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Effect of Cash flow Sensitivity on Financial constraints of Firms: A critical Literature Review

By Ithai Julius Kamenchu[1], Meru University of Science and Technology

Abstract

In Corporate Finance, there has been a heated debate for over twenty five years on whether investment cash flow sensitivity is a measure of financial constraint. Fazzari, Huhhard and Peterson (1988) argue that the Pecking Order Theory predicts that firms facing financial constraints rely more on internal funds and thus will display high investment cash flow sensitivity contrary to the arguments by KZ and Cleary. Secondary data is used to provide a critical review of literature on investment cash flow sensitivity. The study asserts that whether investment cash flow sensitivity is related to firm's financial constraint is still a puzzle. Relevant literature is available from developed economies which include USA, UK, Brazil, India and China. No literature is available from developing economies. Besides financial constraints, empirical studies confirm that investment cash flow sensitivity is affected by other factors which include financial systems, firm's size, age, credit worthiness and industrial structure. There exist no regional or local studies on investment cash flow sensitivity. Furthermore methods of dividing firms into either financially constrained or non-financially constrained pushed the arguments into further controversy. Further research studies are recommended to provide a local outlook on these controversies.

Key Words: *Cash flow sensitivity, Financial Constraints*

[1] Assistant Lecturer (MUST), PhD Candidate (UON), jithai@must.ac.ke;ithai7788@gmail.com