

PLANNING OF DUE DILIGENCE AS AUDITING SERVICE



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A Nowadays, audit companies are introducing new professional services. There is due diligence among such audit services. The study of the problem is of interest because it helps to identify new problems and trends in the market of audit services. The study objective is to develop the risk-oriented approach methodology for conducting due diligence, provided with the support of investment transactions on an equal basis with audit and other professional services, by studying the work of foreign and Russian scientists. Based on the results of the study, the scheme for performing due diligence is presented. All stages of performing due diligence are described. The algorithm of risk-oriented planning of due diligence is disclosed. Due to the absence of special audit standards for planning agreed-upon procedures, including due diligence, the scheme and the due diligence algorithm are proposed that provide an understanding of the process of conducting an expertise of the proposed transaction with capital, as well as the features of the pre-due diligence planning.

B Audit services, due diligence, investment, risk, risk-based approach, mergers and acquisitions.

ПЛАНИРОВАНИЕ АУДИТОРСКОЙ УСЛУГИ ДЬЮ-ДИЛИДЖЕНС

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A В настоящее время аудиторские компании внедряют новые профессиональные услуги. Среди таких аудиторских услуг – дью-дилідженс. Исследование поднимаемой проблемы представляет интерес, так как способствует выявлению новых проблем и тенденций на рынке аудиторских услуг. Цель исследования – на основе изучения работ зарубежных и российских ученых разработать для аудиторской практики основанную на риск-ориентированном подходе методику проведения услуги дью-дилідженс, оказываемой при сопровождении инвестиционных сделок наравне с аудитом и другими профессиональными услугами. По результатам исследования представлена схема проведения дью-дилідженс, описаны этапы выполнения аудиторской услуги. Раскрыт алгоритм риск-ориентированного планирования дью-дилідженс. Ввиду отсутствия специальных стандартов аудиторской деятельности по планированию согласованных процедур, в том числе по дью-дилідженс, предложены схема и алгоритм дью-дилідженс, которые позволяют получить понимание процесса выполнения экспертизы предполагаемой сделки с капиталом, а также особенностей предпроверочной работы.

B Аудиторские услуги, дью-дилідженс, инвестирование, риски, риск-ориентированный подход, слияния и поглощения.

ПЛАНУВАННЯ АУДИТОРСЬКОЇ ПОСЛУГИ ДЬЮ-ДІЛІДЖЕНС

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A Сьогодні аудиторські компанії впроваджують нові професійні послуги. Серед таких аудиторських послуг – дью-ділідженс. Дослідження цієї проблеми має інтерес, оскільки сприяє виявленню нових проблем і тенденцій на ринку аудиторських послуг. Мета дослідження – на основі вивчення робіт зарубіжних і російських учених розробити для аудиторської практики засновану на ризик-орієнтованому підході методику проведення послуги дью-ділідженс, наданої під час супроводу інвестиційних угод разом з аудитом та іншими професійними послугами. За результатами дослідження представлена схема проведення дью-ділідженс, описані етапи надання аудиторської послуги. Розкрито алгоритм ризик-орієнтованого планування дью-ділідженс. Зважаючи на відсутність спеціальних стандартів аудиторської діяльності з планування узгоджених процедур, в тому числі щодо дью-ділідженс, запропоновані схема й алгоритм дью-ділідженс, які дозволяють отримати розуміння процесу виконання експертизи передбачуваної операції з капіталом, а також особливостей передперевірочної роботи.

B Аудиторські послуги, дью-ділідженс, інвестування, ризики, ризик-орієнтований підхід, злиття і поглинання.

Problem statement. The absence of the concrete description of the sequence of actions during planning and conducting such auditing service as the due diligence procedure.

