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03

DUE DILIGENCE

The Due Diligence Handbook

The verification playbook for buyers: what to check, how to check it, and the red flags that should stop a deal cold.

What's Inside

CHAPTER 1

Diligence Is Verification, Not a Vibe

Everything before diligence is the seller's story. Diligence is where you independently verify that story against source documents: bank statements, tax returns, contracts, and customers. The goal is not to kill the deal — it is to confirm exactly what you are buying and reprice anything that turns out different from advertised.

30-60
days of exclusivity a typical LOI grants for diligence

4
workstreams: financial, operational, legal, market

100%
of addbacks should be independently verified

Structure beats intensity. Buyers who wander through diligence chasing random documents miss systematic problems. Buyers who run four parallel workstreams with a checklist finish faster and catch more. This handbook is organized around those four workstreams.

PRO TIP

Diligence pays for itself

Industry lore says most signed LOIs renegotiate or die in diligence. Every reprice is money diligence earned you. A $40K diligence budget that catches a $180K equipment problem returned 4.5x before you even closed.

CHAPTER 2

Financial Diligence

One question: are the earnings real and repeatable? The core technique is triangulation — the same revenue number should appear in the tax returns, the bank deposits, and the POS or invoicing system. When all three agree, believe it. When they diverge, the explanation is the deal.

1. **Tax returns vs. P&Ls (3 years)**
   The tax return is signed under penalty of perjury; the P&L is marketing. Reconcile every gap.
2. **Bank statement proof of cash**
   Trace 12-24 months of deposits against reported revenue. This single step catches most inflated earnings.
3. **Addback verification**
   Demand documentation for every addback. Disallow anything unprovable and reprice.
4. **Revenue quality analysis**
   Recurring vs. one-time, by customer, by month. Seasonality and concentration live here.
5. **AR/AP aging + working capital**
   Old receivables are bad debt in costume. Confirm what working capital conveys with the price.

RED FLAG

The margin drift tell

Gross margin that swings more than a few points year to year without a clear story often signals cost misclassification — sometimes innocent, sometimes engineered to dress up SDE in the listing year. Ask for the general ledger and look at what moved.

CHAPTER 3

Operational Diligence

The business made money for the seller. The operational question is whether it will make money for you — starting the Monday after closing, without the person who built it standing in the room.

Owner dependency audit

- Who do the top 10 customers call? If it's the owner's cell, that's the business
- Who quotes jobs and sets prices?
- Whose name is on the licenses?
- Who do employees actually report to?
- Could the owner take 4 weeks off? Has that ever happened?

Workforce & systems audit

- Key employees: tenure, pay vs. market, flight risk after sale
- Any employee who alone knows critical processes
- Systems: scheduling, CRM, accounting — documented or tribal?
- Equipment age, condition, and replacement schedule
- Supplier concentration and pricing terms

REAL NUMBERS

Price the transition, don't fear it

Owner dependency is the most common finding and it is manageable: a 90-day paid training period, a 3-5 year non-compete with teeth, employee retention bonuses, and a seller note tied to customer retention. Each is a purchase agreement clause — negotiate them, don't hope.

WATCH OUT

Meet the team late, but meet them

Sellers resist buyer-employee contact until late diligence — reasonable. But never close without meeting the 2-3 people the business cannot run without. A key employee learning about the sale on closing day is how they quit on day two.

CHAPTER 4

Legal & Contract Diligence

Legal diligence is where your attorney earns their fee — but you set the priorities. The lease, licenses, and customer contracts kill more main street deals than lawsuits do.

Item	What to verify	Deal impact if broken
Lease	Term left, assignment rights, rate vs. market	No lease = no deal for location businesses
Licenses & permits	Transferability, who qualifies post-sale	Can force delayed closing or dead deal
Customer contracts	Change-of-control clauses, term, pricing	Contracts that die at sale gut the valuation
Liens (UCC search)	Existing debt secured by business assets	Must be paid off or assumed at closing
Litigation & claims	Pending suits, warranty claims, disputes	Escrow or walk, depending on size
Employment matters	Contractor classification, OT compliance, PTO	Misclassification liability transfers in stock sales

PRO TIP

Asset purchase as a shield

Most small deals close as asset purchases partly because the buyer leaves historical liabilities behind. Even then, successor liability exists for some claims — this is why you hire an M&A attorney, not your cousin who does real estate closings.

