Do Customers Play a Corporate Governance Role?

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Abstract

This paper presents new evidence that corporate customers play a governance role in disciplining managerial behavior. Using a comprehensive dataset of customer-supplier relationships, we show that major downstream firms respond to upstream firms' EPS manipulation - instrumented by variations in the incentive to manipulate - by severing business relationships. Ex ante, the threat of withdrawal by major customers appears to deter upstream firms from engaging in EPS manipulation. Suppliers with short-term incentives strategically reallocate trade credit among customers to retain their largest customers, which mitigates the ex-post impact of customer governance.

Empirical Setting

1. We focus on a specific governance issue: ***short-term earnings management***.
   - We look at one type of EPS manipulation: **EPS-boosting share repurchases** – when firms use repurchases to meet or beat analysts' EPS forecasts.
2. Why do customers care?
   - **Concerns about product quality**: EPS-boosting share buybacks reduce financing capacity, investment, R&D, and productivity (Almeida et al., 2016; 2019).
   - **Concerns about supply stability**: EPS-boosting share buybacks worsen supplier's financial strength, may increase default risk.
3. Customers have a monitoring advantage.
   - ***Investors*** only learn about these repurchases *retrospectively*.
   - ***Customers*** frequently engage in business interactions with their suppliers and may **detect the financial cost of EPS manipulation** from changes in *inventory* and *trade credit provision.*