Analysis of recent studies and publications. The works of foreign authors, in particular: Bell R. [18], Bing G. [19], Denison D. [21], Gole W. [22], Cumming D. [20], McGee J. A. [23], Ramsinghani M. [24], Reed A. [25], Sacek A. [26], Shain R. [27], A. Sherman [28] are dedicated to the study of due diligence theory and practice. The Ukrainian scientists, such as Bondar V.P. [1], D.V. Kondratenko [7], I.M. Kondratenko [7], I.M. Nazarenko [10], V.V. Shkirenko [17], also make a study of due diligence. Within the last 10 years, there also appeared the works of Russian scientists on the studied topic: Gerasimova A.V. [2], Guzov Iu.N. [3, 4], Zakhmatov D.Iu. [5], Kerimov V.V. [6], A.V. Panchenko [13], A.I. Piskunov [14], N.D. Savenkova [3,4], Savenkova N.D. [3, 4], Stiazhkina, I.V. [15], Tuikina Iu.R. [5], Sharkov, D.A. [16].

In addition, it should be noted that in the international multidisciplinary bibliographical and abstract databases, there are very many materials on due diligence, for example, the electronic library Science direct has about 18,750 articles, Wiley online library has about 21,780 articles. At the same time, the national bibliographical database of science citation SCIE has about 200 works of Russian scientists and practitioners. It is almost 100 times less in comparison to the number of foreign publications. That is why the management of studies on due diligence appears to be viable from the perspective that it allows expanding knowledge about the studied procedure, detecting new regularities and trends on the audit market, ensures better understanding of the existing problems in due diligence, creates conditions for implementing new ideas on the improvement of theory and practice of auditing activities in this area.

Not previously solved parts of the general problem. Currently, the researchers, studying the problems in accounting, analysis and audit, and the practitioners of auditing activities, still discuss the questions of classification of due diligence in the auditing services system, the questions of development of understandable and applicable methods of due diligence planning, the questions of development of the special standard of auditing activities on planning due diligence and searching for new methods of fulfilment of the procedure, in particular, risk identification, analysis and

assessment for ensuring professional support of the implementation of investment projects.

Purpose of the article. The provision of the service in form of due diligence is the less standardized form of audit activities. The special provisions, instructions and guidelines, developed by the methodologists of audit companies on provision of the service in form of due diligence, are not disclosed to a wider range of individuals. The final due diligence reports also have a confidential nature. That is why there exist difficulties in understanding the process of conducting the studied procedure as well as in understanding how the organization of due diligence is implemented. Accordingly, the purpose of present study is to disclose the specifics of the process of fulfilling such auditing service as due diligence and offer the algorithm of its planning with application of the risk-oriented approach.

Study materials. When conducting their professional activities, the auditing companies are regulated by the requirements of special standards. In Russian Federation, the Russian auditing standards ceased to be effective from 01.01.2018. Therefore, starting from 2018, when providing the services, the auditors should apply the international standards on auditing (ISA).

It should be noted that for the Russian auditing practice, the due diligence is a relatively young direction of professional activities. However, the regulatory and legal framework for conducting due diligence are not clearly enshrined in RF legislation. In addition, the opinions of scientists about the classification of due diligence in the audit system differ. For example, V.V. Kerimov talks about the essence of due diligence and concludes that the studied «service has a complex mixed nature: on the one hand, it partially relates to auditing services, because when it is conducted, the audit procedures are applied..., on the other hand, it relates to other services, related to auditing activities, because when it is applied, the complex of services, not related directly to auditing activities, is used» [6]. Other Russian scientists, Y.N. Guzov and N.D. Savenkova [3], analyzed in detail separate criteria and classified the studied service as agreed-upon procedures, taking into account the following key signs: confidentiality (nonpublic nature of the report on the results of due diligence), account users (limited circle of the persons, defined in the contract), assurance (due diligence is not the audit and does not ensure assurance on the assumptions of reliability, the recipient of due diligence report