CHAPTER 5

Customers, Market & Reputation

The outside view is the cheapest diligence you will do and buyers skip it constantly. The business's customers, competitors, and digital footprint will tell you things the data room never will.

- ☑ Read 2 years of Google/Yelp reviews — note trends, not averages
- ☑ Check review response quality: who answers, how fast, how well
- ☑ Mystery shop: call as a customer, request a quote, gauge the experience
- ☑ Interview 3-5 top customers late in diligence (seller on the call is fine)
- ☑ Ask customers: 'would anything change for you if ownership changed?'
- ☑ Map competitors within the service area — who is growing, who is hiring
- ☑ Search permits/court records for the business and the owner
- ☑ Check BBB, contractor boards, and industry-specific rating sites

RED FLAG

Review cliff

A sudden drop in review volume or rating in the last 6-12 months often precedes the numbers turning down — reviews are a leading indicator, revenue is a lagging one. If reviews fell off a cliff, ask exactly what happened and verify the answer.

CHAPTER 6

Red Flags Ranked

Walk away (rarely fixable)

- Seller caught lying about anything material — trust does not recover
- Bank deposits meaningfully below reported revenue
- Business depends on licenses/relationships that cannot transfer
- Undisclosed litigation or tax liens discovered independently
- Landlord will not assign or renew the lease

Negotiate (price it, don't panic)

- Heavy owner dependency — training, non-compete, seller note
- Customer concentration — earnout or retention-based holdback
- Deferred maintenance — repair credit against price
- Weak addback documentation — recast SDE, reprice
- Month-to-month key employees — retention bonuses at close

The skill is telling the columns apart. Left column: character and structural problems that survive any contract language. Right column: economic problems, and economic problems have economic solutions — priced in dollars, written into the agreement.

CHAPTER 7

Running the Process

1. **Week 1 — Data request out**
   Send the full document request list day one. Seller response speed is itself diligence: organized sellers produce documents in days.

2. **Weeks 2-3 — Financial verification**
   Tax return reconciliation, proof of cash, addback audit. Findings here reprice everything else.

3. **Weeks 3-4 — Operational + legal deep dive**
   Site visits, systems review, lease and license work, UCC searches. Attorney and CPA fully engaged.

4. **Weeks 4-5 — Outside view + key people**
   Customer calls, review analysis, key employee meetings under NDA.

5. **Weeks 5-6 — Reprice and paper it**
   Consolidate findings, adjust price or terms, finalize the purchase agreement, schedule closing.

REAL NUMBERS

Budget honestly

Typical main street diligence: attorney $7.5-20K, CPA/QoE work $5-15K, plus inspections. Roughly 1.5-3% of deal value. It is the best money in the entire transaction.

CHAPTER 8

The Master Checklist — Part 1

The condensed 24 — the checks that catch the most problems per hour invested. Part 1: financial and operational.

- ☑ 3 years business tax returns obtained and reconciled to P&Ls
- ☑ 12-24 months bank statements traced to reported revenue
- ☑ Every addback documented or disallowed
- ☑ Customer concentration measured (top 1, top 5, top 10)
- ☑ Revenue split: recurring vs. project vs. one-time
- ☑ AR aging reviewed; bad debt identified
- ☑ Working capital included in price confirmed in writing
- ☑ Owner dependency map completed (sales, ops, licenses, relationships)
- ☑ Key employees identified; retention plan drafted
- ☑ Equipment inspected; replacement capex estimated
- ☑ Final SDE recast complete; price adjusted to findings

CHAPTER 8

The Master Checklist — Part 2

Part 2: legal, market, and closing.

- [x] Lease term, rate, and assignment confirmed with landlord directly
- [x] All licenses confirmed transferable (or path defined)
- [x] Customer contracts checked for change-of-control clauses
- [x] UCC lien search run and clear (or payoff scheduled)
- [x] Litigation search run on business and owner
- [x] Insurance loss runs reviewed (3 years)
- [x] Google review trend analyzed; mystery shop completed
- [x] 3-5 customer interviews done
- [x] Competitor map built
- [x] Seller training period negotiated in writing
- [x] Non-compete scope, geography, and term agreed
- [x] Funds flow and closing checklist reviewed with attorney
- [x] Day-1 and week-1 transition plan written

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