UNIVERSITY OF ALBERTA

CPA Speaker Series:

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CEO Inside Debt Incentives and R&D Investment

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ABSTRACT

This paper examines how and when CEO debt-like compensation (i.e., "inside debt") affects R&D investment levels. Inside debt has been proposed as a control mechanism for reducing CEOs' risk-taking incentives, and prior evidence suggests inside debt is negatively associated with R&D. We revisit this relation, hypothesizing and finding that the effect of inside debt on R&D investment depends on whether firms require external debt to fund investments. In particular, we find a negative relation between inside debt and R&D investment for firms with low financial constraints, but this relationship is eliminated or reduced for firms facing high financial constraints. To strengthen our inferences, we show that this result holds for firms that are constrained in their ability to raise debt, but not for firms that are constrained in their ability to issue equity. Further, our results are concentrated among firms for which the marginal investment project is likely to include R&D investment. Our findings contribute to the literature on CEO compensation as a management control system, and provide a richer understanding of the role of debt-like incentives in reducing agency conflicts between shareholders and debtholders.

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