Due diligence as a Key Factor of Financial System of Companies

Abstract: Due diligence is a term that means a detailed knowledge of all aspects of business partners as well as the estimate of benefits, obligations and responsibilities related to the potential purchase of a company. It involves much more detailed analysis than the official audit, for example of annual financial statements or business records. Financially, due diligence has the highest specific value, because it has to show all the factors of business of the company. Financial statements serve as a basis for research and analysis of the financial situation, as well as an overview of business results of the company. The main tasks of financial reporting are providing relevant information about the financial position, performance, particularly cash flows generated by the company, which will be useful for diversified users structure to make economic decisions. What we placed the emphasis on are the key types of due diligence, financial, commercial and legal, which provide objective and unbiased information, and business of companies.

Key words: Due diligence, companies, financial systems, financial reporting

1. Introduction

Looking at the value of financial reporting through time, we can clearly conclude that financial reporting was not given particular importance and significance. Extremely modest data representing the essence of management decision-making were used and analyzed by business entities that were put together for the purpose of making the most important decisions of the company’s business.

The generic term ‘financial reporting’ is used to refer to the financial statements (balance sheet, profit and loss - income statement, balance own capital and the balance of cash flows), as well as to financial discovery or explanation of these reports, the report on operations and, for the users of financial statements particularly important, the report of the independent auditor on the reality and objectivity of the balance.

International Financial Reporting Standards IFRS 1, which officially came into operation on 1/1/2004, provide a very clear mission, because the system of unified standards precisely defines the way the financial statements become satisfactory and displays comprehensible interpretations, evaluates and presents each economic category, as well as all economic categories that find their place in elementary financial statements.
The necessity of high-quality financial reporting becomes all the more important because of the increasing number of financial reports, users and institutions for quality control of the financial statements. Hence is the need to establish the concept of quality and quality control. The modern concept of quality control includes the introduction of quality standards of financial reporting, based on the principles of total quality management (TQM). Implementation of quality financial reporting, as well as total quality management reporting imply the review and evaluation of accounting profession education, so it is necessary to pay attention to the concept of quality management control of financial reporting, and to raise the educational level of the accounting profession with respect to international professional accounting regulations from this area and their mutual influence.

2. Financial Situation as a Key Base of Financial Due Diligence

Due diligence is the English word for which there is no adequate translation. Similarly, some of the terms such as broker, dealer, stock market, or software are used in its original form. Due diligence should be defined as the care with which a reasonable person performs a certain action in order to avoid doing harm to other people or their property; it is also the research and analysis of the company or organization to save the business transaction (e.g. business merging or purchase of securities), and the process in which a buyer or investor in a particular company or a particular business, examines the record of the item of knowing whether there are "hidden skeletons in the closet" (Vidaković, S., 2007). Due diligence is a term that means a detailed knowledge of all aspects of operating a business as well as the assessment of the benefits, obligations and responsibilities related to the possible purchase of a company. Due diligence is applied in order to check the current status and a potential business partner or a company. Due diligence is carried out as a security process to avoid intentional or unintentional misinforming of investors. For this reason, the investor independently investigates and confirms the information.

If the due diligence doesn't take place, the risk of the very acquisitions is increased, i.e. of buying a business without collecting the required information, which may result in significant financial losses for investors. For this reason, today almost every business transaction requires due diligence, regardless of how you assess the tangible and intangible property (Ekonomska enciklopedija II, 1986).

Both international and domestic capital markets require transparency of all business activities. Reporting on the business of the company is a good source of objective and unbiased information about the company. There are several types of due diligence (Vidaković, 2007):

- Financial;
- Market (commercial);
- Legal.

The most common link between these three types is between financial and market due diligence.

Financial due diligence has covered a major part of market due diligence, and similarly both of them correspond to a number of the same issues, although these are obviously two different areas of due diligence. What makes these two types different is the fact that for financial due diligence, we use financial statements of the target company, whereas for market due diligence, we provide mainly external information of the target company.

Legal due diligence comprises two prior aspects’ regulatory framework. It gradually deals with property relations and ownership structure of the capital of the target company, the possible intellectual property rights, contracts with specific partners, employees' rights (Vidaković, 2007).

The subject of due diligence may be other important aspects:

- Human environment;
- Information technology;
- Human Resources.

Management of companies and the accounting profession should accept the OECD Principles of Corporate Governance, as that is to the welfare of our companies which are and intend to be the part of national and international financial markets. The responsibility of the company and their management that should be a generator of development, is not only directed towards their shareholders and creditors, but it is much broader and refers to the development of the country and society as a whole.
Due diligence of the private enterprises must be done with special care, because the joint stock companies that are not quoted on the stock exchange are not obliged to publish their financial statements, as they do not have to submit to the Commission for Securities and the Stock Exchange, but also are not obliged to obtain the opinion of the independent external auditor of their financial statements.

3. Financial Due Diligence as the Quality Assessment of Business and Financial Credibility of Companies

The purpose of the financial due diligence is to provide comprehensive and clear overview of the financial position of the company which will help in its assessment. The intention of the financial statement by due diligence is to understand a business, make an assessment of the financial position of the company and provide the basis for the assessment of the business. It is conducted in order to assess the recent operations of a company, the one which is purchased or to be merged with, as well as to make overall projections of the newly formed entity. Financial due diligence has the highest specific weight because it has to show all the factors of business of the company (Vidaković, 2007).