should draw his own conclusions for taking the decision on capital investment). It should be noted that in accordance with p. 7 of art.1 of the Federal Law dated 30.12.2008 №307-FL On Auditing Activities, the open list of other auditing services is defined [11]. Therefore, within the current study, it is deemed legal for us to classify due diligence not as other services, related to auditing activities, but as the audit-related services. In addition to the above, in accordance with the Order of the Ministry of Finance of Russia dated 09.03.2017 №33Н On Defining the Types of Audit Services, including the List of Audit-Related Services, the list of auditing services underwent changes [12]. If previously the review engagement, the compilation of financial statements and agreed-upon procedures were distinguished as the audit-related services, then after the above-mentioned order came into force, the audit-related services include such groups of services: the reasonable assurance services, the limited assurance services, the non-assurance services. The group of non-assurance services includes the compilation of information and the study of the subject of client's order through fulfilling the agreed-upon procedures. In his article, V.V. Shkirenko pays attention to the fact that the due diligence procedure is regulated by the International Standard on Related Services 4400, Engagements to Perform Agreed-Upon Procedures Regarding Financial Information (hereinafter – ISRS 4400) [9]. We support the viewpoint of V.V. Shkirenko. As per the results of the comparative analysis of audit and due diligence, M.I. Kuter and N.A. Antonova [8] concluded that there are the similarities (methods, information base, meters, subjects); however, the number of differences is much higher, which is why the due diligence procedure should not be equated with the audit. We also consider that taking into account the implementation of international standards on RF territory, while fulfilling the agreed-upon procedures, it is necessary to be regulated by ISRS 4400 [9]. While analyzing the said regulatory document, it is established that when the agreed-upon procedures are conducted, the assurance is not expressed. As per the results of due diligence, the investor anticipates receipt of the report on found risks of the proposed capital transaction for developing further actions, but not drawing up the financial statements and checking the interim financial information. In addition, the attention is paid to the paragraph 13 of ISRS 4400, dedicated to the planning of agreed-upon procedures. The paragraph 13 of ISRS 4400 reflects only one sentence: «The auditor should

plan the work so that an effective engagement will be performed». However, while planning and conducting the agreed-upon procedures, which the due diligence relates to, the concrete actions of auditors are not defined and described in detail. M. Ramsinghani made an interesting remark: currently, the due diligence is rarely conducted as per the concrete algorithm, the procedure is usually conducted in free form [24]. And the quality of provided professional services and, respectively, the success of planned capital transaction depends on the planning. The aim of due diligence consists in helping the investor to form the reasonable idea of the risks of proposed capital transaction with capital through their analysis and assessment. According to G. Bing's opinion, the complex due diligence allows obtaining information and forming the position in order to prevent costly, and sometimes devastating, consequences for the capital transaction [19]. It is also interesting to note the opinion of A. Sherman. The author considers that the due diligence requires more creative and strategic approach; it is necessary to more deeply study the company, in regard to which it is proposed making capital transaction, to study the mission, values, culture and other aspects of the target company, but not to prepare the formal review of key contracts and other corporate documents [28]. D. Denison and I. Ko noted that conducting due diligence should not include traditional approaches [21]. Therefore, the expediency of development of the methods of planning the due diligence procedure, based on the risk-oriented approach, was found. The application of the risk-oriented approach allows the working group experts to concentrate their attention on the areas of activities of the target company, which are mostly exposed to risks, find, analyze, assess the risks, capable of impacting the realization of capital transaction.

The present study suggests the scheme for conducting due diligence, which has its specifics. The interpretation of the general process in form of the suggested scheme combines both the plan and the strategy for fulfilling the procedure. The due diligence plan reveals itself through description of the sequence of operations and actions, performed by the experts. That is why using the scheme, it is easier to determine which stages the experts should undergo during the audit and consequently which tasks should be fulfilled. In its turn, the strategy determines the direction for achieving the due diligence purpose through selection of the procedures, which allow finding and assessing the risks of the investment project. The strategy is determined while conducting

the audit, at the planning stage, because there are certain restrictions, for example, time limits of the project, volumes of audited information etc. The figure 1 illustrates the scheme for conducting due diligence. Thus, we can have understanding of the process of conducting due diligence from the beginning to the end.

As may be seen from Figure 1, the process of conducting due diligence provides for the implementation of several stages:

- 1) preparatory stage;
- 2) determination of the general strategy and procedures;
- 3) implementation of planned procedures;
- 4) final stage.

