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DEVELOPING A STRUCTURED DUE DILIGENCE METHODOLOGY FOR AUDIT FIRMS: A RISK-BASED PERSPECTIVE

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Abstract

The expansion of audit-related services has increased the need for audit firms to provide due diligence engagements that are systematic, risk-sensitive, well documented and compatible with professional quality management requirements. In practice, due diligence is often performed through fragmented checklists or expert judgment, which may create inconsistency in risk identification, evidence collection, reporting and engagement quality. This article develops a structured due diligence methodology for audit firms from a risk-based perspective. The study applies qualitative document analysis, comparative standard mapping and design-science logic to synthesize requirements and principles from ISRS 4400 (Revised), ISAE 3000 (Revised), ISQM 1, OECD risk-based due diligence guidance, ISO 31000 risk-management logic and contemporary sustainability due diligence developments. The proposed methodology consists of seven interconnected stages: engagement acceptance, scope and criteria definition, risk-universe construction, targeted evidence planning, analytical testing, risk scoring and decision-oriented reporting. The results present a practical framework, risk matrix, quality gates, working paper structure and reporting architecture that audit firms can adapt for financial, tax, legal, operational, governance and ESG due diligence. The article argues that due diligence should not be treated merely as a transaction checklist but as a disciplined professional service governed by risk assessment, ethical safeguards, documentation standards and firm-level quality management. The proposed model strengthens comparability, transparency and usefulness of due diligence reports for investors, owners, lenders and other decision-makers.

Keywords: due diligence; audit firms; risk-based methodology; ISRS 4400; ISQM 1; risk scoring; audit-related services; quality management

JEL Classification: M42, G32, G34, K22, Q56

1. Introduction

Due diligence has become one of the most important professional services connected with investment transactions, mergers and acquisitions, privatization, business restructuring, lending decisions, corporate governance reviews and sustainability-oriented value-chain assessments. In an audit firm, due diligence is usually requested when a client or a group of users needs structured factual, analytical or assurance-oriented information about a target entity before making an economic decision. Unlike a statutory audit, due diligence does not normally aim to express an audit opinion on historical financial statements. Its practical value lies in identifying risk areas, quantifying possible exposure, explaining the quality of information and translating complex findings into decision-relevant conclusions.

The problem is that due diligence engagements are frequently organized through informal checklists, separate expert memoranda or unconnected analytical procedures. This creates several methodological weaknesses. First, risk areas may be selected based on the experience of the engagement leader rather than on a documented risk-universe approach. Second, evidence requirements may differ between teams and offices within the same firm. Third, reports may

describe findings but fail to classify their severity, impact and likelihood. Fourth, quality management may be limited to final report review instead of being embedded from engagement acceptance to report issuance. These weaknesses reduce the reliability, comparability and usefulness of due diligence services.

A risk-based due diligence methodology responds to this problem by linking the engagement scope, procedures, working papers and reporting structure to the assessed risks of the target entity. In such a methodology, higher-risk areas receive deeper analytical procedures, stronger evidence requirements, more experienced specialists and more explicit communication to users. Lower-risk areas are not ignored; they are documented through proportionate procedures and integrated into the overall risk profile. This logic is consistent with modern professional service expectations, where audit firms are expected to manage quality, ethics, resources, documentation and communication in a systematic manner.

The objective of this article is to develop a structured methodology for due diligence services provided by audit firms from a risk-based perspective. The article addresses three research questions: (1) What professional and methodological principles should guide due diligence engagements in audit firms? (2) How can audit firms structure due diligence stages, documentation and quality control to achieve consistency and decision usefulness? (3) How can a practical risk scoring model be integrated into due diligence reporting without transforming the engagement into a full statutory audit?

Table 1. Methodological problems in traditional due diligence practice and risk-based solutions.

Problem area	Typical weakness	Risk-based methodological solution
Scope definition	Scope is copied from prior engagements or client requests without documented risk logic.	Define scope through risk universe, materiality, user needs and engagement limitations.
Evidence collection	Teams request large volumes of documents without prioritizing high-risk areas.	Build evidence requests from risk hypotheses and link each document to a procedure.
Specialist involvement	Legal, tax, valuation or ESG experts are involved late or inconsistently.	Trigger specialist involvement when risk indicators pass defined thresholds.
Risk evaluation	Findings are descriptive but not ranked by likelihood, impact or decision relevance.	Apply a transparent risk scoring scale and classify findings as low, medium, high or critical.
Reporting	Reports are lengthy but do not clearly show commercial implications.	Use executive summary, heat map, exception log, quantified exposure and action-oriented conclusion.