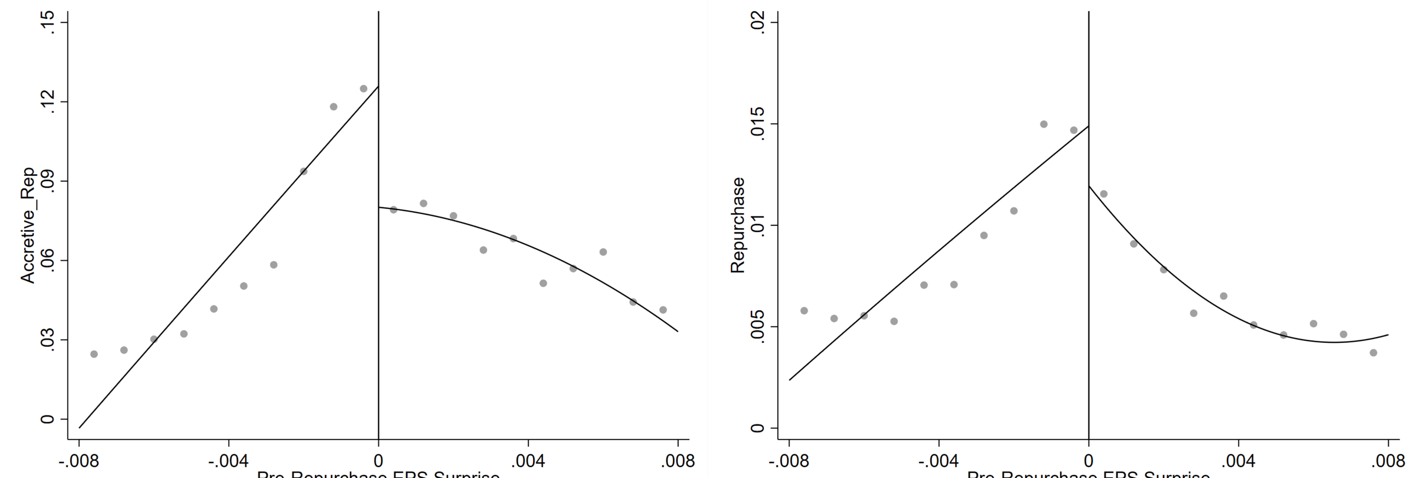
Research Questions

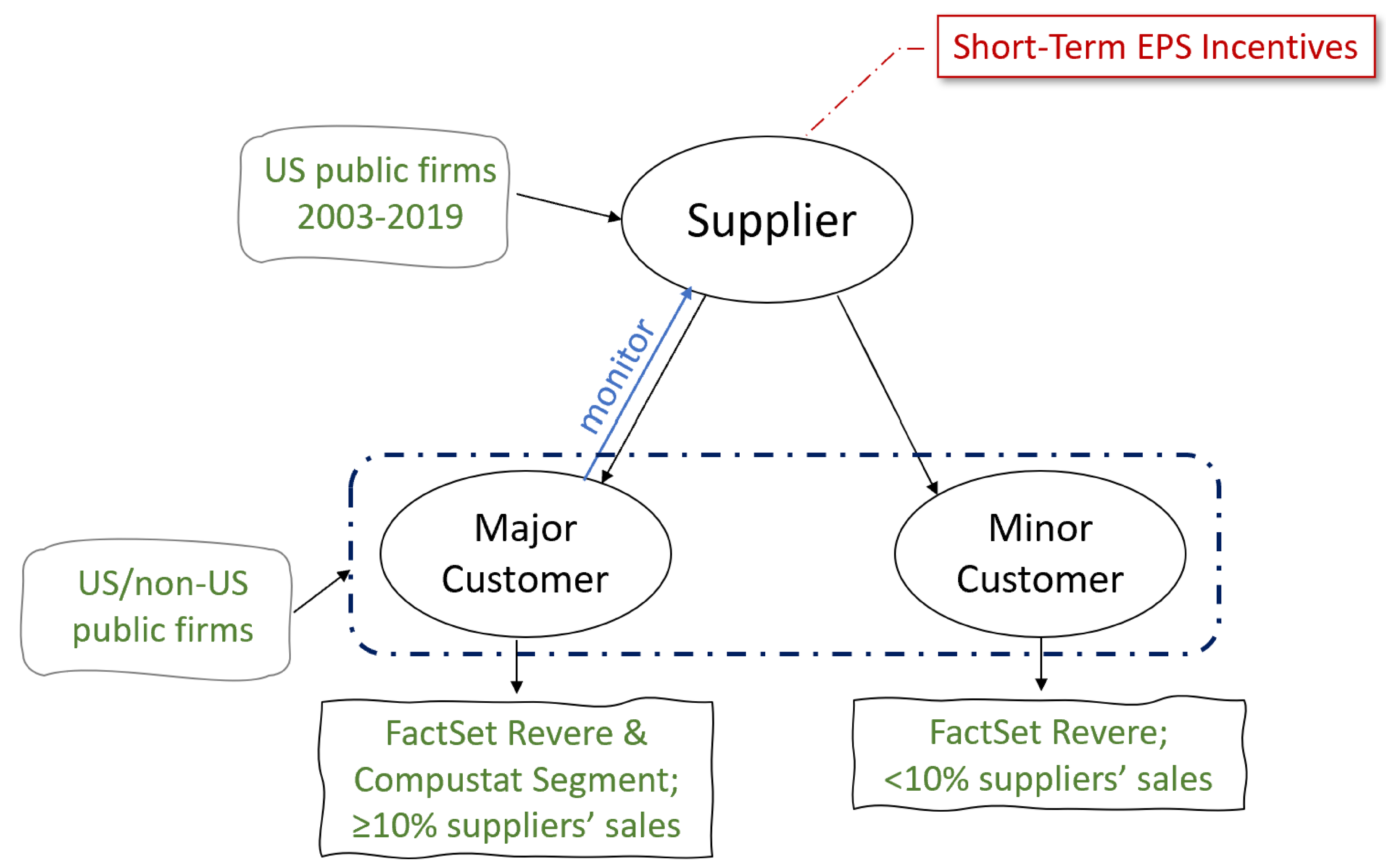
1. Do customers exit supply chain relationships when their suppliers have short-term EPS incentives?
2. If so, is it triggered by customer monitoring?
   - Which customers? Major customers have larger stake, higher incentives to monitor (Cen et al., 2016).
3. Does customer monitoring deter EPS-boosting repurchases ex ante?

Identification Strategy

We use a fuzzy **Regression Discontinuity Design** (RDD):

- ***Discontinuity***: firms are more likely to conduct repurchases when they are about to miss analysts' EPS forecast (Almeida et al., 2016).
- Pre-repurchase EPS surprise = repurchase-adjusted EPS - analysts' forecast.
- To capture firms' incentive to conduct EPS-boosting repurchases:
  - ❖ *Treated Firms*: Neg_Sue = 1, pre-repurchase earnings surprise < 0;
  - ❖ *Control Firms*: Neg_Sue = 0, pre-repurchase earnings surprise ≥ 0.





Results

- Major customers ***exit*** the supply chain relationship when a supplier has short-term EPS incentives.

	Relationship Break						
	OLS			Cox Hazard Model			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Neg_Sue	0.006 (0.007)	0.001 (0.008)	0.001 (0.008)	0.009 (0.030)	0.016 (0.030)	0.009 (0.030)	0.016 (0.030)
Neg_Sue × Major Customer		0.043*** (0.015)	0.045*** (0.015)	0.597*** (0.203)	0.596*** (0.202)	0.597*** (0.203)	0.596*** (0.202)
Observations	47108	47108	47063	85305	85209	85305	85209
R^2	0.651	0.652	0.653				
Controls	No	No	Yes	No	Yes	No	Yes
Supplier*Customer FE	Yes	Yes	Yes				
Customer*Year FE	Yes	Yes	Yes				
S.Industry*C.Industry*Year FE	Yes	Yes	Yes				
Year Strata				Yes	Yes	Yes	Yes
S.Industry Strata				Yes	Yes	No	No
C.Industry Strata				Yes	Yes	No	No
S.Industry*C.Industry Strata				No	No	Yes	Yes

- **Ex-ante effect of customer governance**: the presence and importance of major customers *deter* EPS-boosting repurchases when suppliers have short-term EPS incentives.
- How do short-termist suppliers respond to customer governance?
  - Despite the ex-ante effect of customer governance, EPS-boosting repurchases still *exit in equilibrium* because other factors also matter!
  - How do short-termist suppliers mitigate the consequences?
  - ✓ Short-termist suppliers prioritize their ***largest customer*** at the expense of *other major customers*.
  - ✓ They re-allocate their **trade credit** resources: extend more trade credit to the *largest customer* while cutting trade credit to *other major customers*.

Conclusions

- ❖ ***Major corporate customers*** perform governance functions on their suppliers:
  - ✓ ***Monitor*** suppliers regarding issues such as EPS manipulation.
  - ✓ ***Exit*** the relationship when their suppliers have the incentive to manipulate EPS.
  - ✓ Deter EPS-boosting repurchases ex ante.
- ❖ To mitigate the impact of customer governance, short-termist suppliers retain their *largest customer* by offering more generous trade credit terms.

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