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.

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<thead>
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<th>Relationship Break</th>
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<th>Cox Hazard Model</th>
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<tr>
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<td>(2)</td>
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<tr>
<td>Neg_Sue</td>
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➢ 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.

References