

How Financial Myopia Increases Corporate Risk: An Industry White Paper

This analysis, which is supported by primary data, well-supported theory, and industry examples, explains how financially myopic behavior increases corporate risk. Specifically, the analysis defines financial myopia as a concept and identifies a set of undesirable outcomes that may result when practicing myopic behavior. Each of these outcomes has the potential to increase corporate risk.

Supply Chain Management



Robert J. Trent,
Ph.D.

rjt2@lehigh.edu

February, 2020

Hardly a week passes without a consulting or academic analysis becoming available that addresses the topic of risk. While these analyses often approach risk from different perspectives, most conclude that when a risk becomes a reality the result is usually less than positive. And, these analyses almost always argue that risk is increasingly on the minds of executive leaders. According to Deloitte, Allianz, and IBM (to name several firms that actively research risk), the need to address enterprise and global risk has never been greater.

If executive leaders are concerned about risk, why do so many companies behave in ways that increase rather than decrease their risk exposure? When certain kinds of financial behavior lead to unintended consequences, organizations are engaging in behavior that is described as myopic. The negative outcomes from financially myopic behavior are often subtle, thereby failing to capture the interest or attention of executives and others who study risk management.

Examples of financial myopia and their unintended consequences are not hard to find. Consider the case of a U.S. supplier of specialty metal products that has witnessed its customers taking significantly longer to pay invoices. What customers do not realize, which is part of their myopia, is this supplier has an employee who calculates the financial cost of lengthened payment terms. This supplier then adds this cost into its pricing whenever possible. The supplier will not admit to this practice and, as its business grows, has become more selective regarding which customers it chooses to serve.

The arguments presented here are supported by primary data, well-established theory, and industry examples. The following sections present financial myopia as a concept and identify undesirable consequences that can result from myopic behavior. Each consequence increases a company's risk exposure with the potential to harm corporate performance.

UNDERSTANDING FINANCIAL MYOPIA

While financial myopia can be defined in various ways, the term as it is used here refers to the inability to comprehend, anticipate, or be concerned with the consequences that result from shorter-term financial actions taken that affect adversely one or more parties within a supply chain.¹ While myopia is often thought of in terms of a visual defect, it also applies to a lack of imagination, foresight, or intellectual insight. It does not take much imagination, foresight, or insight, for example, for a customer to unilaterally reduce a supplier's invoice amount or lengthen the time it takes to pay those invoices. All that is required is the coercive use of power by one party over another, something that is effective primarily in the short term. The longer-term effects from exercising this power, however, are often quite different. Actions become myopic when they circle back and harm the originating party financially in ways that were not intended or anticipated.

¹ In finance, financial myopia is about focusing on short-term outcomes, such as stock market returns which are often random in the short-term, at the expense of a longer-term strategy or outcome, which is not random.

What causes customers to take actions that affect the financial integrity of their trading partners? While no single answer applies to all situations, the pressure to improve financial performance in most industries is relentless, and taking actions that offer a rapid infusion of cash is often too tempting to ignore. Something similar happened when procurement groups forced suppliers to participate in reverse internet auctions and compete solely on price even when auctions were not the right approach for sourcing an item. As will be explained, when a customer takes actions that harm others, it is reasonable to expect those who are harmed to respond accordingly. These responses can take a variety of forms, and they can cycle back and affect the customer, thereby increasing risk.

Procurement and finance groups are primary contributors to financial myopia. Consider the possible responses when procurement groups reduce supplier invoice amounts to lower their purchase costs; fail to share savings from supplier-provided improvements; force suppliers to hold inventory so they can deliver on a so-called just-in-time basis; stipulate that suppliers provide design or other services with no additional compensation; stress shorter-term contracts and frequent supplier switching; and mandate annual price reductions, even when material costs are rising. Each of these can affect adversely a supplier's financial health.

