

# The Due Diligence Interview in Forensic Analysis Engagements

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*This discussion provides forensic analysts with a road map to follow to conduct effective due diligence interviews. This is an important topic for both novice and experienced forensic analysts. Forensic analysts that have practiced for many years may take the due diligence interview for granted. After all, these analysts may have conducted dozens or even hundreds of due diligence interviews over their careers. However, as summarized in this discussion, the forensic analyst should not be dismissive of the due diligence interview. This is because (1) it can be a “hot topic” during deposition and trial expert testimony cross-examination and (2) a failure to conduct a proper due diligence interview may result in an unfavorable result in a forensic analysis engagement. In forensic analysis engagements, the dollars at stake are often substantial. Therefore, if a management interview is available, the forensic analyst should spend sufficient time (1) preparing for the due diligence interview (and not just relying on his or her past experience with conducting due diligence interviews) and (2) meeting with appropriate company management.*

## INTRODUCTION

Forensic analysts are commonly asked to prepare business valuation (or solvency/insolvency, transfer price, or lost profits/economic damages) analyses for various forensic and dispute resolution purposes. These various controversy-related purposes may relate to taxation, bankruptcy, lender liability, shareholder disputes, GAAP compliance, intellectual property, contract disputes, condemnation/ eminent domain, and other controversies.

In the commercial forensic analysis assignment, the forensic analyst often conducts a due diligence interview (the “management interview”) as part of the assignment. The forensic analyst may learn more about the subject company and the subject interest from the management interview than from any other single source, including from documents provided by the client and/or the subject company.

Accordingly, information obtained by the forensic analyst in the management interview often affects the subject valuation, transfer price, economic damages, or other analysis conclusion.

Every business and every subject ownership interest has unique attributes. This axiom is especially true for a business valuation prepared for commercial litigation purposes. The management interview is important to the forensic analysis. This is because it is often where the analyst learns the unique attributes of the subject ownership company and the subject interest.

For example, let’s consider a subject company that owns a chain of 10 regional grocery stores. The grocery industry:

1. is well covered by analysts and
2. is comprised of publicly traded companies that are relatively similar to each other.

Therefore, this hypothetical subject company would appear to be easy to analyze. However, the management interview may disclose unique attributes about the subject regional grocery chain.

Examples of such unique (and not obvious) attributes of this hypothetical grocery chain include the following:

1. The company generates a significant amount of sales from its private label line of products.
2. The company uses an inventory accounting method that is not normal for the industry.
3. The company management is nearing retirement age.
4. The company is planning a significant information technology upgrade.
5. The company auditors identified material weakness in the company's internal controls.

It is noteworthy that these factors are meant to be illustrative of the types of issues that:

1. may not be evident by analyzing company-provided documents,
2. may have a material impact on the value of the subject interest, and
3. are most likely discovered during the management interview.

An analysis of these unique attributes will help the forensic analyst determine:

1. if valuation adjustments are appropriate;
2. where the selected valuation pricing multiples should be relative to the comparable publicly traded companies (if the financial analyst relies on a market approach valuation method);
3. whether the estimated discount rate should be adjusted upward or downward from the discount rate derived for the industry (if the analyst relies on an income approach valuation method); and/or
4. if other similar valuation adjustments are appropriate.

The September 2010 decision in the dissenting shareholder appraisal rights case of *Albert Trostel & Sons Company* (“ATS”) v. *Edward U. Notz and Sandra Keep Notz* (collectively, “Notz”)<sup>1</sup> provides an example of the importance of the management interview in commercial litigation.

The opposing valuation experts in this case relied on different financial projections. According to the District Court decision, the financial projections that the two experts relied on had a material impact on their valuation conclusion.

Through his management interviews and document review, the ATS valuation expert determined that the financial projections were unreasonably

optimistic. The ATS valuation expert requested and received updated financial projections that reflected a more realistic forecast.

Conversely, the Notz valuation expert relied on the original (and more optimistic) forecast.

