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## INTERNAL CONTROL: METHODOLOGICAL DISTINCTIONS OF COUNTERPARTY CREDITWORTHINESS CHECKS



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### Abstract

**Subject** This article deals with the issues related to the methodology of client acceptance procedures within the internal control framework.

**Objectives** The article aims to develop methodological approaches to perform internal control when checking the counterparty creditworthiness.

**Methods** We used the methods of comparative analysis and systematization.

**Results** The article proposes a method for internal control when checking counterparties' financial reliability preceding the conclusion of a contract, including working papers of the controller, mitigating the business risk.

**Conclusions and Relevance** The proposed algorithm for counterparty creditworthiness checks and forms of working documents will help enterprises and entrepreneurs get information about contractors at the stage of contracting, which would reduce the default risk in the future. The findings can be applied in the theory and practice of internal and external control during counterparty creditworthiness checks, as well as in the master's degree educational process in the field of Economics and Economic Expert Analysis.

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Selling its finished products, goods, services, any business entity deals with counterparties (Latin *contrahēns* 'collecting, accomplishing, contracting'). Counterparties are persons or entities *bound by obligations under a common agreement and cooperating in compliance with it*<sup>1</sup>. Such relationships result in accounts receivable or payable.

It is important for any business entity to manage its accounts receivable since it is able to plan its cash flows assuming that amounts due will be timely repaid. In the mean time, business entities need to manage their accounts payable as well since acquiring entities expect suppliers to timely deliver property, work and services. If suppliers fail to perform their contractual obligations in a timely manner, the production process will stall, inducing other consequences and affecting the continuity of business operations.

Accounts receivable are managed so as to secure cash flows or other property and settle accounts with counterparties within the timelines stipulated in the contract. Managing its accounts receivable, the business entity should ensure the quality of its accounting and effective analysis. These challenging issues are examined in proceedings by A. Arens and J. Loebbecke<sup>2</sup>, V.B. Ivashkevich [1], L.I. Kulikova [2], G.S. Klychova and Z.Z. Khamidullina [3, 4], S.A. Kemaeva [5, 6], L.B. Sungatullina [7]. Distinctive aspects of accounts receivable management are studied by N.V. Gorshkova and O.V. Khmeleva [8].

Distinctive aspects of accounting, analysis and accounts payable management are investigated by I.V. Artemova [9], E.A. Vedernikova [10], V.A. Grebennikova and A.N. Ponchishkina [11], V.V. Kopeina [12], N.A. Markova [13].

Auditing and internal control screen accounts receivable and payable. Respective studies are performed by N.G. Sapozhnikova and O.Yu. Trunaeva [14], N.N. Kovaleva, L.V. Ermakova and A.E. Mel'guya [15], M.A. Chaplygina, G.A. Pol'skaya and

N.I. Vinogradova [16], N.O. Mikhaleuk and O.V. Shnaider [17].

Business entities may perform preliminary, ongoing and follow-up control of the transaction time. Preliminary control takes place before a transaction, ongoing control coincides in time with a transaction, and follow-up control goes after a transaction.

Scholarly proceedings mainly discuss the audit of financial statements, external and internal control which are usually of ongoing or follow-up nature. We assign the highest importance to preliminary internal control. Contractual policy is studied by B.A. Shakhmanova as an aspect to be audited [18]. In our opinion, business entity should necessarily conduct the preliminary internal control of counterparties in terms of their creditworthiness.

The counterparty creditworthiness check is a crucial step in the contractual process. It gets especially important if the contract is intended to be long-term and entail substantial financial costs. We believe the counterparty creditworthiness check is the responsibility of the internal control department.

Unreliable entities (the so called *fly-by-night* organizations) affect all parties involved. The State collects less tax. Their counterparties have to face controlling authorities' interrogations concerning such organizations. These issues usually turn to be very costly for business entities, entailing additionally charged taxes, penalties, and denied VAT refunds. Counterparty creditworthiness checks may, if needed, help produce evidence of the business entity's prudence in documenting its business relationships with the counterparty.

General information about counterparties is in public sources on the Internet. For this, business entities need to know identification number of a tax payer (in Russian 'INN'). Publicly available sources are presented in Table 1.

Referring to the sources, we examine the specifics of checking the counterparties which are debtors of an agricultural entity in the Nizhny Novgorod Oblast and buyers of agricultural products for canteens and bakery production.

The Uniform State Register of Legal Entities (abbreviated in Russian as 'EGRUL') provides information on the incorporation date, size of authorized capital, registered address, CEO's details,

<sup>1</sup>For the source article, please refer to: Шатина Е.Н., Козменкова С.В., Фролова Э.Б. Внутренний контроль: методические особенности проверки контрагентов на благонадежность. *Международный бухгалтерский учет*. 2018. Т. 21. № 8. С. 904–916. URL: <https://doi.org/10.24891/ia.21.8.904>

<sup>1</sup>Raizberg B.A., Lozovskii L.Sh., Starodubtseva E.B. *Sovremennyy ekonomicheskii slovar'* [Contemporary dictionary of economics]. Moscow, INFRA-M Publ., 1997, 496 p.