Perhaps the most obvious step taken today by finance groups to improve their own financial position is extending payment terms with suppliers. Larger companies in particular use this strategy since they tend to hold a power position over smaller suppliers. Typically, this results in extending payment from 30 days to 90 days and even longer. Not surprisingly, suppliers usually view this as a coercive use of power. This practice started with retailers that traditionally hold inventory for longer periods and has since spread to large, industrial firms and further upstream to progressively smaller suppliers, many of which are ill-equipped to become the financing arm of their larger customers. Customers are essentially going to their suppliers rather than a financial institution for credit (Storm, 2015). The supplier is financing its customer's payables, often with nothing in return but higher costs.

A widely used corporate metric called the cash conversion cycle (CCC) is a major promoter of financially myopic behavior. The conversion cycle represents the number of days it takes a company to convert its resource inputs into cash. It considers the time needed to sell inventory, the time needed to collect receivables, and the time a company is afforded to pay its bills without incurring penalties. The cash conversion cycle, also known as the cash cycle, is calculated as:

Cash Conversion Cycle (CCC) = (DIO + DSO) – DPO where DIO refers to days inventory outstanding; DSO refers to days sales or receivables outstanding; and DPO refers to days payable outstanding.

As the conversion cycle shortens, the less time capital is committed to working capital, and thus the better off a company is in terms of cash flow and profitability, at least theoretically.² The conversion cycle is widely studied by Wall Street analysts, who then pressure corporate financial managers to identify the fastest ways possible to shorten the cycle. Not surprisingly, these analysts have accelerated the trend toward extending payment cycles as they compare one company to another and then ask why that company is not improving its working capital like other companies (Storm, 2015).

The Hackett Group reports that the average cash conversion cycle for larger companies has improved over the last several years, something that appears to be a positive trend. Further analysis reveals, however, that companies on average are less efficient at managing their inventory and receivables, which extends the cash conversion cycle (Dzinkowski, 2018). Any net improvements are due solely to lengthening the payable period with suppliers (DPO), which is rapidly becoming a standard business practice.

Extended payment periods often result in suppliers borrowing funds from a financial institution or other third-party (such as a fintech) to receive payment in a reasonable time. This process, called supply chain finance (also referred to reverse factoring), is often portrayed in publications and by financial institutions as a win-win solution (McCrea, 2018). These portrayals, however, usually downplay the fee that suppliers must pay to receive expedited payment or the added complexity placed upon suppliers. Reverse factoring fees often range from 1.5% to 3.5% of the factored amount, depending on the lender, the credit worthiness of the supplier's customer, the amount that is reverse factored, and how quickly the supplier wants to be paid. Reverse factoring can mitigate the myopic effect of extended payment terms if a supplier is content with the factoring arrangement.

Figure 1 summarizes a sequence that is triggered by an industrial customer's behavior and performance. Research has revealed that a clear linkage exists between a customer's behavior, the satisfaction a supplier has with that customer, the likelihood of a supplier viewing a customer as preferred, and a supplier's willingness to provide preferential treatment (Trent and Zacharia, 2012). And, once a customer receives preferential treatment, the probability of gaining a competitive advantage that reduces corporate risk improves.

Preferred customer status can lead to benefits that are not available to all customers, something that can create a competitive and even strategic advantage (Porter, 1990). This is often hard for many finance and procurement professionals to grasp, likely because they are driven by measurement systems that promote short-term behavior. Research findings are clear that how a supplier views a customer is a function of a customer's behavior and performance (Trent and Zacharia, 2015). Engaging in financially myopic behavior is a powerful way to ensure the sequence of events presented in Figure 1 does not occur.

² From an accounting perspective, working capital represents the difference between current assets and current liabilities. An operational perspective views it as the money committed to raw materials, work-in-process inventory, and finished goods plus accounts receivables less accounts payables.

Figure 1
Customer Performance Triggers a Powerful Sequence of Events



HOW FINANCIAL MYOPIA INCREASES CORPORATE RISK

A central premise put forth is that behavior that harms others within a customer's supply chain can lead to unintended consequences. A series of studies that measured supplier satisfaction with a customer support some of the conclusions presented here. The measuring instrument used to collect this data is a reverse scorecard where suppliers evaluate an industrial customer rather than a customer evaluating a supplier's performance, which is traditionally the case. Several well-established theories, particularly reciprocity theory, as well as industry examples also support the arguments presented here. The following explores a set of unintended consequences that can result when customers engage in myopic behavior.

