

Due Diligence Interviews in a Forensic Analysis

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This discussion summarizes forensic analysis best practices related to the conduct of a management due diligence interview. Conducting a successful due diligence interview is not a science. However, it does require a combination of preparation and years of practical experience. In order for the due diligence interview to be successful, the interview should involve (1) sufficient forensic analyst preparation time and (2) ensuring that the forensic analyst interviews the right individuals.

INTRODUCTION

A subject entity can be either a plaintiff or a defendant in a litigation matter. A subject entity may become involved in litigation (or other disputed matters) on different occasions.

Forensic analysts are typically retained by legal counsel to a disputing party with regard to one or more of the following issues:

- Valuations
- Damages measurements
- Shareholder disputes
- Bankruptcy
- Mergers and acquisitions
- Transfer pricing disputes
- Tax evasion
- Special investigations

A forensic analyst gathers information from and about the subject entity throughout the due diligence process.

However, a forensic analyst's engagement may not be limited to the above-listed issues. Typically,

a forensic analyst may be retained by the subject entity's owner or management (or by its legal counsel) to assist with and render an opinion regarding a forensic investigation. In the context of this discussion, forensic analysts could be accountants, financial consultants, economists, or any other type of consultant.

This discussion summarizes many of the best practices and procedures for due diligence that a forensic analyst may follow. Before discussing the due diligence procedures, it may be helpful to define what due diligence is and is not.

Due diligence is an investigation, audit, or review conducted to ascertain the relevant facts or details pertaining to a subject under investigation.¹

Due diligence in the financial world entails a comprehensive review of financial records related to pending litigation or other disputed matters. The due diligence process assists the forensic analyst in formulating an unbiased opinion regarding the resolution of litigation or other disputed matters.

An appropriate due diligence has many phases. And, for purposes this discussion, we will consider



due diligence best practices related to the “management interview.”

The management due diligence interview can provide information to the forensic analyst that cannot be gleaned from document review alone. Engaging with management provides the analyst with context that parties outside the subject entity or industry may not be privy to. The analyst may develop an understanding of the relevant factors for the subject entity and the industry through management interviews.

Additionally, these discussions may reveal issues with the financial statements that may have previously been considered insignificant during the original review. Therefore, the due diligence interview is often useful for the forensic engagement. The forensic analyst can better understand the engagement by planning for and conducting a due diligence interview.

A due diligence interview can be conducted with any employee of the subject entity (typically in person, via phone, Zoom, interrogatories). As a rule, “management” refers to the entire organization, from staff accountants to the board of directors (in the case of a public subject entity).

As part of the due diligence process, the forensic analyst may also speak with third parties (e.g., former employees, independent auditors, counsel, commercial bankers, contractors, clients, suppliers).

Due diligence interviews with management typically provide the forensic analyst with more infor-

mation than other sources about the subject entity, ownership interest, or the matter.

The forensic analyst may be provided with source documents (i.e., financial statements, general ledger transactions, bank statements, and depositions) as additional sources of information in preparation for the due diligence interview. However, these source documents do not always tell the whole story.

Frequently, the forensic analyst’s information acquisition during the due diligence interview aids in the development, completion, and reporting of the forensic analyst’s conclusion.

Forensic analysts typically produce an expert report for legal proceedings or expert testimony

before a judge or jury.

With regard to internal investigations, the analyst’s forensic report is provided to the subject entity’s executives or board of directors in many cases. Based on the findings, the forensic analyst is then tasked with formulating recommendations for the subject entity, the ownership interest, or the issue at hand.

Each forensic engagement connected with a lawsuit or other disputed matter may incorporate a due diligence interview. The due diligence interview may help counsel working with the forensic analyst to understand what to expect during the due diligence interview process.

The following issues will be addressed in this discussion:

1. Best practices regarding the due diligence interview process
2. Typical due diligence interview agenda
3. Typical questions that the forensic analyst may ask during the due diligence interview process

MANAGEMENT DUE DILIGENCE INTERVIEW²

There is no one way for a forensic analyst to conduct a management due diligence interview. Each forensic analyst will develop his or her own unique style, refined over time through trial and error.