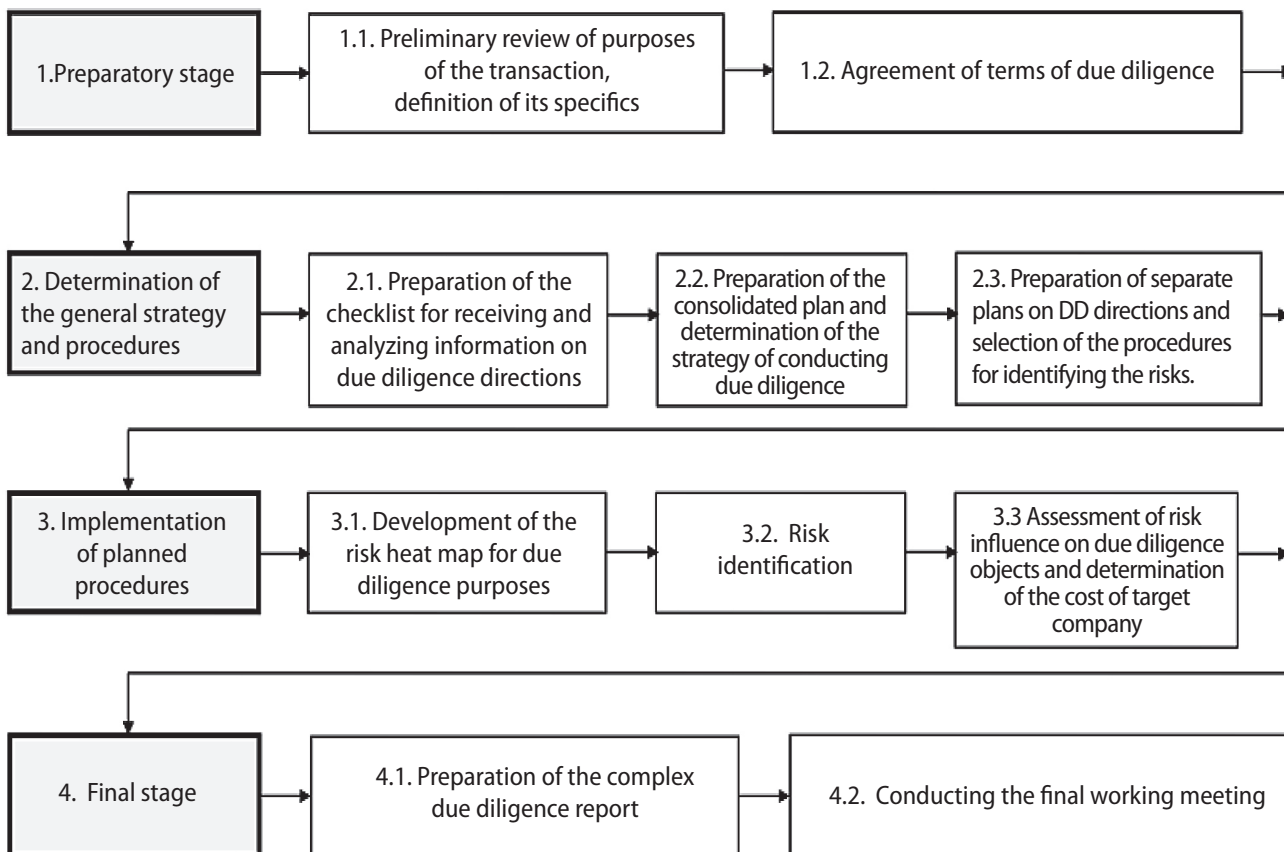
In addition, if we look at the due diligence scheme, we may conditionally distinguish such sub-processes, as planning (1 and 2 stages) and the implementation of procedures (3-4 stages). Each stage includes the stages, the detailed description of which is presented below. Within this study, the special attention is paid to the sub-process of preparation for conducting the due diligence. In this connection, the algorithm of risk-oriented planning of due diligence, which described in detail the actions, allowing the working group experts to prepare for conducting the audit, was developed and suggested.

Stage 1.1. The auditing and consulting company, the group of experts of which will conduct due diligence of the suggested transaction, negotiates with the investor.

