



Foundations On-Demand

Liquidity Workbook

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Introduction To Liquidity

This class is part of a series designed to acquaint you to the mortgage banking industry and increase the knowledge of Self-Employed Income.

In this training you will learn:

- What is Liquidity
- When is a Liquidity Test Required?
- The Current Ratio
- The Acid Ratio
- The Cash Ratio

**In each session, you will be provided with the guidelines most commonly used for full documentation loan file requirements.*



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Intro To Liquidity

Notes:

What is Liquidity?

The definition of Liquidity is the ability of a company to meet its financial obligations as they come due.

A **Liquidity Ratio** is an accounting term used to measure a company's ability to pay its short-term debts.

There are three different Liquidity Ratios in accounting:

- The Current Ratio. Sometimes referred to as the working capital ratio
- The Acid Ratio, also known as the quick ratio
- The Cash Ratio



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Intro To Liquidity



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Notes:

When is a Liquidity Test Required?

According to Fannie Mae guidelines:

For **Partnerships and S Corporations** If the Schedule K-1 reflects a documented, stable history of receiving cash distributions of income from the business consistent with the level of business income being used to qualify, then no further documentation of access to the income or adequate business liquidity is required.

But if the Schedule K-1 does not reflect a documented, stable history of distributions, then the lender must confirm adequate business liquidity.

On the **Partnership K-1** you will need to look at line Box 19 Distributions, Code A. If the box is blank or the figure for distributions is less than the Ordinary income in Box 1 (and you need all the income in Box 1) you will need to perform a liquidity test.

For the **S Corporation K-1** you will need to look at Box 16 Items effecting shareholders basis, Code D and compare that to figure in Box 1 Ordinary income. Again, If the box is blank or the figure for distributions is less than the Ordinary income in Box 1 (and you need all the income in Box 1) you will need to perform a liquidity test.



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Notes:

The Current Ratio

What is the Current Ratio?

The **Current Ratio** indicates a company's ability to pay its current liabilities from its current assets. It is done to quickly measure the liquidity of a company. This ratio is typically done on a business that is not relying on inventory to generate income.

Where can you find the assets and current liabilities information? The information can be found on the borrower's Schedule L, if it is completed. The IRS does not require every partnership or S corporation to complete a scheduled L. If it is not completed you will need to have your borrower supply you with a balance sheet because that is what schedule L is.

Calculating the Current Ratio

The formula for the current ratios is Current assets divided by Current liabilities.

Here is an example:

If a company has assets, totaling 50 thousand dollars and they have current liabilities totaling 25 thousand dollars their current ratio is two... or two to one.

Total Assets	\$50,000
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Total Liabilities	\$25,000
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Answer	2 or 2:1
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What does this mean?

You can see that for every \$1 in current liabilities, the company has \$2 in current assets. A current ratio that is better than 1 to 1 is considered good per Fannie Mae Guidelines.



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The Current Ratio



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Notes:

The Acid Ratio

What is the Acid Ratio?

The Acid ratio is also referred to as the quick ratio.

The purpose of this ratio is to measure how well a company can meet its short-term obligations with its most liquid assets. Remember, liquid assets are those that can be quickly turned into cash. Most of the current assets are highly liquid with the exception of inventory, which often takes a longer amount of time to turn into cash.

Where can you find the information needed? The information can be found on the borrowers schedule L ,if it is completed. The IRS does not require every partnership or S corporation to complete a scheduled L. If it is not completed you will need to have your borrow supply you with a balance sheet because that is what schedule L is.



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The Acid Ratio



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Notes:

The Acid Ratio

Calculating the Acid Ratio

The formula for calculating the acid ratio is Cash & Cash Equivalents plus Short-Term Investments plus Accounts Receivable divided by Current Liabilities.

Cash and cash equivalents refer to such things as cash on hand, checking accounts, savings accounts and money market accounts. Short-term investments are any investments that will mature within 90 days, such as U.S. Treasury bills and commercial paper.

Here is an example:

Cash & Cash Equivalents	\$20,000
Short Term Investments	\$5,000
Accounts Receivable	\$10,000
Inventory	\$15,000
Current Liabilities	\$25,000

Answer **1.4 to 1**

You would add the 20K of cash and cash plus the 5k in short term investments plus the 10k in accounts receivable which equals 35K then divide by the 25K in Current Liabilities. Note that the Inventory was not included in the calculation because it is not a liquid asset.



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The Acid Ratio



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Notes:

The Cash Ratio

What is the Cash Ratio?

The final liquidity ratio that we will discuss is the cash ratio. Of the three ratio calculations, the cash ratio is the most stringent measurement of a company's liquidity. Fannie Mae does not mention this ratio in their guidelines as a liquidity test to perform.

However we wanted to review the cash ratio for informational purposes because it is an actual liquidity test in the financial world.

The cash ratio focuses strictly on the cash and cash equivalents of a company. Accounts receivables, inventory, and prepaid expenses are not as easy to convert to cash as cash equivalents are, so they are not considered for this calculation.

Calculating The Cash Ratio

The formula for the cash ratio is: $\text{Cash} + \text{Cash Equivalents}$ divided by $\text{Current Liabilities}$

Here is an example:

Cash & Cash Equivalents	\$20,000
Current Liabilities	\$25,000
Answer	.8 to 1

Notice that the cash ratio is much smaller than the other two ratios. In analyzing the cash ratio, any ratio greater than 0.5 to 1 is considered good in the financial world. In this case, the cash ratio is 0.8 to 1, meaning that for every \$1 in current liabilities, there are \$0.80 in current assets. This formula would not work with Fannie Mae's guideline of a 1 or greater being ok.



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The Cash Ratio



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Notes: