentence is reflected, that the auditor should plan the work so that an

effective engagement will be performed [23]. At the same time, the specific actions of the auditors in the planning and implementation of the agreed procedures, to which the due diligence relates, have not been determined and are not described in detail.

V. FINDINGS OF THE STUDIES

A clear and understandable plan is required to realize any event. A plan allows you to understand the basic objectives that are expressed at specific stages of the overall process as well as the main aim, in other words, the result, which is planned.

Fig. 1 demonstrates that the process of conducting the due diligence as part of the proposed concept involves several sub-processes: negotiation, planning, conduction of agreed and planned procedures, the preparation of an integrated due diligence report.

Due to the absence of the algorithm established by the standard, the author proposes the following algorithm (see Fig.2) for risk assessment for due diligence.

Negotiating		Planning		Reporting	
N1	Negotiating between the investor and the working group of experts	P1	Preparation of the common plan of due diligence	R1	Performance of analytical procedures
N2	Negotiating between the investor and the target-company owners and managers			R2	Identification of risk
N3	Preliminary analysis of the proposed transaction	P2	Preparation of the individual plans of due diligence	R3	Analysis and assessment of risk
N4	Round table the investor – the working group of experts – the target-company owners and management			R4	Preparation of integrated due diligence report
N5	Signing of the due diligence contract	P3	Preparation of the due diligence check-list	R5	Working meeting on the results of due diligence

Fig. 1. Working technique of the due diligence.

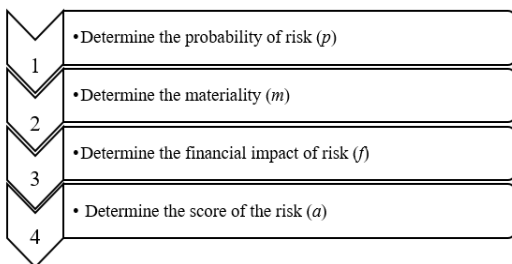


Fig.2. Proposed algorithm for risk assessment in the framework of due diligence.

On the first step, the probability of identified risk should be determined (p). Determination of the probability is made by expertise of the frequency of risk situations` occurrence. So, in Table 1 author proposes following criteria to assess the probability. Every percentage value corresponds to the index from 1 to 5 (I_p). On the second step, the working group of experts determines the materiality (m). Author assumes that m is a grand total on a balance sheet of the target company. If the financial impact of the identified risk is equal or more than m , then the target company will have big problems and will cease to exist in the foreseeable future.

TABLE I. CRITERIA TO ASSESS THE PROBABILITY OF THE RISK

The frequency of occurrence of risk situations	The probability of the risk (p)	The index (I_p) conditional value
Every three years	Risk is extremely unlikely to occur	1
Once a year	Risk is unlikely to occur	2
Half-yearly	Risk is possible to occur	3
Quarterly	Risk is likely to occur	4
Monthly	Risk is extremely likely to occur	5

Third step relates to determination of the financial impact of the risk (f). To determine the specified parameter the working group of experts is to be guided by the following criteria in Table 2. Every calculated value corresponds to the index from 1 to 5 (I_f).

TABLE II. CRITERIA TO ASSESS THE FINANCIAL IMPACT OF THE RISK

The calculated value	The financial impact of the risk (f)	The index (I_f) conditional value
$f < 0,25m$	insignificant	1
$0,25m < f < 0,5m$	acceptable	2
$0,5m < f < 0,75m$	essential	3
$0,75m < f < m$	significant	4
$m < f$	catastrophic	5

On the fourth step, when the probability of identified risk and the financial impact of the risk have already been determined, experts should multiply the indexes I_p and I_f obtained to determine the score of the risk level (a). So, the following formula (1) can be used:

$$a = I_p \times I_f \tag{1}$$

Table 3 demonstrates the risk levels boundaries that are determined based on indexes I_p and I_f . The levels of the risk are indicated by the letters (L, A, C). Based on the risk level, the working group of experts can suggest to the investor different risk management strategies. Author's technique is not complicated. The proposed working technique of the due diligence procedure is clear and applicable, it allows to understand all the steps of the due diligence procedure and the result of risk assessment.

Developed by the author algorithm for risk assessment within due diligence has several advantages: simplicity, absence of complex calculations, considering the specifics of the investment objects.

