

Msc, Dušan B. Radojičić¹

JKP PUT, Novi Sad

FINANCIAL STATEMENTS AS AN INFORMATIONAL BASIS FOR FINANCIAL DUE DILIGENCE

ABSTRACT: Financial reporting is a fundamental element of corporate governance and a key foundation for making informed economic decisions. Historically, financial information was not given adequate importance, even though it forms the basis for assessing financial health and business sustainability. Financial due diligence, as a comprehensive analytical process, combines financial, legal, and market analysis with the aim of identifying risks, opportunities, and the actual state of a company. It goes beyond standard auditing by considering both internal and external data sources. The primary financial statements – the balance sheet, income statement, cash flow statement, and statement of changes in equity – serve as a starting point for this process and provide a comprehensive "financial diagnosis" of the company. A systematic analysis of these reports enables insight into profitability, liquidity, efficiency, and risks, which are crucial for investors, creditors, and other stakeholders. Special attention must be paid to uncovering potential manipulations in financial reports, and therefore a high level of professional skepticism and analytical precision is required.

Key words: financial reporting, due diligence, financial analysis, financial manipulations, financial statements, financial position

¹ dusan.radojicic@jkpput.rs

INTRODUCTION

When observing the development and evolution of financial reporting throughout history, it is evident that this segment of corporate governance was not given appropriate significance for a long time. The information that underpinned managerial decision-making was often limited in scope and depth, even though crucial strategic and financial decisions were based on it (Mitrović et al., 2019, p. 19). Users of public funds are legally obligated to prepare financial statements, which provide information about the financial position, performance, and changes necessary for management to make economic decisions (Dimitrijević et al., 2023, p. 65). Financial reporting, as a central component of financial management, encompasses not only the basic financial statements – the balance sheet, income statement, cash flow statement, and statement of changes in equity – but also the interpretation and explanation of these reports, including the business report and the independent auditor's opinion, which confirms the accuracy and objectivity of the presented data.

With the introduction of International Financial Reporting Standards (IFRS), which officially came into force on January 1, 2004, a globally recognized framework was established to precisely define the criteria for preparing, evaluating, and presenting each economic category contained in the financial statements. These standards contribute to enhancing transparency, comparability, and reliability of information, forming the basis for making rational and informed business decisions (Bulajić, 2017, pp. 37–41).

In the modern business environment – characterized by a growing number of users of financial information, as well as institutions responsible for quality control – the need for high-quality financial reporting has become increasingly pronounced. Within this context, the application of the due diligence concept plays a significant role, serving as a structured and analytically oriented process that enables detailed verification, assessment, and validation of financial data. Through the practical application of due diligence, it becomes possible to identify weaknesses and risks, as well as to confirm the accuracy and reliability of financial reports, which is essential for all capital market participants.

Additionally, the introduction of the Total Quality Management (TQM) concept into the field of financial reporting emphasizes the necessity of continuous improvement in education and professional competence within the accounting profession. The enhancement of quality control systems and compliance with international professional accounting standards are prerequisites for building trust in both financial reports and the business decisions based on them (Bulajić, 2017, pp. 37–41).

