How to calculate income reported K-1 for Partnership or S Corp

Note: The analysis described below is a general concept and may or may not apply to your individual scenario. Each business is unique and you may need to find out additional information about the nature and structure of the business to fully assess the income truly available to the borrower.

Does the K1 (1065 for Partnership or 1120s for S Corp) form show the borrower receiving cash distributions (line 19 on K-1 1065 and line 16 on K-1 1120s) and/or Guaranteed payments (line 4 on K-1 1065) consistent with the business income being used to qualify?

1) YES – Business liquidity analysis is not required – use the appropriate # months average per AUS findings
2) NO – You need to document **both** of the following items.
    a. The borrower has access to the income (either 100% owner or provide partnership agreement or corporate resolution)
    b. The business had adequate liquidity to support the withdrawal of earnings (see below)

Analyzing Business Liquidity and Documenting Adequate Liquidity

1) Complete Trend Analysis (Form 1088)
    a. Validate stable or increasing earnings
2) Review Business Balance Sheet Analysis (Schedule L from 1065 or 1120S returns)
    a. Liquidity Calculation (use column d)
        i. Cash (1d) + Accounts Receivable (2b) + Other Current Assets (6) = **Total Current Assets**
        ii. Accounts Payable (16) + Mortgage Notes & Bonds payable/less than one year (17) + Other Current Liabilities (18) = **Total Current Liabilities**
            1. Total Current Assets – Total Current Liabilities = Current Liquidity (snapshot)
                a. Is total more than ordinary income (box 1 on K-1)?
                    i. YES – Ok to use ordinary income (if solvency and trend analysis are good)
                    ii. NO – **do not use income** or perform further analysis (see below)
    b. Solvency Calculation (Quick Ratio)
        i. Total Current Assets (see above) divided by Total Current Liabilities (see above)
            1. Result > 1 means the business has sufficient solvency to settle current liabilities with current assets
            2. Result < 1 means the business does not have sufficient solvency to settle current liabilities with current assets and would need to rely on future earnings or liquidation of non-current assets which could be detrimental to the business stability
3) Liquidity or Solvency Appear Insufficient – Further Analysis Required
    a. Are mortgage notes and bonds roll over liabilities not truly due in one year (must document)?
    b. How old is the balance sheet from the business returns? Would an updated balance sheet be useful?