2. Literature Review and Conceptual Basis

Due diligence is not a single universal engagement type. In audit-firm practice, it may be organized as a financial due diligence review, tax due diligence, legal and compliance review, operational due diligence, governance review, forensic review or ESG/sustainability due

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diligence. The exact form depends on the users, subject matter, engagement terms and expected output. For this reason, the methodology should begin not with a fixed checklist but with engagement classification. Where the user requests factual findings on agreed procedures, ISRS 4400 (Revised) is highly relevant because it governs agreed-upon procedures engagements, where the practitioner performs procedures agreed with the engaging party and reports factual findings rather than an assurance conclusion (IAASB, 2020a).

Where the engagement requires a conclusion designed to enhance confidence in subject matter information, ISAE 3000 (Revised) becomes more relevant. It provides requirements and guidance for assurance engagements other than audits or reviews of historical financial information, including reasonable and limited assurance engagements (IAASB, 2013). In a due diligence context, this distinction is important: factual findings, limited assurance conclusions and advisory recommendations create different responsibilities, evidence thresholds and reporting language. A structured methodology should therefore require the audit firm to classify the engagement before procedures are designed.

Quality management is another conceptual foundation. ISQM 1 applies to firms that perform audits, reviews, other assurance or related services engagements and requires a system of quality management rather than a narrow final review approach (IAASB, 2020b). For due diligence, this means that quality is not achieved only by checking the final report. It is produced through acceptance decisions, ethical safeguards, assignment of competent personnel, consultation, documentation, supervision, review and monitoring. The proposed methodology integrates quality gates into every major stage of the engagement.

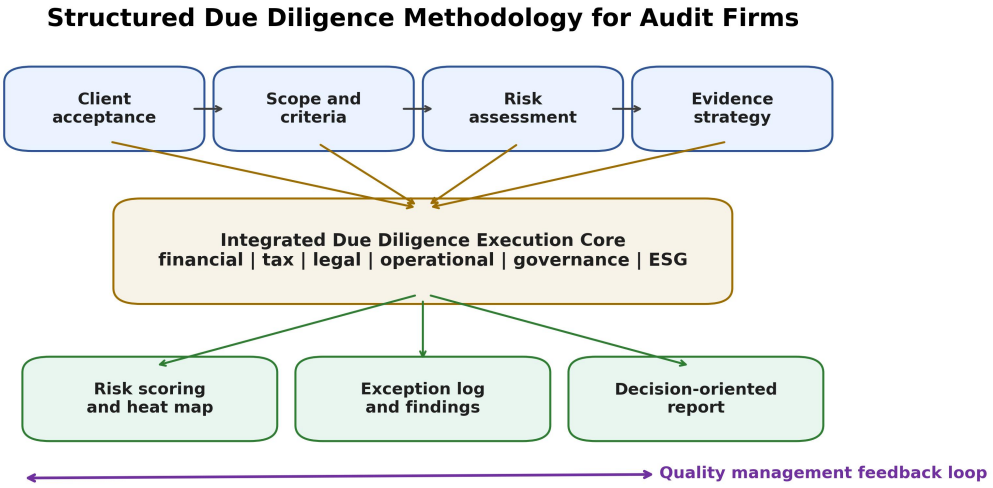

Figure 1. Conceptual architecture of a structured due diligence methodology for audit firms.

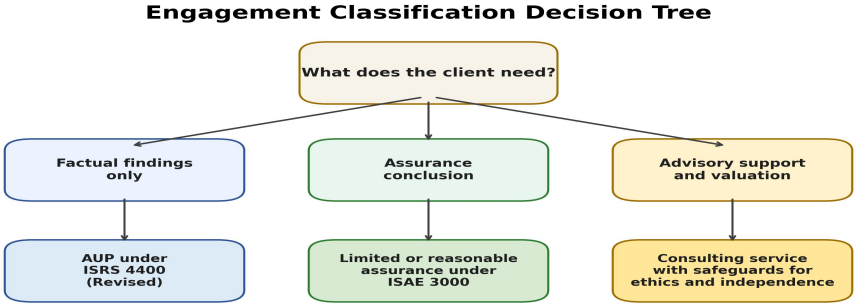

Figure 2. Engagement classification decision tree for due diligence services.