THE FINANCIAL POSITION AS A FOUNDATION FOR FINANCIAL ANALYSIS AND ASSESSMENT

The term due diligence (дју дилигенс) refers to a comprehensive process of systematically and thoroughly examining all aspects of the operations of a potential business partner or target company in cases of acquisitions. In the context of Mergers & Acquisitions transactions, due diligence represents a thorough and systematic assessment of the business activities of a company that is subject to a potential acquisition. The purpose of due diligence is to provide a fundamental understanding of why an M&A deal is carried out and what the implications of the deal are (Bhagwan, V., 2020). This process, initiated by the buyer, aims to identify all relevant risks—financial, legal, and operational—in order to establish an appropriate safety net and prevent potential unpleasant surprises after the transaction is completed. For practitioners, “the goal (of due diligence) is to make the buyer comfortable enough to go through with the deal and close” (Daley, B., and others, 2024). However, aside from the buyer, the seller—i.e., the target company—may also conduct a due diligence process, known as *vendor due diligence*. From the seller’s perspective, this process serves as a tool to improve their negotiating position. Through self-assessment, the seller gains insight into their own weaknesses and risks that could affect the company’s valuation, while simultaneously confirming its competitive advantages, stability, and the accuracy of internal documentation. This increases transparency in the process, builds trust between the parties, and enables negotiations to be conducted on more objective and reliable grounds (Vidaković, S., 2007, pp. 21–22). In this context, the due diligence procedure becomes essential—a tool that helps identify and mitigate potential risks, evaluates operational and financial efficiency or inefficiency, and provides a clear understanding of the overall financial situation of the target company (Ulian, E., 2024).

The primary purpose of due diligence is to evaluate the economic, financial, legal, and market conditions in order to identify all potential benefits, obligations, risks, and liabilities that may arise from the planned transaction. Compared to a standard audit—which often focuses on the analysis of official financial statements or accounting books—due diligence represents a much deeper and more comprehensive analysis that encompasses both financial and non-financial parameters.

A particularly important segment of this process is *financial due diligence*, as it provides key information about the actual financial condition of the entity and the factors that influence the sustainability and profitability of its operations. Financial due diligence is a systematic process of investigating and evaluating a company’s financial information to ensure

sound decision-making in significant transactions, such as mergers, acquisitions, or investments. This comprehensive appraisal involves an in-depth review of financial statements, tax returns, cash flow projections, and other relevant documents, providing critical insights into the financial health of the company and mitigating potential risks (Asamoah, E., and others, 2025). The financial health of a company is reflected in its basic financial statements. Therefore, financial statements serve as the basis for exploring and analyzing the financial situation, providing insight into the financial position, results achieved, and cash flows—thus forming a diagnosis of the company's financial health (Vidaković, S., 2007, pp. 26–27). Each group of interested users, according to their needs and interests, focuses on specific aspects of financial statements. These reports can provide significant information about the company's operations, especially to users who possess adequate accounting knowledge necessary for their proper interpretation. Thus, the primary objective of financial reporting—and therefore financial due diligence—is to provide reliable, relevant, and timely information that will assist various stakeholders, from investors to creditors, in making informed economic decisions. Financial due diligence can be conducted either by the internal resources of the acquiring company or by external consultants. However, it is important to note that when additional parties are involved in the transaction, such as financial organizations that may require access to the financial due diligence report, an independent analysis is necessary, which requires the engagement of external consultants (Honcharenko, O. E., 2024).

In addition to financial due diligence, market and legal due diligence also play a significant role in the overall due diligence process. Market due diligence enables the assessment of a company's positioning relative to competitors, demand trends, and growth potential. On the other hand, legal due diligence identifies all existing and potential legal risks that could affect the legality and stability of operations. It also analyzes property relations and the ownership structure of the target company's capital, which is why it is often considered more demanding than the previously mentioned types of due diligence. However, the most common link occurs between financial and market due diligence. Specifically, financial due diligence often overlaps significantly with market due diligence, as both address a large number of similar questions. What fundamentally differentiates these two types of due diligence is the source of the information: financial due diligence relies on the financial statements of the target company, whereas market due diligence primarily gathers data from outside the target company—so-called external information.

All three types of due diligence—financial, market, and legal—together provide an objective, impartial, and comprehensive picture of a

company's business, which forms the basis for making strategic decisions in processes such as acquisitions, mergers, or investments.

The key objective of due diligence is to answer the question of whether undertaking a proposed business venture is justified and worthwhile. Due diligence is the ideal tool for exercising intelligent management and supporting decision-making in carrying out the sale of a company or in any other investment that requires a thorough prior analysis (Álvarez-Ferrer, A., 2022). The reliability of the expected answer is directly dependent on the quality and credibility of the information on which the due diligence conclusion is based. This conclusion is presented in the form of specific recommendations to the decision-makers, advising them either to proceed with negotiations or to withdraw from the transaction.

