Behavioral Finance

The Interdependent and Intertemporal Nature of Financial Decisions

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Typically, corporate investment, distribution and financing polices are examined in isolation using a static single-equation methodology. In this paper we develop a model that reflects the interdependent nature of financial policies while accounting for the potential effect of adjustment frictions in financial variables.

The model allows firms to determine their investment and financing decisions jointly, as long as the sources of cash equal the uses of cash. As an illustration of this approach, we study the relationship between firms' investment spending and cash flow. A firm's investment, financing and distribution decisions are necessarily interrelated by the identity that sources of cash equal uses of cash. A firm that experiences a one dollar increase in operating cash flow can increase capital expenditures, say, by $1. However, it can also use the incremental cash flow to pay down debt, increase shareholder distributions or make any combination of investment and financing decisions that result in a net response of $1. Furthermore, because of the sources/uses identity, adjustment frictions in any of the firm's decision variables are likely to affect other decision variables in the system.

Our model contains nine equations describing firms' investment (capital expenditures, acquisitions and asset sales), financing (short-term debt issues, long-term debt issues, equity issues and changes in cash balances), and distribution (dividends and share repurchases) decisions. We estimate the model using a Compustat sample that covers 1952–2003.

Results provide strong evidence that ignoring the interdependent and intertemporal nature of financial decisions results in misleading and often incorrect conclusions.

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