During negotiations, the purposes of the client (investor) as well as his preliminary actions within further negotiations with the target company on fulfilment in respect to the suggested due diligence transaction are determined. The client also conducts negotiations with the senior management of the company, in respect of which the examination of the purity of transaction is planned. The agreement of intent should become the result of negotiations between the investor and the target company. The attention should be paid to the cooperation on the receipt of information by the working group of experts, necessary for conducting due diligence procedures, which may be the commercial secret. At this stage, based on the tasks, set by the investor, the experts of the working group conduct the preliminary analysis of available nonfinancial and financial information about the target company, obtain complex idea of the possibility of conducting due diligence, determine the form of the final report and the circle of users, to which this report is addressed, tentatively estimate and discuss the cost of conducting due diligence.

SCHEME OF THE PROCESS OF COMPLETION OF DUE DILIGENCE PROCEDURE

FIGURE.1



Stage 1.2. The experts conduct negotiations with the client and representatives of the target company, in respect of which the due diligence will be conducted. During negotiations, the experts additionally discuss the questions, raised as per results of the preliminary analysis, determine the order of participation of parties in the process of conducting due diligence, clarify the terms of previously drawn up and concluded contract on due diligence for obtaining understanding of the terms by the parties for preparing the final agreement. The result of all negotiations is the agreement of all significant terms of the future examination of the deal. The conclusion of the contract means the agreement of parties on conducting due diligence.

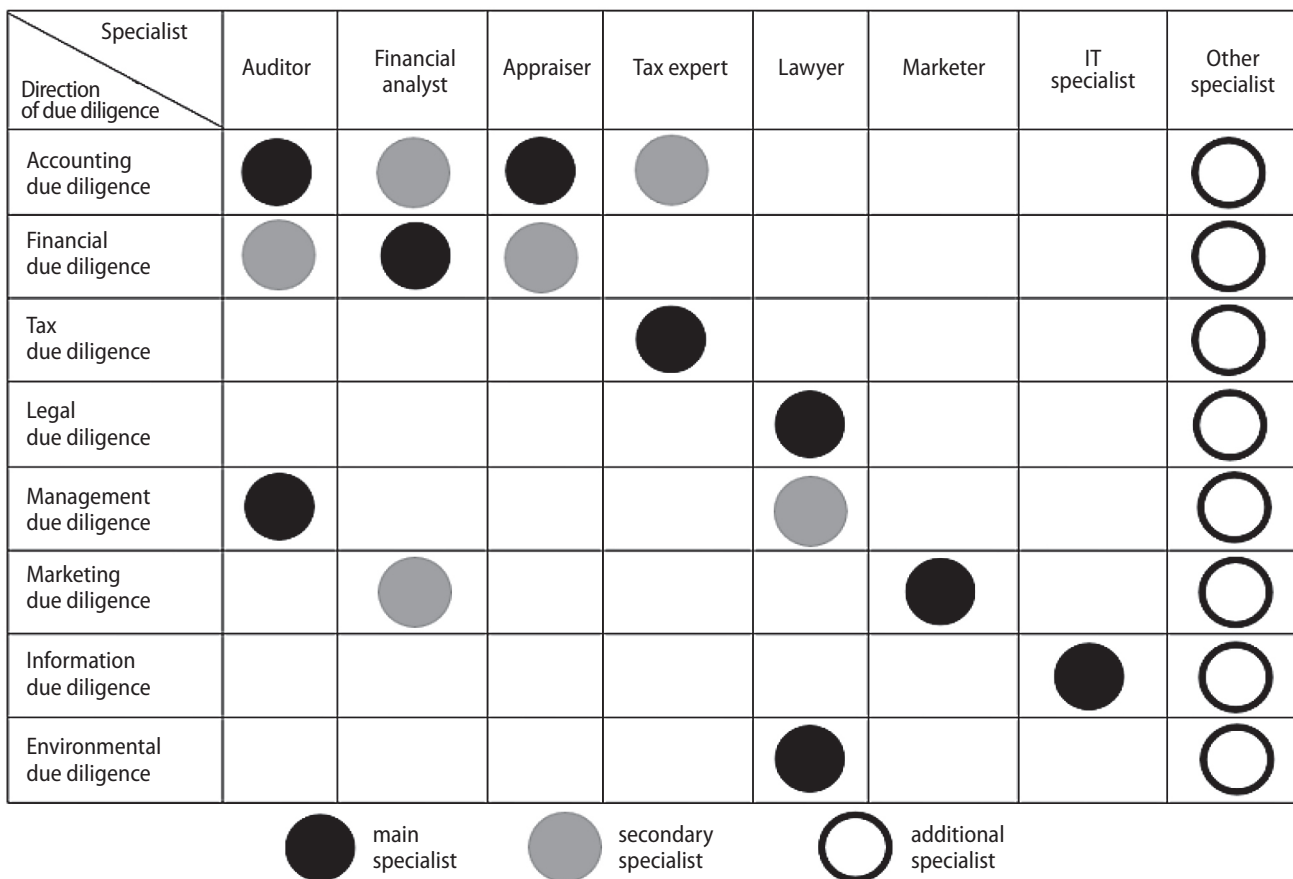
Stage 2.1. The experts of the working group prepare the special questionnaire (checklist), which contains the questions on each direction of due diligence. The checklist, formed based on the specifics of the proposed capital transaction, is sent to the target company for obtaining the requested information (financial and nonfinancial), which the working group of experts needs for conducting