Both domestic and international capital markets insist on a high degree of transparency in business activities. In this context, financial reporting serves as a reliable source of objective and unbiased information, allowing for a better assessment of a company's true value and improving the quality of strategic investment decisions.

Failure to conduct due diligence significantly increases the risk of unsuccessful acquisitions and possible financial losses due to insufficient or unreliable information about the actual financial, legal, or operational condition of a company. This is precisely why due diligence is now applied as an integral part of nearly every significant business transaction—regardless of the type or scope of the tangible or intangible assets being evaluated (Ekonomiska enciklopedija II, 1986).

FINANCIAL STATEMENTS AS A SOURCE OF FINANCIAL INFORMATION

Financial statement analysis (FSA) is a process that examines past and current financial data to evaluate performance and estimate future risks and potential (Olayinka, A. A., 2022). The purpose of financial analysis is to provide a comprehensive, systematic, and clear overview of a company's financial position, serving as a foundation for an adequate and objective business performance assessment. The analysis of financial statements enables a deeper understanding of the structure and dynamics of operations, an evaluation of the current financial state, and the determination of a company's future potential (Mitrović, A., et al., 2019, pp. 16). This type of analysis is particularly significant in the context of evaluating recent performance results, valuing target companies in mergers or acquisitions, and creating business projections for newly formed corporate entities.

Financial analysis holds considerable analytical value, as it integrates all key elements of a company's operations. In this process, financial statements serve as the primary data source and the starting point for assessing the financial health of an enterprise. The basic financial statements – the balance sheet, income statement, cash flow statement, and the statement of changes in equity, as well as the notes to the financial statements, including accounting policies – serve as a kind of “financial diagnosis” or a snapshot of the company’s overall financial health (Vidaković, 2007, pp. 26). Their role is essential in evaluating business performance because they provide comprehensive insights into the financial position, performance, and sustainability of the business model. Financial statements can indicate stability, efficiency, and business success, but they can also reveal certain risks, structural weaknesses, or financial “hotspots” that require further, more detailed analysis. Through systematic interpretation and analysis, it is possible to draw relevant conclusions about a company’s financial stability, liquidity, profitability, and long-term viability – all of which are crucial for stakeholders, including investors, creditors, management, and regulatory bodies.

The financial due diligence process is predominantly based on the financial statements of the target company. The business and financial situation is diagnosed through key performance indicators, the so-called *key ratios*, which are derived from the financial reports. Financial ratio analysis is an indispensable tool in corporate finance for assessing firm performance, comparing industry benchmarks, and informing strategic decision-making (Zhang, Y. et al., 2025).

The balance sheet, or *statement of financial position*, provides an overview of the company’s asset strength — that is, what the company owns (*assets*) and how those assets are financed (*liabilities* and *equity*). It portrays the financial position of the organization at a particular point in time (Raju, K. P., 2022). For due diligence purposes, the balance sheet allows for the assessment of liquidity, indebtedness, and asset strength, as well as the identification of potentially risky positions, such as short-term liabilities exceeding current assets.

The income statement, or *statement of profit and loss*, shows how the company has generated and used financial resources during a given accounting period. Key components of this report include revenue from sales of goods and/or services, expenses (including operating costs and financial obligations such as interest), and net profit or loss — the difference between total revenues and total expenses. It provides insight into operational efficiency, revenue structure, and profitability, which is essential for investors aiming to evaluate the future potential for profit and return on invested capital.

However, the income statement includes only a portion of changes in equity. Comprehensive changes – including capital contributions and withdrawals by owners – are presented in the statement of changes in equity, which gives a broader view of the structure and movements in equity over the reporting period, offering a more complete picture of internal sources of financing.