In its decision, the District Court wrote that the revised forecast that the ATS valuation expert relied on, “appropriately reflects management’s then-current view of the business in terms of finances and operations, and provides the best estimate and expectations for the business going forward.”

The District Court decision ultimately favored the ATS valuation expert. By conducting effective management interviews, the ATS valuation expert uncovered facts about the financial projections that helped the client to achieve a favorable judicial decision.

The remainder of this discussion summarizes:

1. best practices related to the due diligence management interview and
2. typical questions that forensic analysts ask during the due diligence interview process.

## BEST PRACTICES RELATED TO THE DUE DILIGENCE INTERVIEW

There are many ways to conduct the management interview. And, there is certainly no “right” way to conduct the management interview. However, there are some procedural issues that will help the forensic analyst conduct an effective management interview.

First, the forensic analyst should be thoroughly prepared to conduct the interview. The motto “be prepared” is good advice for every aspect of the forensic analysis assignment. It is especially true for the management interview.

Good preparation typically includes the following procedures:

1. Review the subject company’s website and other publicly available data about the subject company.
2. Review documents provided by the subject company and/or the client.
3. Review and analyze the subject company historical and projected financial statements, and pay particular attention to the year-to-year change in the financial statement accounts.
4. Research the subject company’s industry and regional economy (if applicable).
5. Prepare a specific list of detailed questions to ask each party during the management interview.

Second, it is important that the analyst interviews the correct people. Determining the correct people to interview is a collaborative process, with participation of the client, the client's legal counsel, and the subject company. The correct people to interview will vary with every assignment.

Therefore, the analyst should discuss with the client the general topics that will be covered during the management interview. And, the analyst should request to interview the people that are knowledgeable regarding the proposed interview topics.

In some assignments, it may be useful to interview outsiders. Outsiders that the forensic analyst may consider interviewing include the company:

1. attorneys,
2. accountant,
3. banker,
4. customers,
5. suppliers,
6. competitors, and/or
7. former employees.

The forensic analyst should balance the need for client confidentiality with the need for information when determining who to interview.

Third, the forensic analyst should understand the interviewee's bias, if any. The role of the analyst is typically to estimate value, damages, or some other quantitative variable of a subject interest, free of bias. In a commercial litigation assignment, there are usually two sides seeking two very different outcomes.

For example, in a dissenting shareholder matter, the subject company (and management) may want a transaction to close and the dissenting shareholders may want to stop the transaction from closing (or to receive fair value for their shares). In a situation such as this where the subject company management may have bias, it is important that the interviewer (1) be diligent in asking questions and (2) be especially prepared to ask follow up questions.

In most assignments, and especially when the management team has worked for the company for a long time, the company management has much more information about the subject company than the analyst has. This gives the subject company management an advantage in presenting a particular point of view.

However, the forensic analyst can uncover the unbiased truth about the issues related to the subject company and the subject interest by:

1. being sufficiently prepared (see the discussion above), and
2. understanding the potential bias of the interviewee.

Fourth, the due diligence interview should not necessarily be restricted to one interview session. Let's assume that the forensic analyst follows the guidance discussed above—that is, he or she (1) is prepared, (2) interviews the correct people, and (3) filters out potential bias. Nonetheless, the initial due diligence interview often uncovers unique issues about the subject company or the subject interest.

These issues may require the forensic analyst to conduct additional research and, consequently, conduct additional follow-up interviews with the subject company management.

New and unique issues that are uncovered in the initial management interview are often the issues that are the most controversial in the forensic analysis assignment. Forensic analysts on different sides of a forensic analysis assignment often conduct similar analyses and make the same assumptions for most issues in a particular valuation assignment.

It is usually the treatment of just a few unique and material issues that swing the value, price, damages, or other analysis conclusion significantly one way or another.

Understanding what the specific and material issues are and how the issues affect value, and then presenting a persuasive argument for the treatment of these issues, can result in a favorable outcome for the client and the client's legal counsel.

The management interview is an important part of discovering these issues in a forensic analysis assignment.