special detailed procedures and establishing the riskiest areas, intrinsic to the proposed transaction.

Stage 2.2. During this stage, it is necessary to determine the line-up of the group of experts, involved for conducting the investment study, determine the time budget and set a time limit for performing works, based on the specifics of proposed transaction, to highlight the due diligence directions, as per which the special procedures will be realized, to set limits and determine the difficulties, with which the experts of the working group can encounter when conducting due diligence. Reasoning about the experts, who should conduct due diligence, W. Gole is of the view that the team of due diligence should consist of specialists, on each of whom the responsibility of studying business from the viewpoint of the areas of activities or functionality is placed [22]. That is why the result of this stage should become the consolidated due diligence plan, developed based on the composition of labor and the volume of time sources, as well as the quality and number of obtained financial and nonfinancial information on the checklist from the target company. The Figure 2 reflects the option of distributing the

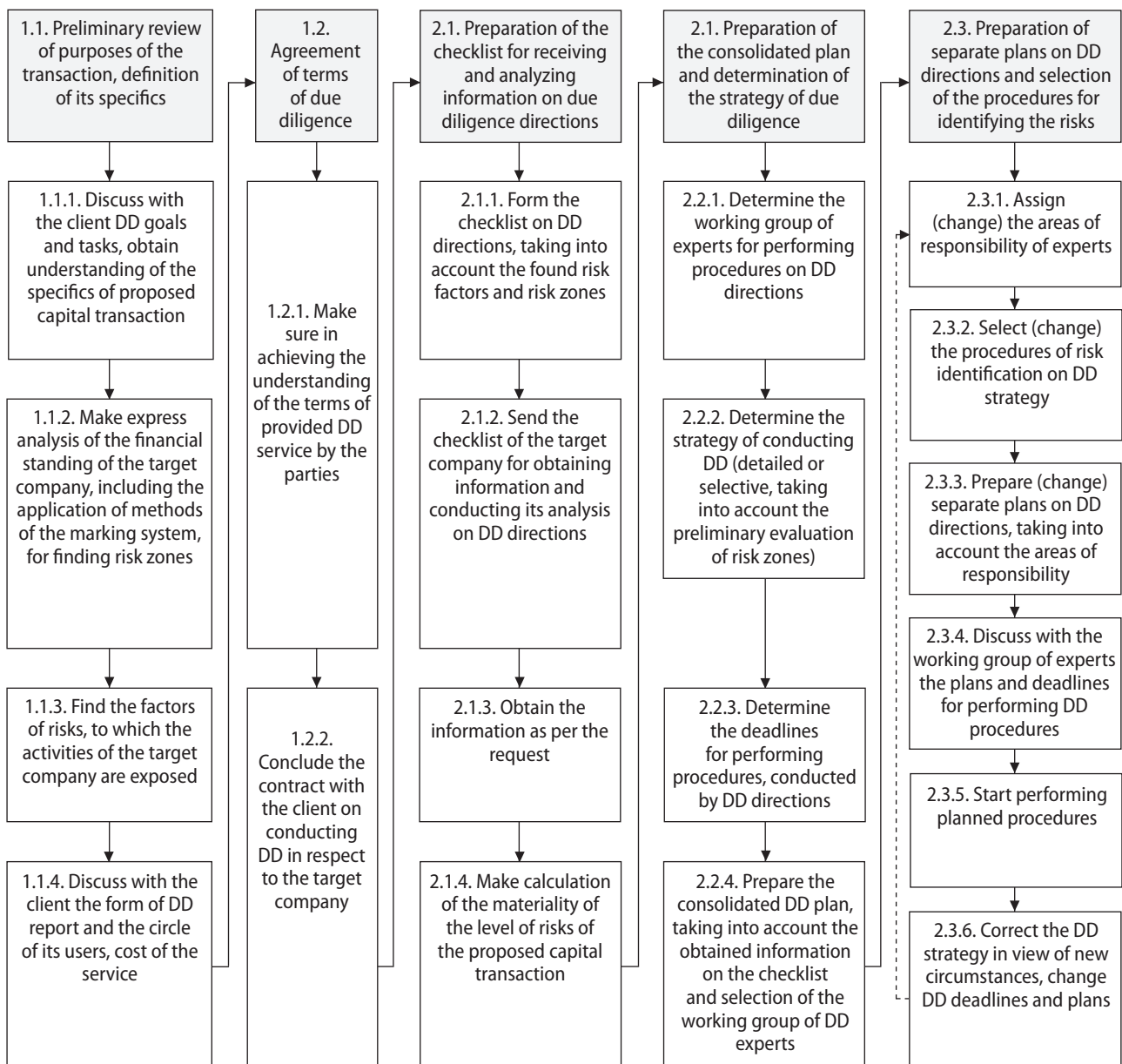
AUTHOR'S VISION OF THE POSSIBLE DISTRIBUTION OF THE AREAS OF RESPONSIBILITY WHILE CONDUCTING DUE DILIGENCE

FIGURE 2



ALGORITHM OF RISK ORIENTED PLANNING OF DUE DILIGENCE

FIGURE 3



areas of responsibility among the group of experts, who conduct due diligence.