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3. Materials and Methods

This article uses a qualitative conceptual design. The research design combines document analysis, comparative mapping and design-science reasoning. Document analysis was applied to professional standards and guidance that are directly or indirectly relevant to due diligence services in audit firms, including ISRS 4400 (Revised), ISAE 3000 (Revised), ISQM 1, OECD due diligence guidance, ISO 31000 and contemporary sustainability due diligence developments. Comparative mapping was used to identify common principles across these sources: scope clarity, risk identification, evidence sufficiency, ethical safeguards, quality management, communication and documentation.

Design-science reasoning was used because the purpose of the study is not only to describe due diligence practice but to construct a practical methodology that can be implemented by audit firms. The proposed methodology is therefore presented as an artifact: a structured sequence of stages, templates, risk scoring tools, quality gates and reporting components. The design criteria were practical applicability, compatibility with professional standards, scalability for different sizes of audit firms, transparency of professional judgment and usefulness for decision-makers.

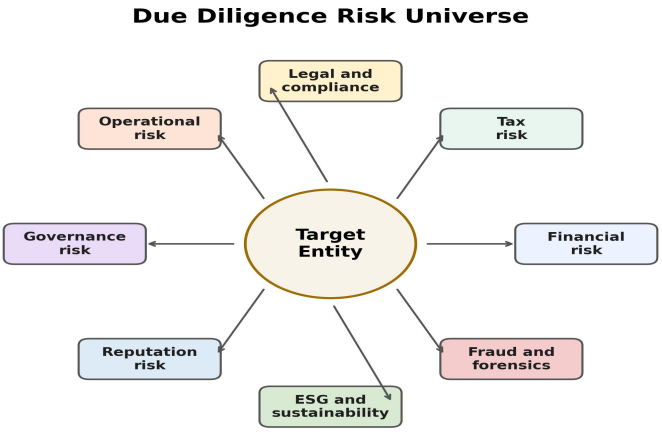

Figure 3. Risk universe used to structure due diligence procedures.

4. Results

The main result of the study is a structured risk-based due diligence methodology that audit firms can use as an internal methodological framework. The methodology is designed to be flexible: it can be applied to full-scope transaction due diligence or to narrower reviews covering selected risk blocks. It does not replace professional standards or legal requirements. Rather, it operates as an internal system for organizing professional judgment, documentation, procedures and reporting.

The methodology contains seven stages. Each stage has a specific purpose, input, procedure set, documentation requirement and quality checkpoint. The stages are sequential but not purely linear. New evidence can require risk reassessment, scope adjustment or specialist consultation. Therefore, the model includes feedback loops, particularly between evidence testing, risk scoring and report review.

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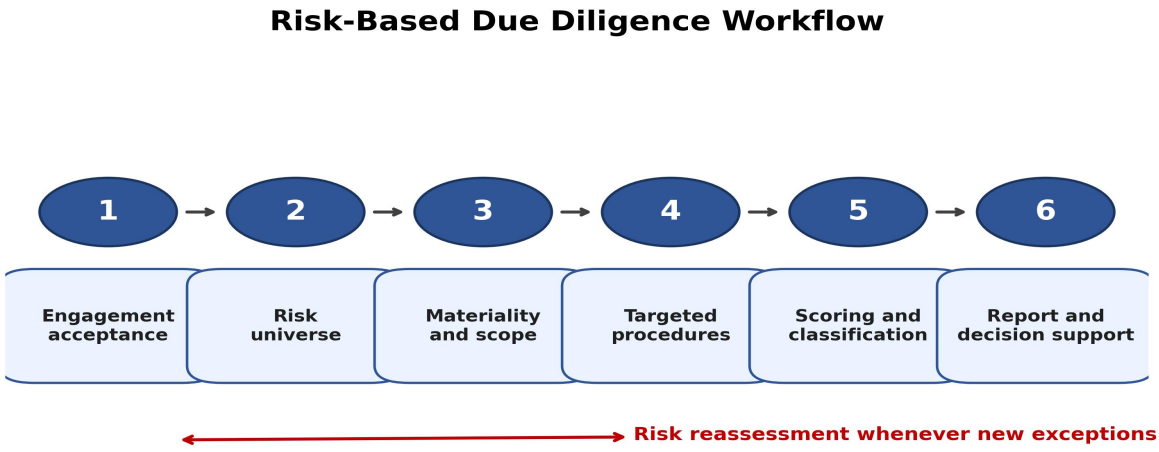

Figure 4. Risk-based due diligence workflow for audit firms.