The cash flow statement is one of the key financial statements and serves to monitor cash movement through operating, investing, and financing activities. It provides a clear view of cash sources and uses, enabling an assessment of liquidity and payment capacity. Operating cash flows reflect cash inflows and outflows from regular business operations, investing cash flows relate to investments in fixed assets and financial instruments, and financing cash flows cover borrowings, loan repayments, and other financial transactions. Within due diligence, this statement is a critical tool for identifying financial risks and assessing the sustainability of the business model.

In capital-intensive industries, many users of financial statements consider the cash flow statement to be the most relevant source of financial information. When interpreted in combination with the balance sheet and income statement, this report provides a deeper analysis of key financial ratios, an objective assessment of historical performance, and more reliable forecasting of future operations.

Ratio analysis is one of the most important tools for assessing a company's financial condition and is rightly considered a fundamental instrument of financial analytics (Rodić, J., and others, 2011, pp. 133). Its essence lies in calculating relationships between specific items from the financial statements — most often from the balance sheet and the income statement — yielding relevant indicators for evaluating liquidity, debt levels, efficiency, profitability, and other aspects of financial performance. Ratio figures alone do not provide sufficient information, but when combined with historical data, current benchmarks, or values from comparable companies, they offer deeper insight into the financial stability and performance of a business entity.

In the due diligence process, ratio analysis plays a crucial role because it enables the identification of key financial risks, weaknesses, and strengths of the company under review. Since due diligence is conducted to assess the actual financial standing and future business prospects, ratio analysis serves as the foundation for making informed investment decisions. In addition to static analysis (examining indicators at a specific point in time), ratio analysis is often complemented by trend analysis, which allows for tracking the movement of financial indicators over time and comparing them with projections and financial plans.

A detailed analysis of financial statements is of fundamental importance, particularly given the possibility of intentional concealment of weaknesses or distorted presentations of the company's financial position. Financial manipulations, which are defined in professional literature as the deliberate misrepresentation of core financial elements, can range from minor exaggerations to serious and systematic fraud — such as falsely reporting profits. Such actions pose the greatest threat to the credibility and validity of financial analysis.

POSSIBILITIES OF MANIPULATION

Under national and international accounting and reporting standards in force, financial records should provide true and relevant information, since the accounting unit is required to record all economic transactions in such a way that the financial records present a true and fair view of the facts that are the subject of accounting. The manner of reporting economic transactions clearly indicates the earnings quality and financial stability of the company (Svabova, L. et al., 2020). One of the most significant challenges faced by professionals during the due diligence process is the existence of financial fraud and deliberately distorted representations in financial statements. Financial manipulations are defined as the intentional distortion of key elements within financial reports, aimed at creating a misleading picture of a company's financial position and performance (Cvetković, D. et al., 2018, pp. 82-83). For this reason, financial analysts are expected to approach the evaluation process with a high degree of professional skepticism, attention, and analytical precision. The reliability and credibility of the available financial data should never be taken for granted but must be continuously re-examined for realism and objectivity.

Particular attention must be paid to specific strategies for manipulating accounting data. One of the most common is artificial profit inflation in the current period, achieved by overstating revenues and/or understating expenses. The purpose of such actions is to present the company in a better light in order to attract potential investors or to secure more favorable financing conditions from creditors. Conversely, there is the opposite strategy: deliberate understatement of profit in the current accounting period, achieved by understating revenues and/or overstating costs. The aim of this technique is to defer profit recognition to a future period, creating the appearance of weaker performance in the present year, which may serve various internal or external interests (Vidaković, S., 2007, pp. 27).

Companies often overstate revenues by artificially increasing amounts on the credit side of revenue accounts and the debit side of accounts receivable. These adjustments affect both the income statement and the balance sheet, and they represent fraudulent activities (Eremić Đodić, J., et al., 2017, pp. 232).

According to Howard Schilit, the literature identifies the so-called “*seven deadly sins of accounting*” which represent the most common forms of manipulative practice and should therefore be carefully analyzed in every financial review process (Vidaković, S., 2001).

The first and most common abuse refers to premature revenue recognition or recognition of revenue with questionable validity – e.g., when a service has not yet been fully performed or the buyer has not formally accepted the goods, but the revenue is already recorded.