<sup>2</sup>Arens A., Loebbecke J. *Audit* [Auditing: An Integrated Approach]. Moscow, Finansy i Statistika Publ., 1995, 560 p.

types of activities, dates of updates to the EGRUL. *Table 2* reflects the proposed form of a working document the internal controller uses.

Having checked commercial court case files, we found out that PAO Machinebuilding Plant as one of the analyzable counterparties is sued in the court. The proposed form of the internal controller's working document, *Commercial Court Case Files Check*, (*Table 3*) shows the findings we made in scrutinizing the debtors.

Therefore, we should analyze financial statements prepared by the Machinebuilding Plant to test whether it meets the going concern principle and is able to repay its debts within the timelines set forth in contracts if the court issues an unfavorable ruling and imposes penalties.

Looking through the register of disqualified persons<sup>3</sup>, business entities may detect whether the would-be counterparty's executive body consists of any disqualified persons (company check). Checking the source<sup>4</sup>, business entities may run through the list of disqualified persons to possibly locate the counterparty's top managers (citizen verification). We suggest documenting the results of such checks in the proposed form of the internal controller's working document as showed in *Table 4*.

Checking the register of material facts<sup>5</sup>, business entities may learn about net assets, results of audits, pledged property. Findings of internal control are given in the proposed working documents, *Check of Register of Material Facts* (*Table 5*).

Searching through the log of mass business registration addresses (the location is qualified as such if it serves as the registered seat for 10 or more companies)<sup>6</sup>, it is possible to figure out the number of legal entities registered at the address in question. What also matters is to search for information about legal entities having taxes in arrears and/or failing to submit tax

returns for more than one year<sup>7</sup>. Findings are presented in the proposed working file of the internal controller, *Check of Mass Business Registration Addresses Database* (*Table 6*).

Business entities should be especially prudent when assessing the following aspects:

- the company's address serving as the registered seat for numerous business entities;
- substantial amounts of taxes due;
- the same person acting as the chief accountant and CEO;
- a short period of time between the official incorporation date and the conclusion of the contract with the supplier.

These aspects come under close scrutiny of financial functions, which should adhere to the statutory document<sup>8</sup>. The document enlists indicia of *mala fide* entities and rules for practicing the approach. To verify the creditworthiness of an entity, it is necessary to gather a set of documents (copies verified by the authorized person) before the contract is concluded or finished products, goods are shipped or services, work are delivered:

- 1) the Certificate of State Registration of the Legal Entity;
- 2) the Certificate of Tax Registration of the Legal Entity;
- 3) Articles of Association in the effective edition;
- 4) Executive Body Appointment Order (director, general manager);
- 5) Minutes of Executive Body Appointment (director, general manager);
- 6) lease contract for the registered address;
- 7) abstract from the Uniform State Register of Legal Entities as of the current date;
- 8) lease contract for warehouse and (or) production premises/facilities;

<sup>3</sup> Federal Tax Service of the Russian Federation. Search through the register of disqualified persons. URL: <https://service.nalog.ru/disqualified.do> (In Russ.)

<sup>4</sup> Federal Tax Service of the Russian Federation. Addresses indicated by several legal entities for the State registration as their registered seat. URL: <https://service.nalog.ru/addrfind.do> (In Russ.)

<sup>5</sup> Uniform federal register of legally valid data on performance of legal entities, individual entrepreneurs and other business agents (Fedresurs). URL: <http://www.fedresurs.ru> (In Russ.)

<sup>6</sup> Federal Tax Service of the Russian Federation. Data on mass business registration addresses. URL: <https://service.nalog.ru/baddr.do> (In Russ.)

<sup>7</sup> Federal Tax Service of Russia. Data on legal entities having taxes in arrears and/or failing to submit tax returns. URL: <https://service.nalog.ru/zd.do> (In Russ.)

<sup>8</sup> Resolution of the Plenum of the Supreme Arbitration Court of the Russian Federation № 53 of October 12, 2006, *On Arbitration Courts' Evaluation of Reasonableness of the Taxpayer's Tax Benefits*. URL: [http://www.consultant.ru/document/cons\\_doc\\_LAW\\_63894/](http://www.consultant.ru/document/cons_doc_LAW_63894/) (In Russ.)

- 9) information on the existence/non-existence of the official web site;
- 10) Balance Sheet;
- 11) tax returns;
- 12) bank account statement;
- 13) statement of specific tax treatment eligibility;
- 14) licenses (if the entity's activity is subject to licensing);
- 15) tax clearance statement;
- 16) copy of the executive body's passport details (director, general manager);
- 17) documents confirming title to motor vehicles;
- 18) contract for lease of motor vehicles or other documents confirming the physical availability of tangible resources for the declared activity;
- 19) information about the average headcount;
- 20) documents confirming the authorized person's entitlement to act as a signatory; copies of passport details of such persons.