TABLE III. CRITERIA TO ASSESS THE LEVEL OF IDENTIFIED RISK

The level of identified risk	The score of risk level (a)
Low (L)	1-4
Acceptable (A)	5-10
Catastrophic (C)	12-25

VI. CONCLUSION

Investors need to get high-quality services to support transactions, because any deal relates to risks of financial loss. Currently auditing companies are providers of services that allow to evaluate the status and give forecasts for investment projects. To provide a professional service of high-level auditing companies improve their practice, that allows to meet challenges of the changing conditions and risky capital market. Due diligence becomes one of the modern audit services. Investors show interest in this procedure. The purpose of the procedure – to identify and assess existing and potential risks of the proposed transaction with the capital, to suggest measures to minimize and prevent identified investment risks. Today, auditing companies conduct due diligence in different ways, there is no universal method or guideline to conduct due diligence. This makes it difficult to control the quality of services provided. In that way many questions arise: what analytical procedures should be conducted, in what order procedures should be conducted, how to identify risks, how to analyze and assess them, how to systematize results obtained during due diligence and present them to the investor? In this article the author proposes the working technique of the due diligence procedure and the algorithm for risk assessment in the framework of due diligence due to the absence of regulatory requirements and widely used techniques. There are also issues that required further studies: determination of effective analytical procedures to identify risks; searching for tools and convenient methods to manage identified risks. Author also considers it is urgent to develop a special form of the report to summarize the results of due diligence. The level of specification of information about the risks to be included in the report is an open question.

REFERENCES

- [1] Bell, R.: Basic Due-Diligence. *Environmental Claims Journal*, vol.13, pp. 123–140 (2001).
- [2] Bing, G.: *Due diligence. Techniques and Analysis: Critical Questions for Business Decisions*. Westport, USA (1996).
- [3] Davis, W.: *The Importance of due diligence. Investigations: Failed Mergers and Acquisitions of the United States*. Companies. Homepage, www.ankarabarasu.org.tr/siteler/AnkaraBarReview/tekmakale/2009-1/1.pdf, last accessed 2017/11/21.
- [4] Denison D., Ko I.: *Cultural Due Diligence in Mergers and Acquisitions*, *Advances in Mergers and Acquisitions*, vol. 15, pp. 53–72 (2016).
- [5] Duffy, J.P.: *Some Thoughts on due diligence*. Homepage, <http://www.bergduffy.com/Personnel/Articles/95ddart1.htm>. last accessed 2017/11/17.
- [6] Gole W., Hilger P.: *Due Diligence: An M&A Value Creation Approach* by William J. Gole and Paul J. Hilger, by John Wiley & Sons (2009).
- [7] Grilly, W.M. Sherman, A.J.: *The AMA Handbook of due diligence revised and updated edition*. Business & Economics (2010).
- [8] Mullins, T., Thornton, B., Adams, M.: *The Role of due diligence in The Business Valuation Process*. *Journal of Business & Economics Research*, vol. 5, no. 5 (2007).
- [9] Reed, A.: *M&A due diligence in the new age of corporate governance*. *Ivey Business Journal. Improving the Practice of Management*, vol. 71, issue 3 (2007).
- [10] Rosman, A.: *Successful Audit Workpaper Review Strategies in Electronic Environments*. *Journal of accounting, auditing & finance*, vol. 22 no. 1. pp.57–83 (2007).
- [11] Sherer, A.: *Merger and acquisition due diligence: a proposed framework to incorporate data privacy, information security, e-discovery, and information governance into due diligence practices*. *Richmond Journal of Law & Technology*, vol. XXI, issue 2 (2015).
- [12] Simmonds, S.: *Due diligence checklist*. Homepage, <http://simmondsstewart.com/docs/due-diligence-checklist>, last accessed 2017/12/23.
- [13] Sinkin, J., Putney, T.: *Do's and don'ts of due diligence*. Homepage, <http://www.journalofaccountancy.com/issues/2014/jun/20139299.html>, last accessed 2018/01/25.
- [14] Sherman, A. J., Welch, J. E.: *Due Diligence in a New Era of Accountability*, *The Journal of Corporate Accounting and Finance*, Sept/Oct., pp. 65–70 (2009).
- [15] Woods, J.: *Due diligence or audit: it's All in a Name*. Homepage, http://app1.hkicpa.org.hk/publications/society_journals/2002/2002-02/26-28.pdf, last accessed 2018/02/12.
- [16] Gerasimova, A.V.: *Methods of analysis and risk assessment on financial due diligence*, *International Research Journal*, no. 1, pp. 28 – 36 (2016).
- [17] Guzov, Y.N., Savenkova, N.D.: *Due diligence: theory and practice*. *Audit journal*, no. 7, pp. 56–69 (2015).
- [18] Kerimov, V.V.: *«Due diligence» as a special audit procedure and intellectual property as an object of intellectual property*, *Economics and management: problems, solutions*, no.3, pp. 47 – 51 (2014).
- [19] *Private Company Insights. Due diligence in growth strategy*. Homepage, <http://www.ey.com>, last accessed 2017/10/17.
- [20] *Due diligence on public companies*. Homepage, <https://www.pwc.com/ca/en/directorconnect/publications/pwc-due-diligence-on-public-companies-2013-01-en.pdf>, last accessed 2017/10/17.
- [21] *Transaction services. Due diligence*. Homepage, <http://www.kpmg.com>, last accessed 2017/10/17.
- [22] *Transaction due diligence* Homepage, <http://www2.deloitte.com>, last accessed 2017/10/17.
- [23] *International standard on related services 4400 (previously ISA 920) "Engagements to perform agreed-upon procedures regarding financial information"*. Homepage, <https://www.ifac.org>, last accessed 2018/02/12.