Negative Impact on Financial Performance

It seems counter-intuitive to suggest that steps taken by an industrial customer to enhance its financial standing could produce a contrary result. Yet, that is exactly what can happen when engaging in myopic behavior. A common response when a customer harms its suppliers financially is for suppliers to add cost adders or fees wherever possible, usually embedded in the unit price, to mitigate the financial burden being inflicted.

Cost adders are a rational response to financial myopia as predicted by reciprocity theory, which is discussed shortly. Supplier cost adders have subtle yet clear financial consequences, many of which are unlikely to be understood or measured by the customer. Inflating the purchase price of a good through cost adders increases the value of a customer's inventory, a result that affects the current asset account on the customer's balance sheet (inventory is a

current asset). Because current assets are part of total assets, inflated inventory values can affect negatively some important corporate indicators such as return on assets (ROA) and return on invested capital (ROIC). Higher inventory values also increase inventory carrying costs and cost of goods sold, which affects gross profit. Interestingly, many firms do not measure inventory carrying charges, an omission that is short-sighted.

As mentioned, extended payment terms are becoming a business norm, particularly with larger customers. Unfortunately, extended terms affect a supplier as operating margin is transferred from the supplier to the customer. Customers that refuse to pay in a reasonable time are deluding themselves if they think suppliers have not thought about the additional costs they are assuming. The chief of the accounting practice unit at the Harvard Business School maintains that eventually the additional financing costs that suppliers incur because they are not being paid promptly work their way back into higher prices (Storm, 2015).

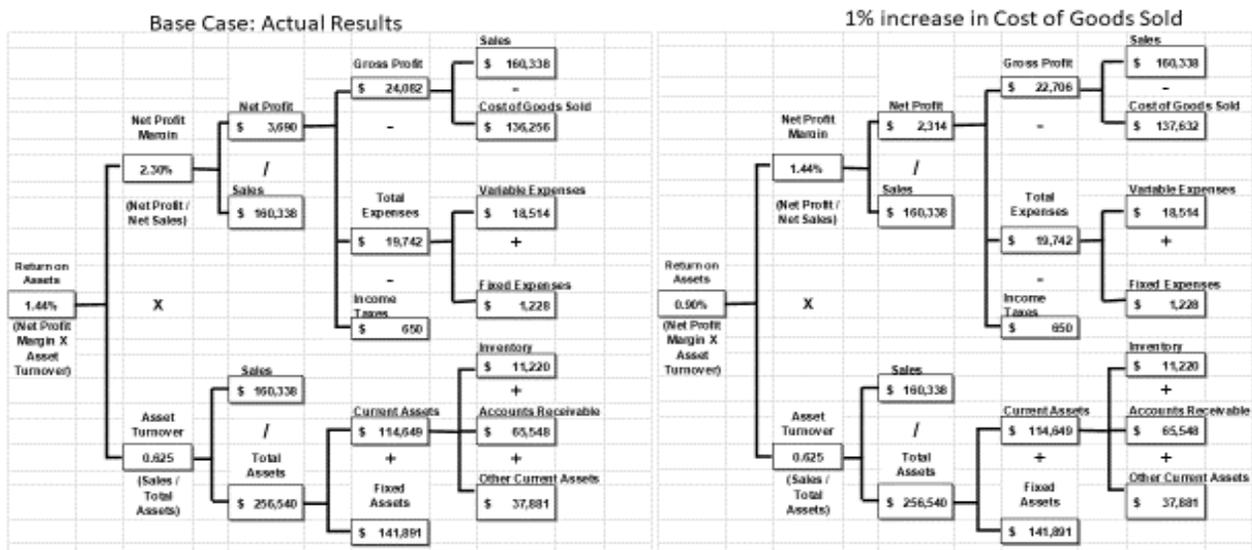
What does it mean to say that extended terms transfer operating margin from suppliers to customers? Suppose a supplier sells 100,000 units of an item to a customer for \$125 per unit on 30-day credit terms. The supplier has a 12% operating profit margin on this sale with a cost of capital of 10%. Assume the customer actually pays in 90 days. What is the finance charge to the supplier and what is the effect on the supplier's operating margin when the customer takes an additional 60 days to pay?

