

What is acid test ratio and ROA ratio?

Investors calculate the acid test ratio, also known as the quick ratio or the pounce ratio. This ratio excludes inventory and prepaid expenses, which the current ratio includes, and it limits assets to cash and items that the business can quickly convert to cash. This limited category of assets is known as quick or liquid assets. The acid-text ratio is calculated by dividing the liquid assets by the total current liabilities.

This ratio is also known as the pounce ratio to emphasize that you're calculating for a worst-case scenario, where the business's creditors could pounce on the business and demand quick payment of the business's liabilities. Short term creditors do not have the right to demand immediate payment, except in unusual circumstances. This ratio is a conservative way to look at a business's capability to pay its short-term liabilities.

One factor that affects the bottom-line profitability of a business is whether it uses debt to its advantage. A business may realize a financial leverage gain, meaning it earns more profit on the money it has borrowed than the interest paid for the use of the borrowed money. A good part of a business's net income for the year may be due to financial leverage. The ROA ratio is determined by dividing the earnings before interest and income tax (EBIT) by the net operating assets.

An investor compares the ROA with the interest rate at which the corporation borrowed money. If a business's ROA is 14 percent and the interest rate on its debt is 8 percent, the business's net gain on its capital is 6 percent more than what it's paying in interest.

ROA is a useful ratio for interpreting profit performance, aside from determining financial gain or loss. ROA is called a capital utilization test that measures how profit before interest and income tax was earned on the total capital employed by the business.