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FREE TOOL FOR BUSINESS BUYERS

The Deal Red-Flag Checklist

18 things to check in a target's financials before you make an offer — the same first pass I run on every deal.

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Before you sign an LOI, run the business through this list.

It's the same first pass I make on every deal after 15 years reading small-business financials from the bank's side of the desk. Work top to bottom. Anything you can't answer is itself a flag — and the questions you can't get answered before the LOI rarely get easier after it.

Nothing here requires an accounting background. It requires asking, and refusing to move on until you have a real answer.

● **GREEN** Good sign — proceed	● **YELLOW** Dig deeper before you offer	● **RED** Serious — resolve or walk

WHAT CHANGED IN THE 2026 EDITION

Seven checks were added this year because they are now among the most common ways a deal breaks late: reconciling bank deposits to reported revenue; the SBA rules that changed on June 1, 2025 and quietly reprice a lot of LOIs; multi-state sales tax exposure that can reach back into years of unfiled returns; contractor-versus-employee classification; tariff and input-cost movement; whether the revenue itself still holds up against AI-driven demand shifts; and how the seller behaves when the questions get specific.

Earnings & add-backs

- [ ] **1. Reported profit vs. add-backs**
  Add up the add-backs used to build the SDE. Are they documented and reasonable?
  Red flag if the SDE leans on large "miscellaneous" or undocumented add-backs you can't trace to a receipt or statement.

- [ ] **2. One-time / non-recurring income**
  Look for grants, one-off project sales, insurance proceeds, or legal settlements inflating the year being sold on.
  Red flag if a strong year was propped up by income that will not happen again.

- [ ] **3. Owner compensation**
  Check whether the owner's pay is added back at a realistic replacement level.
  Red flag if they add back a full salary but you'll still have to hire someone to do their job.

- [ ] **4. Tax return vs. P&L match**
  Compare the internal P&L to the filed federal tax return.
  Red flag if the P&L shows more profit than the tax return — a dressed-up "for-sale" version of the books.

- [ ] **5. Proof of cash**
  Lay 12 months of bank statements next to reported revenue, month by month. Deposits should reconcile to the top line.
  Red flag if deposits don't tie to reported revenue and nobody can explain the gap. This is the single fastest test of whether the books are real, and it is the first thing a lender will run.

Revenue quality

- [ ] **6. Customer concentration**
  Get revenue by customer for three years — not a summary, the actual breakdown.
  Red flag if any single customer is more than roughly 20–25% of revenue. Note that diligence routinely finds true concentration materially higher than what was represented before the LOI.

- [ ] **7. Revenue trend (3 years + TTM)**
  Chart revenue across the last three years and the trailing twelve months.
  Red flag if the last 12 months are sliding while the price assumes growth.

- [ ] **8. Recurring vs. one-time revenue**
  Separate revenue that repeats each year from project-by-project work.
  Red flag if "stable" revenue is actually re-won from scratch every single year.

- [ ] **9. Revenue durability**
  Ask what this business looks like in five years. Whether demand is exposed to AI substitution, tariff-driven customer pullback, or a platform or referral source you don't control.
  Red flag if the earnings are real today but the demand behind them is structurally exposed and the price assumes it holds.

Margins & costs

- [ ] **10. Gross margin trend**
  See whether margins are holding or shrinking as costs rise.
  Red flag if input costs went up but customer prices never did — the seller absorbed the squeeze and you inherit it.

- [ ] **11. Input cost & supply exposure**
  For anything that buys materials, parts, or inventory: ask where it's sourced and what tariffs or freight changes have done to landed cost in the last 18 months.
  Red flag if recent quotes from suppliers are materially higher than what's reflected in the financials you're pricing on.

- [ ] **12. Hidden or below-market costs**
  Check rent, and any costs the owner covers personally that you'd inherit.
  Red flag if the building is owner-owned and rent is below market — your real costs jump the day you close.

Balance sheet & cash

- [ ] **13. Working-capital needs**
  Estimate the cash the business needs to operate between doing the work and getting paid.
  Red flag if you'll have to inject cash on day one just to keep it running — and nobody priced that into the deal.

- [ ] **14. Accounts-receivable aging**
  Pull the A/R aging and see how much is over 60 and 90 days.
  Red flag if a large share of "revenue" is old and may never collect.

- [ ] **15. Deferred maintenance & capex**
  Check the age and condition of equipment, vehicles, and systems. Sellers often cut maintenance and hiring in the year before a sale to make earnings look better.
  Red flag if big replacement costs are waiting for you right after closing.

Tax & compliance exposure

- [ ] **16. Sales tax nexus exposure**
  Ask which states the business collects and files sales tax in, and compare that to where it actually sells and delivers. Ask for the filings.
  Red flag if the business sells across state lines or sells taxable services and has never filed in those states. Where no return was ever filed, the clock never started — a state can go back to the first year nexus existed, and exposure in these situations is commonly quoted at 5–15% of historical revenue plus penalties. In an asset purchase this can still follow the buyer.

- [ ] **17. Worker classification**
  Find out how many workers are paid on a 1099 rather than W-2, and whether those roles look like employees in practice — set hours, company tools, supervision, long tenure.
  Red flag if the margins depend on treating a crew of workers as contractors. Reclassification brings back payroll taxes, penalties, and interest, and it is an active IRS focus area.

Owner & people

- [ ] **18. Owner-dependency**
  Ask where estimating, pricing, key relationships, and licenses actually live.
  Red flag if the business is really the owner — and the value leaves when they do.

- [ ] **19. Key staff & licensing**
  Confirm whether critical people will stay, and whether a required license is tied to one person.
  Red flag if one technician or manager holds the license or owns the client relationships.

Deal structure & financing

- [ ] **20. Does the structure still work under current SBA rules?**
  If you're using SBA 7(a), the rules changed on June 1, 2025 under SOP 50 10 8. A complete change of ownership now requires a minimum 10% equity injection. A seller note only counts toward that injection if it's on full standby — no principal or interest for the life of the SBA loan — and it can cover no more than half the required injection. If the seller keeps any equity, they generally have to personally guarantee the loan.
  Red flag if your LOI was built on a seller note carrying your down payment, or on terms a seller is unlikely to accept once they understand full standby. Deals structured on the old rules get repriced or die in underwriting.

- [ ] **21. Does the deal pencil?**
  At the asking price and today's rates, do the real earnings cover the loan payments and still leave you a living wage? Your salary and the debt service are one calculation, not two separate hurdles.
  Red flag if the recast earnings barely cover debt service — a coverage ratio under roughly 1.25×, which is the cushion lenders look for. A deal that only pencils in a perfect year is telling you something.

The one that isn't a number

- [ ] **22. How the seller behaves under questions**
  Track how requests get answered. Speed, completeness, and whether the story changes when new documents show up.
  Red flag if documents arrive late or incomplete, explanations shift, or basic facts have to be uncovered through contradiction. Buyers expect rough edges. A seller who won't be straight about the small things is telling you what diligence on the big things will be like.

FREE · 20 MINUTES · NO OBLIGATION

Want a second set of eyes on a real deal?

Book a 20-minute Clarity Call. Bring whatever you have — the listing, the broker's numbers, your LOI — and I'll look at it with you and tell you honestly what I'd examine first. If a full Deal Financial Review makes sense after that, I'll quote it on the call. If it doesn't, you'll still leave knowing more about your deal than you came in with.

20-Minute Clarity Call

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