Financial statements serve as the primary basis for research and analysis of the financial situation, as well as the diagnosis of the health of the company. It is extremely important to know and analyze financial statements because of potential concealing of shortcomings of a company. The biggest threat to the quality of due diligence is the administration of financial fraud and deception which, in the professional literature, is defined as intentionally unrealistic presentation of the basic elements of financial reporting of companies, which range from harmless to very dangerous exaggeration in presenting false profits.

Howard Schilit emphasizes seven basic forms of manipulation of accounting, which are referred to as "the seven deadly sins in accounting" on which special attention must be paid in the process of financial due diligence (Vidaković, 2001):

1. Revenues of dubious quality - income credited and service has not yet been made; income credited, the customer has not confirmed the receipt of the goods; income credited, the buyer has no obligation to pay; sales of goods and invoicing to a subsidiary (subsidiary company); compensate some value to customers and posting of compensation as income.
2. Posting false arrival - Cash received from loans, credited as income, return on investment has been posted as revenue, vendor rebates related to future purchases credited as income.
3. Increase by one-time sales - to increase profits by selling undervalued assets, the inclusion of sales or earnings from investments as part of income, showing sales or profits from investments by reducing their own costs.
4. Displaying the running costs in future or previous business period - very slow amortization costs, delineation of normal operating costs.
5. Avoiding recording of costs or their adequate reduction - failure to record the expenses and obligations that must be covered or settled, reducing the burden of change in accounting assumptions, showing suspicious reserves as income.
6. Display of current revenues in the next business period - the creation of reserves and their display as income in the next business period.
7. Displaying the future costs in the current business period as special charges - Increasing amount of specific costs, inadequate presentation of research costs in connection with the structuring of the company.

4. Summary of Task and Financial Reporting

The basic purpose of financial reporting is to present the economic substance of transactions and events in a way that they really take place, but also to show the consequences of such events in the accounting aspect. For this reason, the conditions that reflect actual transactions and other events indirectly using the standard, express interest in giving a true and fair final account of how transactions and events affect the entire business enterprise. This way of presenting the situation, in which the value of any economic system is measured, is of paramount importance and interest to all those who depend on the realized economic performances of the company subject to reporting (Tpa-Group, 2016).

For our economic systems, this represents a challenge if you take into account the fact that IFRS represents the most prestigious and most reputable reporting system adopted and practiced by global companies. With its
conception, IFRS is primarily directed to disclose to the public its framework for the preparation and presentation of financial statements. As such, it is intended for general public which is interested in reliable market information, and should ensure a balance between two fundamental categories that form the basis of reporting, and these are its users, on the one hand, and the other content of the information to be presented on the other (LehmanBrown, 2016).

The main task of financial reporting is to provide relevant information about the financial position, performance, particularly cash flows generated by the company, which will serve to a diversified structure of various users to make economic decisions. To achieve this objective, it is necessary that financial reports provide information about (Ekonomska enciklopedija II, 1986):

- property;
- obligations;
- equity;
- income and expenses, including gains and losses;
- cash flows.

This information, along with other information, set forth in the notes to the financial statements, helps users to predict future cash flows of the company, especially the dynamics of creation and certainty of cash and cash equivalents.

If we analyze the requirements for information to be provided by the financial statements, we can conclude that the true and fair presentation of the property and financial status forms the image and success of the company positions itself as a kind of imperative strategic decision making. On these premises the basic utility of reporting for the needs of users of financial statements compiles, where the real picture of the activities of the company considers the current formula, rather than past economic relations and the expected benefits. It's about giving priority to the present and future property and financial conditions and performance, not past, which are comments on the statistical value (Vidaković, 2001).

Expression of balance sheet items at fair value is primarily based on the fact that the accounting value of assets with the use of assumptions in IFRS represent the values that correspond to the planning which defined the expected economic benefits from their further economic use in the company.

In order to prepare financial statements in accordance with International Accounting Standards and International Financial Reporting Standards, Audit Committee, the responsible subject, has at least three members who are independent from business and interest of the company, but are professionals in the field of accounting and finance. Their task is to supervise the preparation and submission of financial statements to the regulator of the capital market or stock exchange, as well as to control segments of the risk management of the company LehmanBrown (2016).  

5. Conclusion

In conclusion, there is the fact that modern accounting is in accordance with the new standards that place professional accountants in a new position. They have to worry about accounting terms to include only the amounts of assets, liabilities and equity, income and expenses which respect the principle of fair value. In fact, the basic question is who is responsible for determining the fair value measurement and its postulates. For a true and fair picture of the economy of a company, the most responsible is the company management, on the basis of internally developed systems to monitor and control resulting business changes and events. This means that the company must have adopted accounting policies (decisions on the adopted accounting policies), governing the method for determining the current value of assets and liabilities of the company.

To successfully operate a company in the long run, it is necessary to take into account the degree of utilization of all its resources, regularly monitor and analyze the level of their use and find ways to use them more optimally.

The reason for the proper implementation of international standards with additional disclosure (when they become necessary) ensures the realization of a unique interest in almost all cases - and this is a fair value for the fair presentation of the financial statements.

References