The second form of manipulation involves fictitious (false) revenue recognition – recording revenue without meeting the legal requirements, such as recognizing revenue from property sales at the full selling price, recognizing revenue from business combinations, or recording financial and other income as sales revenue.

The third form of abuse is reflected in earnings inflation through non-operating gains, such as selling previously written-off assets, using gains from real estate sales to offset current expenses, or including such gains in regular sales revenue.

The fourth technique involves timing manipulation of expenses – shifting them to previous or future periods to influence the current period’s result. Examples include changing accounting policies, reducing asset impairment, or slowing down depreciation of costs in order to reduce expenses over a certain period, i.e., the so-called “stretching” of depreciation.

The fifth technique of manipulation refers to the omission or understatement of liabilities – avoiding recording existing obligations that must be settled or covering them up using arbitrary accounting assumptions.

The sixth strategy includes the deferral of revenue to future periods – creating unnecessary and fictitious reserves, or altering accounting assumptions to reduce liabilities.

The seventh type of abuse involves accelerated recognition of future expenses in the current period – shifting future costs into the present through reserve creation, then recognizing those reserves later as income. This also includes recognizing revenue from a merger that was actually earned before the merger took place (Cvetković, D. et al., 2018, pp. 88-89).

CONCLUSION

In contemporary business environments, the optimality of decision-making is no longer based solely on the quantity of available financial and accounting information, but primarily on its quality. The traditional approach, which emphasized accuracy, comprehensiveness, and timeliness of data, has evolved into a model that increasingly values deeper, more substantial, and analytically meaningful information. The modern business setting, marked by high dynamism and complexity, often results in information overload, which does not in itself guarantee relevance in the decision-making process.

The volume of information represents only a starting point for establishing an efficient and sustainable business system—whether on a micro- or macro-level—but this foundation must be complemented by a careful analysis of the structure and content of the information. In this context, the application of the due diligence concept plays a key role. As a tool for in-depth analysis, it enables the systematic collection, evaluation, and filtering of relevant financial and accounting data. Its importance lies not only in identifying potential risks but also in enhancing the quality of the information itself, thereby directly contributing to informed, sustainable, and responsible decision-making.

The consistent application of due diligence reflects a trend toward returning to sound business practices and ethical standards. Only through synchronized consideration of both the quantitative and qualitative aspects of financial information can accounting consistently fulfill its primary function—serving as the foundation for effective management and the long-term stability of the business system (Vidaković, S., et al., 2017, pp. 115-116).

REZIME

FINANIJSKI IZVEŠTAJI KAO INFORMACIONA PODLOGA FINANIJSKOG DUE DILIGENCE-A

Finansijsko izveštavanje predstavlja temeljni element korporativnog upravljanja i ključnu osnovu za donošenje informisanih ekonomskih odluka. Istorijski gledano, finansijskim informacijama nije pridavan dovoljan značaj, iako one čine osnovu za procenu finansijskog zdravlja i održivosti poslovanja. Finansijski due diligence, kao sveobuhvatan analitički proces, objedinjuje finansijsku, pravnu i tržišnu analizu, sa ciljem identifikacije rizika, potencijala i stvarnog stanja preduzeća. On prevazilazi okvire standardne revizije, uzimajući u obzir kako unutrašnje tako i eksterne izvore

podataka. Osnovni finansijski izveštaji – bilans stanja, bilans uspeha, izveštaj o tokovima gotovine i izveštaj o promenama na kapitalu – predstavljaju polazište u ovom procesu i pružaju „finansijsku dijagnozu“ kompanije. Sistematična analiza ovih izveštaja omogućava uvid u profitabilnost, likvidnost, efikasnost i rizike, što je od suštinske važnosti za investitore, kreditore i druge zainteresovane strane. Posebnu pažnju zahteva otkrivanje eventualnih manipulacija u finansijskim izveštajima, zbog čega je neophodan visok nivo stručne skepse i analitičke preciznosti.