Some forensic analysts conduct their interviews with a greater or lesser degree of structure, technology, travel, and so on. Whether or not a client can communicate and understand what is being asked of them during an interview depends on whether the forensic analyst can effectively communicate the interview questions.

For a due diligence interview to be successful, the forensic analyst should be adequately prepared to conduct the interview. What does that mean? To the best of their abilities, forensic analysts should examine and interpret all information provided in the engagement document request, all court filings, and all public data regarding the subject entity or the industries in which it operates.

The following best practices may be considered in a forensic analyst's preparation for a due diligence interview:

1. Conduct an in-depth examination of the subject entity's website and any other publicly available data.
2. Conduct a thorough review of all documents provided by the subject entity's management and counsel.
3. Review, examine, and analyze financial statements of the subject entity, both historical and prospective.
4. Examine the subject entity's website and any other publicly accessible data in detail.
5. Prepare a list of specific questions to ask each person interviewed during the due diligence interview process.

After reviewing documents provided by appropriate parties and developing due diligence interview questions, the forensic analyst should identify the subject entity's appropriate individuals to interview.

The individuals the forensic analyst may interview will vary according to the engagement. Senior management and key employees, legal counsel, independent accountants or consultants, suppliers, customers, and former employees are sometimes interviewed.

The primary goal of the due diligence interview is for the forensic analyst to ascertain the truth. As the forensic analyst conducts the due diligence



interview, the forensic analyst should filter out any information not relevant to the matter.

The primary goal of the forensic analyst is to ask the interviewee clear and direct questions. If the interviewee does not provide the necessary information or answer the question adequately, the forensic analyst is responsible for asking follow-up questions or obtaining additional documents.

The objective for the forensic analyst is to remain focused so that he or she may formulate a clear and concise conclusion; therefore, unnecessary information should be eliminated.

It is a best practice for the forensic analyst to consider the possible objectives and motives of the interviewee before conducting the interview. For instance, management may provide answers about the reliability of their organization's financials that align with the incentives and metrics to which their individual performance is graded, therefore compromising their statements' unbiased nature and validity.

A forensic analyst's responsibility is to use discretion regarding the interviewees' unique motivations in these cases.

During the due diligence interview, it is possible that new or unexpected issues may be discovered, which may or may not have a significant impact on the engagement. The forensic analyst should understand the important issues and how these issues affect the forensic analysis conclusions.

THE DUE DILIGENCE INTERVIEW AGENDA

The interview style and process are individual to each case. Ordinary sense, staff availability, and

other circumstantial realities often dictate the logistical practicality of the meeting. The forensic analyst rarely has control over what happens during the interview process.

Senior management is busy running their businesses and is often tied or called to duty during the interview. Before the management due diligence interview, the forensic analyst should communicate and effectively coordinate with the appropriate parties (i.e., senior management, counsel, bankers, accountants) when, where, and what time the due diligence interview is scheduled to take place.

The forensic analyst should review the engagement budget to see what time is allotted, including travel time.

The following list provides a sample agenda for a due diligence interview:

- Tour the entity's facility
- Conduct interviews with the owners and senior management to understand the big picture items of the subject entity or subject interest
- Conduct interviews with financial personnel, line managers, and any other identified personnel to ascertain an understanding and description of the business's critical internal and external components
- Follow up with senior management or other subject entity personnel if there are any unresolved questions or additional questions after the due diligence interview
- Discuss any new or previously unknown issues that may affect the forensic analyst's conclusion with counsel, if any

The forensic analyst should better understand the subject entity or interest when leaving the due diligence interview.

BEST PRACTICES REGARDING INTERVIEW QUESTIONS

There is no standardized list of due diligence interview questions that a forensic analyst should ask. The list of questions presented in Exhibit 1 is not intended to be comprehensive or all-inclusive. After reviewing the documents received during the initial document request, the forensic analyst should develop his or her own list of questions.

The forensic analyst may consider the following areas when developing due diligence interview questions: (1) background and history, (2) ownership and capital structure, (3) services and product lines,

(4) customer and supplier relationships, (5) management and personnel, (6) contractual relationships, (7) competitors and industry overview, (8) financial results and information, (9) contractual relationships, and (10) litigation and other material facts.