4.1. Stage 1: Engagement acceptance and ethical screening

The first stage determines whether the audit firm should accept or continue the due diligence engagement. The acceptance decision should consider independence, conflicts of interest, competence, resources, reputation risk, legal restrictions and the intended use of the report. In many cases, due diligence is requested by a potential investor, buyer or lender, while the target entity provides the documents. This creates a three-party information environment where access rights, confidentiality and responsibility for information must be clearly defined.

The engagement team should document the identity of the engaging party, target entity, intended users, purpose of the report, expected deliverables, restrictions on distribution and any limitations in access to information. If the work is to be performed as an agreed-upon procedures engagement, the procedures and reporting format must be agreed in sufficient detail. If an assurance conclusion is expected, the firm must assess whether suitable criteria and sufficient appropriate evidence can be obtained. If the engagement is advisory, the firm must consider safeguards against self-review, advocacy or management responsibility threats.

4.3. Stage 3: Risk-universe construction

The third stage constructs the risk universe of the target entity. This is a structured list of potential risk areas that may affect the engagement objective. A standard risk universe should include financial risk, tax risk, legal and compliance risk, operational risk, governance risk, reputation risk, ESG risk and fraud risk. However, the model should remain adaptable. For banks, insurers and regulated entities, regulatory capital, prudential ratios and compliance risks may be central. For manufacturing companies, inventory, environmental obligations and supply-chain dependencies may be more important. For technology firms, intellectual property, cybersecurity and revenue recognition may dominate.

The risk universe should be documented in a risk register. Each risk item should include a risk description, source of risk, possible impact, likelihood, relevant documents, planned procedures, responsible team member, specialist involvement and current status. This register becomes the central control tool of the engagement. It prevents duplication, supports supervision and makes it easier to explain how the final report was derived from the original risk assessment.

Table 3. Risk blocks, indicators and evidence sources in the proposed methodology.

Risk block	Key indicators	Main evidence	Typical

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		sources	procedures
Financial	Revenue quality, EBITDA normalization, working capital, debt-like items	Financial statements, trial balance, contracts, bank records	Trend analysis, reconciliation, normalization, debt schedule review
Tax	Tax arrears, uncertain positions, transfer pricing, VAT exposure	Tax returns, reconciliations, correspondence, assessments	Compliance review, exposure calculation, tax authority correspondence analysis
Legal	Ownership, litigation, licenses, material contracts	Charter documents, contracts, court records, registers	Contract review, litigation summary, legal confirmation
Operational	Customer concentration, supplier dependence, capacity, continuity	Sales data, procurement data, production reports, KPIs	Concentration analysis, site review, process walkthrough
Governance	Related parties, control environment, board oversight	Minutes, policies, internal audit reports, ownership data	Related-party mapping, control assessment, governance gap analysis
ESG and reputation	Environmental exposure, labor issues, sanctions, public controversy	ESG reports, permits, media, regulator notices	Screening, permit review, incident analysis, reputational scan
Fraud	Unusual journals, override, round sums, hidden liabilities	General ledger, journal entries, emails, supporting documents	Anomaly testing, forensic interviews, red-flag review

4.4. Stage 4: Evidence planning and procedure design

The fourth stage translates risk assessment into procedures. This is where a structured methodology creates clear advantages over checklist-based practice. Each procedure should be linked to a risk statement. For example, if the risk statement is that reported EBITDA is overstated due to non-recurring income, the procedure may require reconciliation of management accounts to audited financial statements, review of other income, analysis of one-off transactions and normalization adjustments. If the risk statement is that tax liabilities are understated, procedures may include reconciliation of tax returns to accounting records, review of open tax audits and calculation of potential penalties.

Evidence planning should also define the level of evidence required. High-risk findings should not rely only on management explanations. They require documentary evidence, external confirmations where feasible, analytical corroboration or specialist review. Lower-risk areas may be covered through inquiry, limited document review or ratio analysis. The methodology therefore links risk rating to evidence depth, which improves efficiency and consistency.

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4.5. Stage 5: Analytical testing and exception evaluation

The fifth stage performs the planned procedures and evaluates exceptions. Analytical testing should include horizontal analysis, vertical analysis, ratio analysis, cash-flow analysis, working-capital analysis, debt and commitment review, tax reconciliation, related-party analysis and trend comparison. Where data are available, audit firms may also use data analytics, such as transaction stratification, duplicate testing, Benford-type screening, outlier identification, journal-entry analysis and dashboard visualization.