## CAVEATS REGARDING THE LIST OF QUESTIONS

It is important to consider several caveats regarding the use of any standardized list, including the list of management interview questions that is presented on the following pages.

First, the following list is not intended to be comprehensive and all-inclusive. For example, the list does not cover the unique questions that would be appropriate to ask if the subject company was a hospital.

And second, not every question listed is appropriate for every project. The list provided below is generally applicable to the valuation of an ownership

interest in an operating company. The list provided below should not substitute for the analyst's independent judgment.

## SUMMARY AND CONCLUSION

The management interview is often a common part of the controversy-related valuation, lost profits, or economic damages assignment. Therefore, it is important that forensic analysts know how to conduct an effective management interview.

The management interview may be an important procedure. This is because it may affect the outcome of the forensic analysis assignment. When unique and material issues are present in a company or for a subject interest, the management interview is often where these issues are uncovered.

The primary purpose of the management interview is to enable the analyst to get questions answered. In addition, the management interview is also used to uncover information that the forensic analyst may not already know about.

A list of due diligence interview questions is presented below. As mentioned above, this list is not intended to be comprehensive. It is presented as a reference that the analyst can use to generate ideas when preparing for a management interview.

Every situation has unique attributes. And, both the list provided below and information provided above should not substitute for the independent judgment of the forensic analyst.

### Note:

1. *Albert Trostel & Sons Company v. Edward U. Notz and Sandra Keep Notz*, 2010 WL 3835117 (E.D. Wis.).

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## Forensic Analysis Due Diligence Illustrative Interview Questions

For purposes of this discussion, the management interview questions are categorized into three principal categories: (1) questions related to the subject company operations, (2) questions related to the industry and economy, and (3) questions related to the subject company financial statements. Within these three principal categories, there are several subcategories.

The list below provides a "Top 15" list of questions for each subcategory of questions.

Even a well-prepared interviewer will fail to ask the perfect questions to uncover all material issues. Therefore, at the end of the interview, the analyst may ask each interviewee a catch-all question. For example, the analyst may ask, "Do you know of any information that has not been covered and that could have a bearing on the valuation of the company?" This type of question may compel company management to discuss any material information that they may have been deliberately hiding during the interview.

### Questions Related to the Company Operations

This category of questions helps the forensic analyst to understand how the subject company operates. By asking these questions, the analyst will gain an understanding of the business risks and opportunities that exist for the subject company. Every forensic analysis engagement has unique attributes. These questions help uncover the factors that are unique to a particular engagement.

#### Company History and Organization

1. When was the company founded?
2. Describe the key events in the company history.
3. Describe any historical mergers, acquisitions, or divestitures.
4. Describe any historical ownership changes.
5. Describe any historical changes in the company lines of business.
6. Describe any historical changes in the geographic area served.
7. Provide a list of company owners and the respective ownership interests.

8. Are any of the owners active in the business? If yes, explain.
9. Is the stock subject to any stockholders' agreement, stock restriction agreement, buy-sell agreement, etc.?
10. List the names of subsidiaries of the company or ownership interests in other companies, including the percentage owned by the parent company.
11. List all known related parties (including subsidiaries, affiliates, or relatives) that the company does business with.
12. List the states where the company currently transacts business.
13. List the locations of the company facilities and the primary activity at each (i.e., manufacturing plant, sales office, etc.), including whether the location is owned or leased.
14. List all historical transactions in the common stock of the company in the five years prior to the valuation date. Describe the circumstances surrounding each of the transactions, including whether the transaction was arm's-length.
15. List all current litigation classified by (a) claims against the company and (b) claims on behalf of the company.

