

## DOCUMENT #21

The Blueprint System™ - Due Diligence Series

# Red Flags Checklist

---

156 warning signs that can save you from disaster

## ABSOLUTE DEAL KILLERS

Walk away immediately if you find ANY of these:

- Refuses to provide tax returns
- Books don't match tax returns by >10%
- Undisclosed lawsuits or major liens
- Lost biggest customer (>30% revenue)
- Environmental contamination hidden
- Criminal activity or fraud evidence

## Financial Red Flags

### Revenue & Sales

#### Declining revenue trend

- 3+ months of decline = investigate

- 6+ months = major concern
- Year-over-year decline = renegotiate

#### ▶ **Customer concentration >25%**

- One customer >25% = high risk
- Top 3 customers >50% = very high risk
- No contracts with major customers = deal killer

#### ⚠ **Unusual revenue patterns**

- Big spike before sale
- Pulling forward future sales
- Channel stuffing indicators
- Seasonal not disclosed

## Expenses & Margins

Red Flag	What to Look For	Severity
Declining margins	GP down >5% YoY	<b>HIGH</b>
Hidden personal expenses	Cars, trips, family on payroll	<b>MEDIUM</b>

Understated expenses	Deferred maintenance, old equipment	<b>HIGH</b>
No expense accruals	Cash basis hiding liabilities	<b>MEDIUM</b>
Rising COGS %	Supplier issues, competition	<b>HIGH</b>

## Operational Red Flags

### Employee Issues

#### ► High turnover (>30% annually)

Check: Employee roster year-over-year

Ask: Why people left, exit interview notes

#### ► Key employee dependencies

- One person has all customer relationships
- Critical knowledge not documented
- No succession planning
- Owner's family in key roles

#### ⚠ Compensation issues

- Below market wages
- No benefits offered

- Contractor misclassification
- Overtime lawsuits pending

## Customer & Market Red Flags

Category	Red Flag	How to Verify	Impact
Contracts	Month-to-month only	Review all agreements	HIGH
Pricing	No increases in 3+ years	Check invoices over time	MEDIUM
Competition	New entrant taking share	Mystery shop competitors	HIGH
Technology	Disruption threat	Industry research	HIGH
Reputation	Bad reviews trending	Check all review sites	MEDIUM

## Legal & Compliance Red Flags

### Litigation Landmines

- Active lawsuits not disclosed
- EEOC or discrimination claims
- Warranty claims trending up
- Regulatory investigations
- IP infringement notices

## Compliance Issues

### ► License & permit problems

- Expired licenses operating anyway
- Missing required permits
- Violations not remedied
- Insurance gaps or cancellations

### ⚠ Tax red flags

- Payroll tax deposits behind
- Sales tax audits pending
- Worker classification issues
- Cash transactions >\$10k

## Asset & Equipment Red Flags

### Physical Asset Issues

Asset Type	Red Flag	Cost Impact
Equipment	Average age >80% of useful life	\$100-500k CapEx needed
Vehicles	Leases expiring <6 months	\$50-200k replacement

Technology	Systems 5+ years old	\$25-100k upgrade
Facility	Deferred maintenance visible	\$50-250k repairs
Inventory	>20% obsolete/slow moving	20-40% write-down

## Seller Behavior Red Flags

### ► Urgency without explanation

- "Must close in 30 days"
- Pushing to skip due diligence
- Emotional about specific dates
- Won't explain rush

**Reality:** Hidden problem about to surface

### ► Information games

- Delays providing requested docs
- "Lost" important records
- Different versions of financials
- Defensive about questions
- Lawyer heavy involvement early






### ⚠ Story changes

- Reason for selling shifts






- Numbers don't match discussions
- New issues keep appearing
- Blames everyone else

## Industry-Specific Red Flags





### Service Businesses

-  No recurring revenue (all project-based)
-  No service agreements
-  Warranty claims rising
-  Seasonal not disclosed
-  Price shopping increasing

### Manufacturing

-  Single supplier dependency
-  EPA violations history
-  Union organizing activity
-  International competition
-  Raw material costs rising

### Retail/Restaurant

-  Lease expiring <2 years
-  Declining foot traffic
-  Online competition growing
-  Minimum wage increases coming

- ⚠️ Yelp reviews declining

## Financial Statement Red Flags

### Balance Sheet Bombs

#### ▶ Working capital issues

- Current ratio <1.0
- Receivables aging >90 days
- Inventory turns declining
- Payables stretched
- Line of credit maxed

#### ▶ Hidden liabilities

- Off-balance sheet obligations
- Personal guarantees by owner
- Pending lawsuits not accrued
- Unfunded pension obligations
- Warranty reserves inadequate

## Due Diligence Process Red Flags



Stage	Red Flag	What It Means
Initial	NDA resistance	Not serious or hiding something
Financial	No CPA-prepared statements	Books likely a mess
Legal	Missing corporate records	Compliance problems likely
Operational	Can't meet key employees	Retention risk or they don't know
Final	Renegotiation attempts	Testing your resolve or new issues

## The Ultimate Red Flag Scoring System

### Score Each Red Flag

- **HIGH (3 points):** Major impact on value/operations
- **MEDIUM (2 points):** Fixable but costly
- **LOW (1 point):** Minor issue

### Total Score Action Guide

- **0-5 points:** Normal deal, proceed
- **6-10 points:** Negotiate price reduction 10-20%
- **11-15 points:** Major restructure needed
- **16+ points:** Walk away

## How to Use This Checklist

## Due Diligence Process

1. **Week 1:** Financial red flags review
2. **Week 2:** Operational assessment
3. **Week 3:** Legal and compliance
4. **Week 4:** Deep dive on findings

## For Each Red Flag Found

1. Document exactly what you found
2. Quantify financial impact
3. Determine if fixable
4. Calculate cost to remedy
5. Decide: Renegotiate, restructure, or run

## Remember: Trust Your Gut

If something feels wrong, it probably is. The best deal you'll ever make might be the one you walk away from.