Every exception should be evaluated according to cause, evidence, amount, likelihood, impact and possible transaction implication. This avoids a common weakness in due diligence reports: listing many observations without explaining which matters are decision-critical. Exception evaluation should distinguish between information gaps, control weaknesses, confirmed exposures, contingent risks and negotiation points.

4.6. Stage 6: Risk scoring and classification

The sixth stage converts due diligence findings into a structured risk profile. The proposed model uses a 5-point likelihood scale and a 5-point impact scale. The total score equals likelihood multiplied by impact. Scores from 1 to 5 are classified as low, 6 to 12 as medium, 13 to 19 as high and 20 to 25 as critical. The purpose of scoring is not to replace professional judgment but to make judgment transparent, comparable and explainable. Each score should be supported by a short rationale and evidence reference.

Risk scoring should be applied at two levels. At the individual finding level, each exception receives a score. At the risk-block level, an aggregate score is calculated based on weighted findings. The weights may reflect the engagement objective. In a financial due diligence engagement, financial and tax risks may have higher weights. In sustainability due diligence, ESG, governance and supply-chain risks may receive higher weights. The final report should disclose the scoring logic to avoid misleading precision.

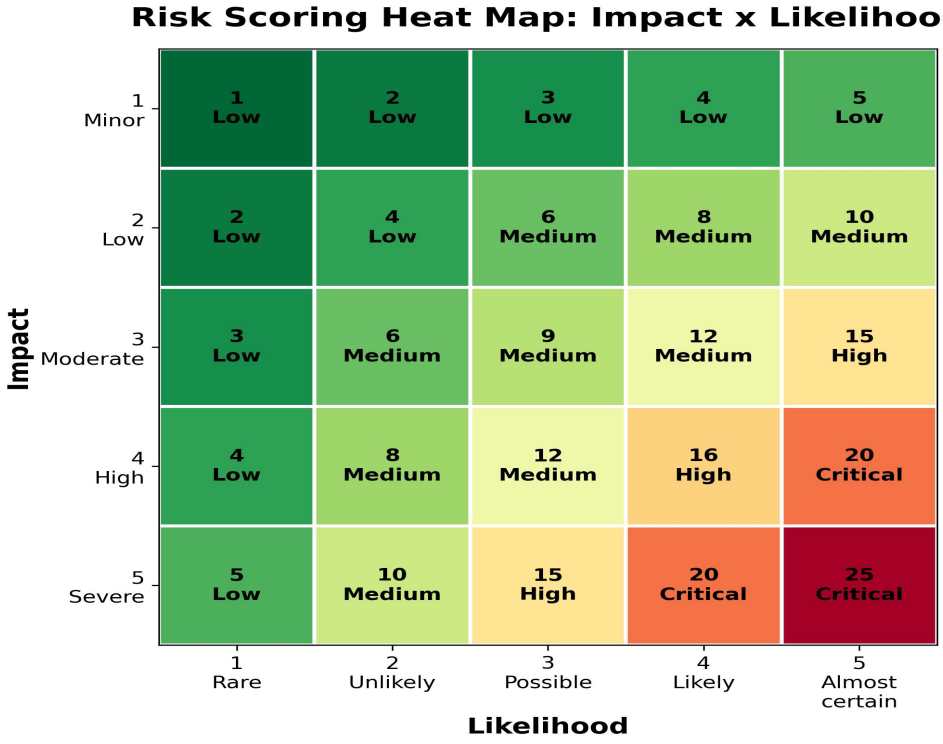

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Figure 5. Impact-likelihood heat map for due diligence risk scoring.

4.7. Stage 7: Decision-oriented reporting

The seventh stage communicates the results. A due diligence report should not be a collection of working paper summaries. It should be a decision-oriented document that explains what was done, what was found, how serious the findings are, what limitations exist and what the user should consider before making a decision. The proposed report architecture includes an executive summary, scope and limitations, risk heat map, key findings by risk block, quantified exposures, quality of earnings analysis where relevant, tax and legal exposure summary, governance and ESG observations, recommended actions, appendices and evidence references.

5. Discussion

The proposed methodology has several implications for audit-firm practice. First, it changes the starting point of due diligence from document collection to risk understanding. This is important because a long document list does not guarantee effective due diligence. Without a risk logic, teams may spend excessive time on low-risk documents and overlook high-impact issues. A risk-universe approach creates a disciplined link between the engagement objective, risk assessment, evidence strategy and report content.

Second, the methodology supports consistency across engagements. Many audit firms rely on experienced professionals who have strong practical knowledge but use different approaches to documentation and scoring. This may be acceptable in small engagements, but it becomes problematic when firms expand due diligence services, involve multiple offices or train new personnel. Standardized working papers, quality gates and scoring rules create a common internal language while preserving professional judgment.