It should be noted that the developing e-commerce made many buyers and sellers use Internet resources to seek and offer goods, work and services. Strengths can be found in every aspect of e-commerce. However, there are still many weaknesses which entail millions of losses for businesses. Sometimes Internet resources

happen to lack reliability and transparency. There more frequently reoccur bogus websites repeating the information of renown companies. Modern technologies and their growth raises the state of alert among the e-commerce market actors. Online services can be used to verify the reliability and creditworthiness of counterparties before contracts are concluded, such as website trust flow checks (Yandex), online reputation and Internet safety service (WebMoney Advisor, Web of Trust), domain name search, online scams checks, anti-virus software.

Users acquire additional information to verify the creditworthiness of their counterparties.

For example, using the Yandex service of trust flow check<sup>9</sup>, the user inserts details in the search box. The details are processed online and converted into tables. They help evaluate the creditworthiness of a counterparty. Certainly, it will not be a 100-percent guarantee of partners' reliability but will expand the user's knowledge of the counterparty's reputation.

The above data sources help reveal the quality of counterparties, their solvency, integrity and evaluate the potential of further cooperation. If the business entity chooses to enter into contracts for supply, purchase and sale, it can refer to the findings of the analysis as described above to determine the appropriate format of settlements with the counterparty in order to mitigate possible risks in the future.

<sup>9</sup>Yandex service for checking the website trust flow. URL: <https://xtool.ru>

**Table 1****Publicly available sources on the Internet**

Website	Aspects to be checked
www.nalog.ru	Data verification in the Uniform State Register of Legal Entities
http://kad.arbitr.ru	Check of commercial court files
https://service.nalog.ru/disqualified.do	Register of disqualified person to check whether the counterparty's top managers are mentioned there
https://service.nalog.ru/addrfind.do	Information about mass business registration addresses
https://service.nalog.ru/baddr.do	Data on legal entities which cannot be contacted at the address indicated in the Uniform State Register of Legal Entities
https://service.nalog.ru/zd.do	Data on entities failing to perform tax liabilities
http://www.fedresurs.ru	Check of registers of material facts

Source: Authoring

**Table 2****Working document, Check through the Uniform State Register of Legal Entities**

Debtor's Tax ID	Check results			
	Authorized capital, RUB	Core activity	Signatory of financial documents	Amendments to incorporation documents
52XXXXXXX PAO Machinebuilding Plant	902,027,280	25.30 Production of a steam generating unit, other than central heating boiler	–	–
52XXXXXXX PAO Instrument Engineering Plant	256,206,678	26.51.6 Production of other devices, meters, equipment and tools for measurements, control and tests	Oleg M. Petrov	–
52XXXXXXX OOO Khlebozavod	27,819,450	10.71 Production of non-durable bread, pastry, cakes and baked confectionery products	Aleksei A. Ivanov	–

Note. Business data are conditional.

Source: Authoring

**Table 3****Working document of the internal controller, Commercial Court Case Files Check**

Taxpayer's ID/Name of Debtor (Counterparty)	Check results			
	Case Number	Current phase / judge	Claimant	Defendant
52XXXXXXX PAO Machinebuilding Plant	23.06.2017 A00-00000/2017	Arbitration Court of Moscow, A.G. Metel'kova	TRIADA Federal State Unitary State-Financed Enterprise	PAO Machinebuilding Plant
52XXXXXXX PAO Instrument Engineering Plant	No data			
52XXXXXXX OOO Khlebozavod	No data			

Source: Authoring based on the web service. URL: <http://kad.arbitr.ru/> (In Russ.)

**Table 4****Working document, Check of Register of Disqualified Persons**

Taxpayer's ID of Debtor	Name	Results of Check	
		Disqualified persons in the executive body of the counterparty (organization)	Disqualified persons (CEO)
52XXXXXXX	PAO Machinebuilding Plant	–	–
52XXXXXXX	PAO Instrument Engineering Plant	–	–
52XXXXXXX	OOO Khlebozavod	–	–

Source: Authoring based on URL: <https://service.nalog.ru/disqualified.do>; URL: <https://service.nalog.ru/addrfind.do>

**Table 5****Working document, Check of Register of Material Facts**

Taxpayer's ID of Debtor	Results of Check			
	Net assets, thousand RUB	Audit Report on financial statements	Pledged property	Information on restructuring/dissolution
52XXXXXXX PAO Machinebuilding Plant	Not available	No data	1. Toyota Highlander 2. Lexus LX 570	None
52XXXXXXX PAO Instrument Engineering Plant	4,290	Financial statements, in material respects, give a fair and true view of the financial position of PAO Instrument Engineering Plant as of 31.12.2017, results of its financial and business operations for FY 2017 in compliance with the Russian rules for financial reporting	None	None
52XXXXXXX OOO Khlebozavod	No data	No data	No data	None

Source: Authoring based on source data: URL: <http://www.fedresurs.ru>

**Table 6****Working document, Check of Mass Business Registration Addresses Database**

Debtor, its address	Number of registered personalities
PAO Machinebuilding Plant	No data
PAO Instrument Engineering Plant	No data
OOO Khlebozavod	No data

Source: Authoring based on the website. URL: <https://service.nalog.ru/addrfind.do>

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