The supplier's expected operating profit from this sale is $\$125 \times .12$, or \$15 per unit. The financial cost to the supplier of the extended 60-day payment term is the \$125 selling price \times 10% cost of capital \times 60/365, or \$2.05 per unit. The new operating profit is $\$15 - \2.05 , or \$12.95 per unit. The effect of the extended payment term reduces the operating margin on this sale from 12% ($\$15/\125) to 10.4% ($\$12.95/\125), which represents over a 13% reduction in operating margin. The customer, on the other hand, improved its financial position at the expense of the supplier. The extended payment term represents a cost to the supplier of \$205,000 ($\2.05 finance cost per unit times 100,000 units). Imagine the costs to a supplier that has 40 or 50 major customers, each with multiple orders throughout a year and each extending its payment cycle. A smart supplier will look to recoup these added costs whenever possible.

Figure 2 shows just how susceptible a company's financial performance can be when suppliers respond in ways that increase a customer's costs. Holding all other variables constant in this analysis, this figure shows how sensitive some companies are to price increases from suppliers. Using an automotive OEM as an example, this figure shows the effect on return-on-assets (ROA) when this company's cost of goods sold account increases by even a modest amount due to higher unit costs from suppliers. (The cost of goods sold account includes the costs of purchased goods). If supplier price adjustments result in a 1% increase in this company's cost of goods, ROA would decline from 1.44% to .9%, or a 37% decrease. While not shown here, a 2% increase in cost of goods sold results in ROA declining from 1.44% to .37%, or a 74% decline. These figures do not include any increases in the value of inventory, which affects the asset portion of the ROA equation.

Figure 2 reveals how financially myopic behavior increases risk at the corporate level. An industrial customer that is financially weak, such as the one featured in Figure 2, could easily be tempted to improve its financial position quickly at the expense of its suppliers. If suppliers respond to the customer’s behavior, and the chances are they will, that customer may find itself in even worse financial shape after suppliers make pricing and other adjustments. The customer featured in Figure 2 is susceptible to even minor changes in its cost structure, something this company should recognize before taking actions that are financially myopic.

Figure 2
“What-If” Effect on ROA: Automotive OEM



Erosion of Trust

Underlying the strength of all relationships is trust, which is not particularly surprising. It is hard to imagine buyers and sellers sharing proprietary information, for example, when a lack of trust characterizes the relationship. As will be explained, an erosion of trust that a supplier has with its industrial customer is an unintended consequence of financial myopia. This erosion presents a serious risk since numerous studies confirm the critical linkage between trust and effective relationships.

General perspectives of trust describe this concept in terms of the reliability, honesty, and ability of a person or thing. A simple perspective argues that “simply put, trust means confidence in others” (Covey, 2008). Another perspective defines trust as a willingness to be vulnerable to another party (Schoorman, Mayer, and Davis (2007). Perhaps the perspective that best explains why financial myopia damages trust relates to three essential elements that underlie trust-based relationships: ability, benevolence, and integrity. Applied to relationships, *ability* represents the likeliness to perform; *benevolence* represents an unwillingness to behave opportunistically toward the other party, even when the opportunity to do so presents itself; and *integrity* relates to a commitment to fairness, justice, and ethical behavior (Mayer, Davis,

and Schoorman, 1995). Myopic behavior does not align well with these dimensions of trust, particularly benevolence.

Most industrial firms recognize that the next generation of performance advantages will increasingly require collaborative relationships with select suppliers. The most intense of all supplier-buyer relationships, collaborative relationships feature the sharing of risk, resources, and rewards. They also feature the sharing of confidential or proprietary information. Not surprisingly, trust is a major component affecting these sought-after but relatively rare relationships. Trust forms the basis upon which competitive advantage is built, driven by a collaborative culture that supports teamwork, open and honest communication, and innovation between companies (Keith, Vitasek, Manrodt, and Kling, 2016).