SUMMARY AND CONCLUSION

The due diligence interview is one of several components of a forensic analysis in connection with litigation or other disputed matter. As a result, the forensic analyst should be proficient in conducting interviews. The due diligence interview is helpful because the answers provided by the interviewee may directly affect the forensic analyst's conclusion.

When the entity or object of interest presents material issues, the due diligence interview provides an opportunity to resolve them. The primary objective of the due diligence interview is to allow the forensic analyst to ask and receive answers to questions.

In addition, the due diligence interview may elicit information that the forensic analyst is not aware of before the interview. Exhibit 1 presents a list of questions the analyst may consider during a due diligence interview. Exhibit 1 is not an exhaustive list. Rather, it is intended to serve as a reference which forensic analysts may use or modify as they prepare for a due diligence interview.

Each forensic analysis may be different. Therefore, neither the interview question list below nor the information above should replace the forensic analyst's professional judgment.

Notes:

1. "Due Diligence Definition & Uses for Stocks," Investopedia, <https://www.investopedia.com/terms/d/duediligence.asp>.
2. Robert F. Reilly and Robert P. Schweih, *Best Practices: Thought Leadership Valuation, Damages, and Transfer Price Analysis* (Ventnor, NJ: Valuation Products and Services, 2019).



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Exhibit 1 Due Diligence Interview Sample Questions

The following is a list of possible interview questions for a due diligence interview. While this is not an exhaustive list of questions that a forensic analyst may ask during the due diligence interview, the following list provides a starting point to prepare for the interview.

Background and History

- When was the subject entity founded, who founded it, and if there has been sufficient ownership change since its inception?
- What are the subject entity's current entity status (e.g., corporation, partnership, limited liability company, sole proprietorship, etc.) and tax status?
- Describe the evolution of the subject entity lines of business since its inception and the subject entity's current lines of business.
- List all related parties that the subject entity does business with. In addition, indicate all names of any divisions or subsidiaries in which the subject entity owns an equity interest.
- Describe each location maintained by the subject entity and its primary activity.
- Describe any restrictions on transferring the subject entity's equity interests (i.e., buy-sell agreements, restricted stock agreements, etc.).
- Discuss any other key dates or events in the subject entity's history.

Product Lines (Services) and Marketing

- Describe the nature of the subject entity's (a) manufactured and/or sold products or (b) provided services.
- Which product line or service offered is the fastest growing and the slowest growing?
- What is the largest product sold or service offered by the subject entity over the last five years, and how has this product mix changed over time?
- Describe the subject entity's markets and how it distributes its products or services. Are subject entity's sales either seasonal or cyclical?
- What is the typical life cycle of the subject entity's products/services?
- What are the advantages/disadvantages of the subject entity's products/services?
- Does the product/service have any rival technology, products, or services that affect future demand?

Customer

- Why do customers want to use or purchase the subject entity's product/services?
- List the top 10 customers by revenue for the last five years.
- Does an annual customer sales exceed 10 percent of revenue? If so, who is that customer? Is there any risk of losing that customer? How does the subject entity intend to mitigate that loss if the customer leaves?
- Does the subject entity have contracts or exclusive vendor agreements with certain customers?
- What does the subject entity's backlog look like? Are there any large contracts pending?
- How does the subject entity set prices? Are there substitutes for either subject entities?

Suppliers

- What raw materials or other supplies are the subject entity dependent on?
- Who are the firm's suppliers?
- What is the subject entity's supplier count?
- Are any of those suppliers the subject entity's sole source of supply?
- How long has the subject entity had a business relationship with each of its key suppliers?
- Are any suppliers the sole (or primary) source of a particular product for the industry?

Exhibit 1 (cont.) Due Diligence Interview Sample Questions

- Explain how supplies were/are priced.
- What is the current supply-cost trend?
- List and provide copies of any long-term supply contracts or other special purchasing arrangements with suppliers that you have in place.
- How much notice does the subject entity or the supplier need to end the business relationship? Could the subject entity change suppliers without hurting the business? If so, why or why not?
- If the subject entity needed to find a new supplier for a critical supply, (1) could it do so and (2) how long would it take?

