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 *contrahens* 'collecting, accomplishing, contracting'). Counterparties are persons or entities *bound by obligations under a common agreement and cooperating in compliance with it*¹. 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. Loebbecke², V.B. Ivashkevich [1], L. 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. Sapoznikova and O.Yu. Trunaeva [14], N.N. Kovaleva, L.V. Ermakova and A.E. Mel'guy [15], M.A. Chaplygina, G.A. Pol'skaya and N.I. Vinogradova [16], N.O. Mikhalenok 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. Thee 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,
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, business entities may detect whether the would-be counterparty's executive body consists of any disqualified persons (company check). Checking the source, 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, 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), 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. 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. 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;

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1 Federal Tax Service of the Russian Federation. Search through the register of disqualified persons. URL: https://service.nalog.ru/disqualified.do (In Russ.)
2 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.)
3 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.)
4 Federal Tax Service of the Russian Federation. Data on mass business registration addresses. URL: https://service.nalog.ru/baddr.do (In Russ.)

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7 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.)
8 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/ (In Russ.)
9) information on the existence/non-existence of the official website;
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, antivirus software.

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

For example, using the Yandex service of trust flow check\(^9\), 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.

\(^9\) 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 | Signatory of financial documents | Amendments to incorporation documents |
|-----------------|---------------|----------------------------------|--------------------------------------|
| Authorized capital, RUB | Core activity | | |
| 52XXXXXXXXXXXX | 902,027,280 | 25.30 Production of a steam generating unit, other than central heating boiler | – | – |
| PAO Machinebuilding Plant | | | |
| 52XXXXXXXXXXXX | 256,206,678 | 26.51.6 Production of other devices, meters, equipment and tools for measurements, control and tests | Oleg M. Petrov | – |
| PAO Instrument Engineering Plant | | | |
| 52XXXXXXXXXXXX | 27,819,450 | 10.71 Production of non-durable bread, pastry, cakes and baked confectionery products | Aleksei A. Ivanov | – |
| OOO Khlebozavod | | | |

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 | Claimant | Defendant |
|-------------------------------------------|---------------|----------|-----------|
| Case Number | Current phase / judge | TRIADA Federal State Unitary State-Financed Enterprise | PAO Machinebuilding Plant |
| 52XXXXXXXXXXXX | 23.06.2017 A00-00000/2017 | Arbitration Court of Moscow, A.G. Metel'kova | PAO Machinebuilding Plant |
| PAO Machinebuilding Plant | | | |
| 52XXXXXXXXXXXX | No data | | |
| PAO Instrument Engineering Plant | | | |
| 52XXXXXXXXXXXX | No data | | |
| OOO Khlebozavod | | | |

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

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### 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) |
| 52XXXXXXXXXX            | PAO Machinebuilding Plant                       | –                | –               |
| 52XXXXXXXXXX            | PAO Instrument Engineering Plant                | –                | –               |
| 52XXXXXXXXXX            | 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 |
| 52XXXXXXXXXX            | Not available | No data | 1. Toyota Highlander |
|                         |                 |         | 2. Lexus LX 570 |
| PAO Machinebuilding Plant | No data | No data | None |
| 52XXXXXXXXXX            | 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 |
| PAO Instrument Engineering Plant | No data | No data | No data |
| 52XXXXXXXXXX            | No data       | No data | None |
| OOO Khlebozavod         | 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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