Ključne reči: finansijsko izveštavanje, due diligence, finansijska analiza, finansijske manipulacije, finansijski izveštaji, finansijska situacija

REFERENCES

1. Asamoah, E., Kofi, E. N., Adukpo, T. K., & Mensah, N. (2025). *The role of financial due diligence in safeguarding investment portfolios in the US capital market*. World Journal of Advanced Research and Reviews, 25(3), 901-908.
2. ÁLVAREZ-FERRER, A. N. T. O. N. I. O., & Kalembe, N. (2022). Due Diligence: una revisión sistemática de literatura académica. Revista de Comptabilitat i Direcció, 34, 141-156.
3. Bulajić, S., (2017) *Due Diligence as a Key Factor of Financial System of Companies*
4. Bhagwan, V. (2020). *A management tool for the due diligence stage of M&A transactions* (Doctoral dissertation, Stellenbosch: Stellenbosch University).
5. Cvetković, D., & Bošković, V. (2018), *Pojavni oblici kreativnog računovodstva i najčešće manipulacije u finansijskim izveštajima*, Odbor časopis za Menadžment, finansije i pravo, 4(2), 78-89.
6. Vidaković, S., (2007) *Finansijski due diligence privrednih društava*, Mala knjiga, Novi Sad.
7. Vidaković, S., (2001) *Analiza poslovanja preduzeća u Tržišnoj privredi*, Beograd
8. Vidaković, S. V., & Parnicki, P. P. (2017), *Računovodstvo-primaran izvor informacija za efikasno upravljanje preduzećem*, Poslovna ekonomija, 11(1)
9. Daley, B., Geelen, T., & Green, B. (2024). *Due diligence*. The Journal of Finance, 79(3), 2115-2161.
10. Dimitrijević Lj., Eremić-Đodić, J., Radojičić, D., (2023) *Impact of schemes on the formation of financial statements in the public sector*, Stručni rad, Časopis Poslovna ekonomija broj 2, pp. 63-75.

11. Eremić Đodić, J., Laban, B., Tomić, A., (2017), *Forenzička revizija – sprečavanje, otkrivanje i odgovornosti za finansijske kriminalne radnje u kompanijama*, Stručni rad, Časopis Poslovna ekonomija broj 2, pp. 224-246.
12. Honcharenko, O. E. (2024). *Financial due diligence in mergers and acquisitions transactions*. ІННОВАЦІЙНА ЕКОНОМІКА, (1-2024), 103-111.
13. Mitrović, A., Milašinović, M., (2019) *Finansijski izveštaji kao izvor finansijskih informacija za potrebe analize finansijskih izveštaja*, Conference proceedings zbornik radova
14. Olayinka, A. A. (2022). Financial statement analysis as a tool for investment decisions and assessment of companies' performance. *International Journal of Financial, Accounting, and Management*, 4(1), 49-66.
15. Raju, K. P. (2022). *Financial Statement Analysis-An Overview*. *International Journal of Multidisciplinary Educational Research*, 11(1), 1-5.
16. Rodić, J., Vukelić, G., Andrić, M., Lakićević, M., & Vuković, B. (2011), *Analiza finansijskih izveštaj*,. Bečej: Proleter
17. Savremena Administracija, *Ekonomika enciklopedija*, Beograd, 1986.
18. Svabova, L., Kramarova, K., Chutka, J., & Strakova, L. (2020). *Detecting earnings manipulation and fraudulent financial reporting in Slovakia*. *Oeconomia Copernicana*, 11(3), 485-508.
19. Ulian, E. (2024). *The role of the due diligence procedure in the decision making for mergers and acquisitions*. *Journal of Research on Trade, Management and Economic Development*, 21(1), 39-48.
20. Zhang, Y., Silva, B., Moreau, É., & Tāne, H. (2025). Financial ratio analysis: A literature review working paper.

Ovaj rad je primljen **02.06.2025**, a na sastanku redakcije časopisa prihvaćen za štampu **01.07.2025**. godine.