W. Gole also notes that all specialists, who conduct due diligence, look at the target company through the prism of their individual professional experience. While conducting the investment study on the directions, the received results have the crucial importance for effective due diligence. Nevertheless, individually, these results do not ensure sufficient understanding of what is happening. That is why for conducting the effective due diligence, it is necessary to perform the cross-functional analysis, i.e. to conduct all verification procedures in conjunction for ensuring the complex approach [22].

Stage 2.3. At this stage, the areas of responsibility of the working group members are assigned. Then, based on the consolidated plan, the selected experts prepare the detailed plans of conducting due diligence by directions. Such plans allow concretizing the circle of possible procedures and focus attention on the risks, necessary for identification, taking into account the specifics of proposed transaction. When the new circumstances, affecting the course of conducting due diligence, are established in the target company activities, the necessity of correcting the strategy of conducting the examination (the dashed line is noted on Figure 3) is discussed, the correction of areas of responsibility is made, the volumes of works are reallocated.

Stage 3.1. After obtaining necessary information for the checklist, the working group experts conduct analysis of obtained data. Based on them, the special calculations of coefficients are made. Taking into account the obtained values, the risk map of the proposed transaction is built with the line of tolerance and zones, reflecting the level of risks and their influence on due diligence objects. The risk map will

allow the experts to correlate all identifications and risks after conducting the assessment procedure and clearly demonstrate the investor the existing threats, taking into account their consequences.