### **Products or Services Offered**

1. List and describe the company's products/services and the approximate proportion of the most recent fiscal year sales and gross profit produced by each.
2. How are products/services priced?
3. What products compete with the company's products?
4. What are the products' advantages and disadvantages versus its competitors?
5. Why do customers select your company to provide products or services instead of other companies?
6. How long is a typical product/service sale cycle?
7. How frequently are products changed/modified?
8. Which product lines have reported the fastest sales growth, which have reported the slowest sales growth?
9. Which product lines are the most profitable, and which are the least profitable?
10. Does the company have patents, technology, or expertise that prevents or hinders other companies from duplicating its products or services?
11. List any products or services that are unique, or not easily duplicated by new or existing competitors.
12. Are sales of the company products cyclical?
13. Are sales of the company products seasonal? If so, what are typically the strongest and weakest months for the company sales?
14. What are the company plans for future products/services?
15. Describe the research and development activities of the company.

### **Manufacturing**

1. What percentage of products is manufactured by the company and what percentage is manufactured by a third party?
2. Where are the company's products manufactured?
3. Describe the company's manufacturing process.
4. Is the manufacturing process labor intensive or capital intensive?
5. What is the age and condition of the company's manufacturing facilities?
6. What is plant capacity relative to the current operating levels?
7. Who is the plant manager and how long has he or she been employed by the company?
8. Does the company have any planned expansion of its manufacturing facilities?
9. Does the company have any planned asset dispositions related to its manufacturing facilities?
10. How do the manufacturing facilities compare to similar companies in the industry?
11. Do the manufacturing facilities enable the company to earn superior or inferior profit margins compared to similar companies in the industry? Why?
12. How technologically advanced are the company's manufacturing processes?
13. Are the manufacturing employees unionized?
14. Describe the company's relationship with its manufacturing employees.
15. Does the company have any legal issues such as workers compensation claims resulting from the manufacturing process?

## Customers

1. Provide an overview of the company's customer base.
2. How are the company's products used by customers?
3. List the ten largest customers (as measured by sales) for the most recent fiscal years, and the percentage of total sales made to each of those customers.
4. For the company's largest customers (as measured by sales), how long has that person or company been a customer of the company?
5. Does the company provide credit to any of its customers? If so, describe the conditions in which the company offers credit and the credit terms offered by the company.
6. Do customers tend to consistently purchase goods and services from the same company, or do they switch?
7. Identify the most important markets for the company's product/services.
8. What are the key recent trends in each of these markets?
9. Are the company's key markets increasing, decreasing, or stable?
10. Does the company have any existing contracts with customers? If so, provide copies of representative contracts.
11. Approximately how many customers does the company have?
12. Approximately what percent of your business has the company served continuously for at least the past two years?
13. Are there any large contracts, significant new customers, or new markets that the company anticipates adding during the next 12 months?
14. Are there any large contracts, existing customers, or present markets that the company expects to lose, terminate, or abandon during the next 12 months?
15. Does the company sell products or provide services to federal, state, or local governments or governmental agencies? If so, what percent of the company's total business is from federal, state, or local governments or governmental agencies?

## Suppliers

1. What raw materials or other supplies does the company rely on?
2. Who are the company suppliers?
3. How many suppliers does the company have?
4. Are any of those suppliers the sole source of supply for the company?
5. For each key supplier, how long has the company had a business relationship with that supplier?
6. Are any of your suppliers the only (or primary) entity that supplies the industry with a particular product?
7. Describe how supplies were/are priced?
8. What is the trend in the cost of supplies?
9. List and provide copies of any long-term supply contracts or other special purchasing arrangements in place with suppliers.
10. How much notice is required by either the company or the supplier to terminate the business relationship?
11. Could the company switch suppliers without a detrimental impact on the business? Why or why not?
12. If the company had to find a new supplier for a key supply, (a) could it and (b) how long would it take to find a new supplier?
13. Has the company considered becoming more vertically integrated by acquiring a supplier or by expanding its line of business?
14. To what extent does the company fabricate versus assemble products, and how much flexibility does the company have in this respect?
15. Does the company use derivatives or other hedging to protect against increasing prices?