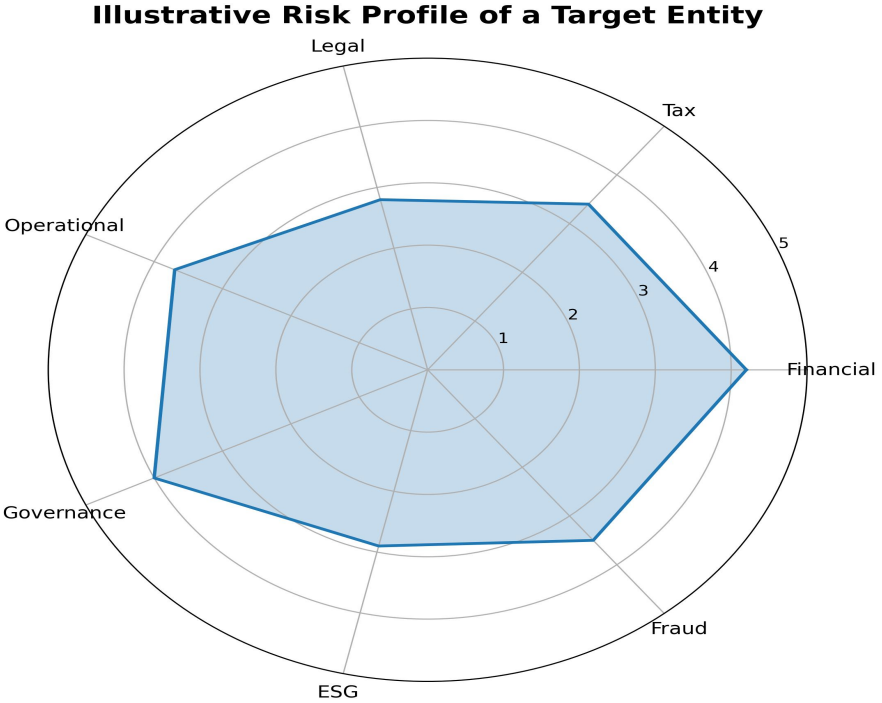

Figure 6. Illustrative risk profile by due diligence risk block.

Third, the methodology clarifies the boundary between agreed-upon procedures, assurance and advisory services. This boundary is essential for avoiding misleading reports. Users may assume that a due diligence report provides assurance similar to an audit opinion, even when the practitioner has only performed selected procedures. Clear engagement classification and careful reporting language reduce expectation gaps and protect both users and audit firms.

Fourth, risk scoring increases decision usefulness but must be applied carefully. Numerical scores can create a false impression of precision if they are not supported by clear criteria and evidence. Therefore, each score should be accompanied by a narrative explanation, evidence reference and description of limitations. The scoring model should also be calibrated to the engagement objective. A risk that is critical in a lending due diligence engagement may be less significant in a strategic market-entry review, and vice versa.

6. Conclusion

This article developed a structured due diligence methodology for audit firms from a risk-based perspective. The proposed methodology responds to a practical problem: due diligence engagements are often performed through fragmented checklists, inconsistent procedures and descriptive reports that do not sufficiently classify risk severity. By integrating engagement acceptance, scope definition, risk-universe construction, evidence planning, analytical testing, risk scoring and decision-oriented reporting, audit firms can make due diligence services more consistent, transparent and useful for decision-makers.

The core contribution of the article is the transformation of due diligence from a document-driven process into a risk-driven professional service. The proposed framework links each risk area to procedures, evidence, working papers, scoring and reporting. It also embeds quality management gates throughout the engagement, reflecting the importance of firm-level systems, competence, ethical safeguards, review and monitoring. The methodology is compatible with agreed-upon procedures, assurance and advisory engagements, provided that the engagement classification and reporting language are clearly defined.

For audit firms, the practical recommendation is to develop internal due diligence standards that include a risk register, procedure matrix, evidence hierarchy, scoring scale, exception log, report architecture and quality review checklist. For researchers, the proposed model can be tested through expert surveys, case studies, archival engagement-file analysis or comparative studies across audit firms. For regulators and professional bodies, the model highlights the need to clarify the professional boundaries of due diligence services and encourage consistent documentation practices. Overall, a risk-based due diligence methodology can strengthen the role of audit firms in investment decisions, corporate governance, transaction transparency and responsible business conduc

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