Stage 3.2. For each direction (module) of due diligence, the experts of the working group conduct concrete procedures (*Table 1*). As per

MODULES OF THE RISK-ORIENTED PLANNING OF DUE DILIGENCE

TABLE 1

№ S. NO	NAME OF THE MODULE OF DUE DILIGENCE	DUE DILIGENCE PROCEDURES
1	Accounting due diligence	<ul style="list-style-type: none"> • Analysis of the accounting system; • Analysis of the accounting records; • Analysis of audit opinions; • ...
2	Financial due diligence	<ul style="list-style-type: none"> • Analysis of the financial standing; • Analysis of the validity of the equity-to-debt ratio; • Check of calculations of due interests; • Check of compliance with the covenant; • Property and activities insurance; • ...
3	Tax due diligence	<ul style="list-style-type: none"> • Analysis of the tax accounting system; • Check of calculations of tax payments; • Check of tax declarations; • Analysis of the results of tax inspections; • ...
4	Legal due diligence	<ul style="list-style-type: none"> • Check of the charter and other founding documents; • Check of contracts and agreements to them; • Check of licenses and permissions; • Analysis of information about judicial proceedings; • ...
5	Management due diligence	<ul style="list-style-type: none"> • Evaluation of the effectiveness of the company's management; • Evaluation of the effectiveness of other categories of the company's employees; • Check of observance of the terms of collective agreement; • Check of the implementation of human capital investment programs; • ...
6	Marketing due diligence	<ul style="list-style-type: none"> • Analysis of the market competitiveness; • Analysis of output products; • Analysis of buyers; • Analysis of suppliers; • ...
7	Information due diligence	<ul style="list-style-type: none"> • Functional testing of operating information systems; • Testing of operating systems and communication channels; • Testing of the periodical technical maintenance of the systems; • Testing of the maintenance of employees' qualification level for working with information systems; • ...
8	Environmental due diligence	<ul style="list-style-type: none"> • Check of the compliance with requirements to environmental protection; • Check of the correctness of environmental tax charge and payment; • ...

the results of performed procedures, the areas, requiring special attention, are detected and the risks, impacting the determination of the cost of investment transaction, are identified. Thus, the risk-oriented approach to conducting due diligence is implemented. As per the results of found risk zones of the proposed transactions, the working group of experts compares found risks with typical ones, determines the types and draws up the risk profile. Based on the further identification, the experts of the working group propose advisory measures on prevention and minimization of found risks, disclose recommendations to the investor for approving the managerial decision.

Stage 3.3. After the identification, the working group of experts conducts analysis and evaluation of the influence of found risks on due diligence objects. The analysis helps to establish the risk factors, or the reasons for risks and their expected consequences. At the risk evaluation stage, the experts should understand how strongly the concrete risks, in particular, their financial consequences, influence the due diligence objects and why they can be dangerous for the potential capital transaction.

Stage 4.1. After conducting planned procedures, aimed at risk identification, and evaluating risks on each due diligence direction, the individual reports are drawn up. Based on the said reports of experts, the complex report is formed. The main element of the complex reports is the risk heat map, on which the found risks are marked, taking into account the due diligence objects.

Stage 4.2. As per due diligence results, the final working meeting is organized. The results of evaluation of the influence of identified risks on due diligence objects and the conclusions, which

the participants of the working group made based on the analysis of the information (financial and nonfinancial), are discussed at the final meeting. The investor obtains all necessary explanations and recommendations, replies to the emerging questions. However, it is worth remembering that the investor as the client of due diligence should not with complete certainty rely on the obtained conclusions and opinions of the working group experts. The investor should independently approve weighted managerial decision on implementation of the investment project, in respect of which the due diligence procedure was conducted.

Conclusions and prospects of future studies.

The due diligence is less standardized form of audit activities (special professional standards on planning the studied service are absent). That is why, this study suggest the interpretations of conducting the due diligence procedure. The scheme of conducting due diligence is clearly presented. Each stage of the studied procedure is described in detail. The algorithm of the risk-oriented planning of due diligence is disclosed. The scheme of conducting and the algorithm of planning the due diligence allow getting the general idea of the process of the examination of proposed capital transaction and understanding the specifics of the preparatory work, conducted by the auditors and other experts of the working group.

As the prospects of further studies, we deem it appropriate: to assess the condition of the audit market in respect to due diligence in the world and in Russia; to suggest new special forms of the audit documentation for planning the due diligence; to search for new methods and techniques for conducting audit procedures within due diligence; to develop software tools for conducting the due diligence.

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