

Go with a low flow ratio AST

If you're new to investing, one of the important financial terms you'll encounter is "flow ratio," which reveals how well a company manages its cash flow.

Flow ratio equals (current assets minus cash and marketable securities) divided by (current liabilities minus short-term debt).

Here's how it works:

Consider Johnson & Johnson. For the fiscal year ending in 2001, the company had \$18.47 billion in current assets. Subtract \$3.76 billion in cash and \$4.21 billion in marketable securities, and the balance is \$10.5 billion.

Then take \$8.04 billion in current liabilities and subtract \$0 in short-term debt. Divide \$10.5 billion by \$8.04 billion, and the flow ratio is about 1.31.

A flow ratio below 1.25 is admirable; 1.31 is still respectable.

To better understand the equation, consider a flow ratio's components.

Subtracting cash from current assets leaves mainly accounts receivable and inventories. A strong company will demand rapid payment from its customers, keeping its accounts receivables at low levels. And it will try to keep only minimum inventory on hand. So a low number for this part of the equation is a good sign.

Current liabilities, after debt is subtracted, are usually dominated by accounts payable. That's money a company owes and can temporarily use, interest-free. A high number for this part of the flow ratio is preferred.

Divide an ideally low asset number by an ideally high liability number, and you get a low flow ratio — 1.25 and below. This says that a company is aggressively collecting payment from others, while gradually making its own payments, resulting in having more cash at its disposal.

SOURCE: www.motleyfool.com