## Marketing

1. What is the approximate total size of the market (in dollars) for the products offered by the company?
2. What is the estimated company market share for each of the products and services offered?
3. How has the company's market share for each of the products and services offered changed in the last five years? Ten years?
4. What are the key selling features of the company's products (i.e., price, product quality, brand name, service, etc.)?

5. What warranty does the company offer for its products or services? And, how frequent do customers submit warranty claims and/or make returns?
6. How intense is the competition in the industry?
7. How are the company's products priced?
8. Describe how new business opportunities are identified, followed-up, prioritized and pursued, and by whom.
9. What distribution channels does the company use for its products (i.e., retailers, distributors, direct sales, etc.)?
10. How is technology used in the company's marketing?
11. Describe any changes in the marketing budget from year-to-year.
12. Describe the experience and tenure of the sales staff.
13. Does the company depend on one or small number of employee to generate sales?
14. Describe the historical turnover in the sales staff.
15. On what basis are the company's sales people compensated?

## Management and Employees

1. Provide a copy of the most current organization chart, along with resumes for key members of the management team.
2. How long have the key members of the management team been employed by the company?
3. 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?
4. Provide the total compensation for each member of the company management team, including perquisites.
5. How many hours per week do each of the key members of the management team spend working for the company?
6. How many employees does the company have?
7. What unions represent the company's employees, and when do the contracts expire?
8. How many employees are covered by collective bargaining agreements?
9. Has the company experienced any work stoppages due to a strike?
10. What is the total number of employees in each organizational area: executive management, operating/service delivery, marketing/sales, accounting, and administration/personnel.
11. What are the most critical skills and backgrounds needed in the development, production, and distribution of the company's products/services?
12. Identify any key positions that have been difficult to fill due to shortages of labor with appropriate skills.
13. Describe the current labor market for the company's industry. That is, is the supply of employee candidates robust or sparse?
14. How extensively are independent contractors used?
15. List the members of the company's board of directors and provide a description of the background of each member.

## Company Outlook

1. Describe the company strengths, weaknesses, opportunities, and threats.
2. What are the most important things the company must accomplish to be successful over next five years?
3. What is the expected annual growth over next five years in revenue, operating profit, and net profit?
4. What is the biggest risk to achieving the projected financial results?
5. How could the actual financial results greatly exceed the projected financial results?
6. What is the level of capital spending required to support the projected growth?
7. What are the known large and infrequent capital expenditures that will be made within the next five years (e.g., a plant expansion, an IT upgrade, the replacement of machinery)?
8. Do you expect any changes in the product lines or service lines offered by the company in the next five years (either expansion or contraction)?
9. Are there any internal factors that constrain growth, such as lack of access to capital or insufficient cash?
10. Does the company plan to acquire other companies in the next five years?
11. Are the company's profit margins expected to change over the next five years? Why or why not?
12. Does the company prepare an annual budget or a forecast? Describe the process to create the annual budget and/or forecast.
13. Is the annual budget or forecast considered conservative, baseline, or aggressive?

14. How do the projected growth and profit margins compare to historical growth and profit margins?
15. Does the company plan to change the ownership in the future (through share buybacks or the issuance of shares)?

## Questions Related to Industry and Economic Factors That Affect the Company

These questions help put the subject company in context relative to other similarly situated companies. These questions also help the analyst to understand the long-term outlook for company.

### Industry and Economy

1. What national or regional economic factors impact the company's sales (e.g., interest rates, inflation, disposable income, etc.)?
2. How does your company differ from other companies in the industry?
3. How has the company performed in recent recessions? During a strong economy?
4. Is government regulation a factor in your business? If so, how?
5. What stage of the industry life cycle is the subject company industry in (i.e., introduction, growth, maturity, or decline)?
6. What are the most important recent developments or trends in your industry?
7. How many companies of your approximate size (e.g., revenue within plus or minus 50 percent) are in the industry?
8. Is the industry generally comprised of small "mom-and-pop" companies or large multi-national companies?
9. Describe the barriers to entry in your industry.
10. How has the size of the industry changed in the last five years?
11. How is the size of the industry expected to change in the next five years?
12. What level of innovation and/or change is required to stay competitive in the industry?
13. Does the company generally lead or lag the industry in new products, pricing, and other similar factors?
14. Is the technology employed at your company considered (a) outdated, (b) current, or (c) leading edge compared to the industry standard?
15. What trade associations does the company belong to?

