Do Cashflow Performance Metrics Incentivize CEOs To Be Better Innovators?

ABSTRACT: Building on prior research that postulates a positive relationship between firms’ cash flow and innovation output (Levitas and Macfadyen, 2009; Myers and Majlup, 1984; Schumpeter, 1942), we examine whether the use of cash flow performance metrics in CEOs’ compensation contracts has a positive effect on firms’ innovation output. We hypothesize and find that firms using cash flow performance metrics in CEOs’ incentive contracts show higher innovation output and higher product market pricing power; in addition, the higher innovation output is not effected through higher innovation input but through higher innovation efficiency. We find that the incentive effect of cashflow metrics on innovation output exists in both cash grants and equity grants. Further, we find that the incentive effect is stronger for more capable CEOs, more powerful CEOs, and CEOs receiving higher incentive pay. Our findings are consistent with cash flow metrics being useful as managerial incentives that promote firm innovation.