Financing Cash Flow: Changes in Debt & Equity

In our series on the cash flow statement, we have examined operating cash flows, which measures cash flow through day-to-day operations, and investing cash flows, which measures the net cash from investment or disposition of long-term assets held by the firm. This month we examine financing cash flows, which pertains to changes in capital funding, namely debt and equity. Cash flows from financing looks at activities that allow a firm to raise capital and repay investors, such as issuing cash dividends, adding or changing loans or issuing or redeeming more stock.

One cannot automatically say with cash flows from financing that a negative number is bad and a positive one is good. Early-stage and high-growth companies are unlikely to generate enough cash from operations to fund investment, so they need to turn to capital providers to issue more company stock or notes and bonds. These firms will have positive cash flows from financing. A more mature company should be generating excess cash from operations that exceeds the investment needs of the company, allowing the firm to reduce its debt, repurchase shares and pay a dividend to shareholders. These firms will tend to have negative cash flows from financing. However, even a mature firm may have positive financing cash flows after issuing debt or equity to fund a large acquisition.

Each line item of the financing cash flows section should be evaluated to understand whether the company is raising capital or repaying capital and what changes are being made to the capital structure—i.e., the proportion of debt to equity. A financing activity only appears on the cash flow statement if there is an exchange of cash during the specified period.

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