### Competition

1. Who are the most significant competitors of the company? List publicly traded competitors as well as privately owned competitors.
2. Does the company follow the financial results and/or public filings of any publicly traded companies? List which ones.
3. How large are competitors in terms of revenues?
4. Where are competitors located?
5. What is the estimated competitor market share for each of the products and services offered by the company?
6. What are the key strengths and weaknesses of competitors versus the subject company?
7. On what basis do companies in this industry compete (e.g., price, quality, service, technology, or some other basis)?
8. How often do the company's customers switch between the company and its competitors?
9. How easy is it for the company customers to switch between the company and its competitors?
10. Do any competitors have proprietary technology or patents that give them a competitive advantage over the company?
11. Do the company's competitors have greater or weaker economies of scale compared to the company?
12. How has competition changed in the last five years (i.e., new competitors, regulatory changes that affected competition, erosion of pricing power, etc.)?
13. How does branding help (or hurt) the company to compete? Or, are the company products unbranded and viewed like a commodity by the company's customers?
14. For each product or service line, if the company bids on a project, (a) what companies is it typically competing against and (b) why is/isn't the company successful in winning the bid?
15. How intense is the competition amongst firms in your industry?

## Questions Related to Company Financial Statements

Understanding the subject company financial statements is an important procedure. This is because of the significant impact the financial statements have on the value of the subject interest in the subject company. An in-depth discussion of the subject company historical financial statements will also clue the analyst in to any financial statement adjustments that may be necessary.

The analyst should have a general understanding of each line item on the financial statements and a thorough understanding of the material line items (as determined by the independent judgment of the analyst).

Consider, for example, the company's accounts receivable. The analyst may need to understand:

1. if company management considers the stated receivables to be collectable,
2. how long receivables typically remain outstanding,
3. what customer accounts are included in the accounts receivable account,
4. if the receivables are the result of company sales or other business activities, and/or
5. other similar issues.

Questions that relate to each line item of the financial statements are not included in the list below. These questions have not been included primarily because the number of questions that relate to the specific line items in the financial statements cannot be condensed into a "Top 15" list.

## Historical Financial Results

1. If applicable, provide a copy of the auditor's letters to management for the past five years.
2. Describe the accounting principles used by the company (e.g., revenue recognition methods, cash versus accrual basis, and inventory accounting methods).
3. Have there been any changes in accounting principles in the development of the financial statements over the past five years?
4. How do the current accounting principles compare to the accounting principles used by other companies in the industry?
5. Explain all significant year-over-year changes in the financial statement accounts (e.g., the interviewee should explain changes such as (a) a 50 percent annual increase in accounts payable, (b) a 15 percent annual decrease in sales, or (c) the gross margin improved from 30 percent of sales to 40 percent of sales).
6. Describe any nonrecurring or extraordinary income or expenses during the past five years.
7. What plans does the company have for capital expenditures over the next 12 months?
8. Has the company received any offers to buy the company during the past five years? If so, describe the details of each offer or provide a copy of any written offers received.
9. Are any stockholders guarantors of corporate loans? If yes, explain.
10. Describe short- and long-term sources of credit and how they were used over the past five years.
11. Is the current capital structure (a) sustainable and (b) expected to change over the next five years?
12. Has the company been compliant with all loan covenants? If not, explain why.
13. Discuss the company's dividend history and the outlook for future dividend payments.
14. Summarize any assets owned by the company that may be classified as (a) nonoperating assets or (b) excess assets. That is, are there any assets that do not contribute to the primary operations of the company (e.g., cash and cash equivalents that are not needed for future working capital or capital expenditures).
15. Describe any company assets or liabilities that are not recorded on the company balance sheet.