Management and Employees

- Provide a copy of the most current organization chart and resumes for key management team members.
- How long has the subject entity employed the key members of the management team?
- Do any of the key members of the management team have known health issues, or are any of the key members of the management team close to retirement age?
- Provide the total compensation for each subject entity management team member, including perquisites.
- What unions represent the subject entity's employees, and when do the contracts expire?
- Collective bargaining agreements cover how many employees?
- Has the subject entity experienced any work stoppages due to a strike?
- What is the total number of employees in each organizational area: executive management, operating/service delivery, marketing/sales, accounting, and administration/personnel? What are the most critical skills and backgrounds needed to develop, produce, and distribute the subject entity's products/services?
- List the members of the subject entity's board of directors and describe each member's background.

Subject Entity Outlook

- Describe the subject entity's advantages, disadvantages, opportunities, and threats.
- What are the expected annual growth in revenue, operating profit, and net profit over the next five years?
- How is it possible that the actual financial results will far outperform the projected financial results?
- What level of capital investment is required to support the projected growth?
- Is the annual budget or forecast regarded as conservative, standard, or aggressive? How do the projected growth rates and profit margins compare to the historical rates and profit margins?
- Is the subject entity planning to change its ownership in the future (via share buybacks or share issuance)?

Industry and Economy

- What national or regional economic factors influence the subject entity's sales (for example, interest rates, inflation, disposable income, and so on)?
- What distinguishes the subject entity from other companies in the industry?
- How has the subject entity fared during recent downturns? During a good economic period?
- Is government regulation an issue in the industry? If so, how so?
- In what stage of the industry life cycle is the subject entity industry (introduction, growth, maturity, or decline)?
- What are the most recent significant developments or trends in the industry?
- How many companies in the industry are the approximate size (e.g., revenue within plus or minus 50%)?
- Is the industry dominated by small "mom-and-pop" businesses or large multi-national corporations?
- Describe the entry barriers in the industry.
- How has the industry's size changed in the last five or the next five years?

Exhibit 1 (cont.) Due Diligence Interview Sample Questions

- Is the subject entity's technology considered (1) outdated, (2) current, or (3) cutting-edge in comparison to the industry standard?
- What trade associations are the subject entity a member of?

Competition

- Who are the subject entity's most significant competitors? List both publicly traded and privately owned competitors.
- In terms of revenue, how big are the competitors?
- Where can I find competitors?
- What is the subject entity's estimated competitor market share for each of its products and services?
- What are the main advantages and disadvantages of competitors compared to the subject entity?
- What factors drive competition in this industry (e.g., price, quality, service, technology, or some other factor)?
- Do the competitors of the subject entity have greater or lesser economies of scale than the subject entity?
- How has competition changed in the last five years (new competitors, regulatory changes affecting competition, pricing power erosion, etc.)?
- How intense is the competition among companies in the industry?

Historical Financial Results

- Provide a copy of the auditor's letters to management for the previous five years, if applicable.
- Describe the subject entity's accounting principles (e.g., revenue recognition methods, cash versus accrual basis, and inventory accounting methods).
- Have accounting principles changed in the development of financial statements over the last five years?
- Explain any significant year-over-year changes in the financial statement accounts (for example, the interviewee should explain changes such as (1) a 50 percent annual increase in accounts payable, (2) a 15 percent annual decrease in sales, or (3) the gross margin improved from 30 percent to 40 percent of sales).
- Describe any nonrecurring or unusual income or expenses you have had in the last five years.
- What capital expenditure plans does the subject entity have for the next 12 months?
- Are there any stockholders who are guarantors of corporate loans? If so, please explain.
- Describe the short- and long-term credit sources, as well as how you used them over the last five years.
- Is the current capital structure (1) sustainable and (2) likely to change in the next five years?
- Discuss the dividend history of the subject entity and the outlook for future dividend payments.
- Summarize any assets owned by the subject entity that are (1) nonoperating assets or (2) excess assets. That is, are there any assets that do not contribute to the subject entity's primary operations (e.g., cash and cash equivalents are not needed for future working capital or capital expenditures)? Describe any assets or liabilities of the subject entity that are not recorded on the subject entity balance sheet.

Source: Robert F. Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership Valuation, Damages, and Transfer Price Analysis* (Ventnor, NJ: Valuation Products and Services, 2019).