Customers with the most trusting supplier relations should also have the most financially rewarding relationships (Henke, Stalkamp, and Yenyurt (2014). A key premise from Henke's research is that trust equals profits, and lower trust means profits foregone. Building trusting relationships with suppliers is a financially responsible activity that every company should undertake. Other research has concluded that by working to create trust-based relationships with suppliers, the opportunity to be the recipient of meaningful supplier-provided benefits that are not necessarily available to other companies is maximized (Keith, Vitasek, Manrodt, and Kling, 2016, Covey, 2008).

What is the relationship between myopic behavior and trust? Table 1 presents data that should concern any company that is taking financial advantage of its supply chain members. Major suppliers to a transportation equipment OEM provide the data presented in this table. As part of a research project studying supplier satisfaction, suppliers provided their perception of this customer's ability to provide payment in a reasonable time. Then, that response was compared against other important study questions.

Supplier responses divide almost evenly between two groups in terms of how suppliers rate this customer's ability to pay in a reasonable time. The rating scale used is 0 is much worse than the ideal customer; 3 is somewhat less than the ideal; and 6 is equal to the ideal customer in terms of paying in a reasonable time. The lower-rated segment (the left column of the table) includes suppliers that provide a customer rating of 0, 1, 2, or 3; the higher-rated segment (the right column) includes suppliers that provide a customer rating of 4, 5, or 6. As an aside, suppliers indicated in this study that receiving payment in a reasonable time along with earning a fair financial return are the two most important outcomes they sought from their customers. This finding alone suggests that engaging in myopic behavior might not be a wise decision.

The differences between the segments in Table 1 are meaningful. Compared to the higher-rated segment, the lower-rated segment indicates less overall satisfaction with this customer; less likelihood of viewing this customer as preferred; a less cooperative or collaborative relationship with this customer; and appreciably less relationship trust.

Table 1
A Transportation Equipment Customer's Ability to Pay in a Reasonable Time

Customer's Ability to Pay in a Reasonable Time: Lower-Rated Segment	Avg. Rating	Customer's Ability to Pay in a Reasonable Time: Higher-Rated Segment	Avg. Rating
Overall satisfaction with this customer (1= very dissatisfied; 7 = very satisfied)	4.02	Overall satisfaction with this customer (1= very dissatisfied; 7 = very satisfied)	5.10
Level of trust that characterizes the relationship with this customer (1= very low, 7 = very high)	3.83	Level of trust that characterizes the relationship with this customer (1= very low, 7 = very high)	6.23
Type of relationship the supplier has with the customer (1 = counter-productive; 7 = collaborative)	3.72	Type of relationship the supplier has with the customer (1 = counter-productive; 7 = collaborative)	5.15
How the supplier views this customer (1= a least preferred customer; 7 = a most preferred customer)	4.69	How the supplier views this customer (1= a least preferred customer; 7 = a most preferred customer)	5.80

N = 113

The contrast between the two segments regarding the trust that characterizes the supplier-customer relationship is especially concerning. An absence of trust is clearly an issue for suppliers that are less satisfied with this customer's ability to pay in a reasonable time. (Similar findings occur when evaluating this customer's ability to provide a fair financial return). When a customer takes unilateral actions that harm a supplier's financial standing, that customer is not demonstrating benevolence. The customer is acting in its own self-interests and behaving opportunistically as it takes financial advantage of suppliers. Suppliers might also question this customer's integrity given this customer's disregard for fairness, justice, and ethical behavior. Financial myopia increases corporate risk by undermining perhaps the most important predictor of successful relationships.

Retaliation by Suppliers

When confronted with myopic behavior, supplier retaliation is a predictable response. Unfortunately, the possibility of retaliation is often not considered when making financial decisions. A consulting team comprised of finance experts recommended that a retailer switch to a 220-day payable period with suppliers from its current 60-day payable period. The team's analysis provided abundant data showing how the retailer would benefit financially. What the analysis failed to consider was the impact this change would have on suppliers. It also failed to consider any retaliatory actions in response to this change. When these omissions were pointed out the consulting team leader responded by saying that is outside the scope of the

analysis. What is “outside the scope” of the analysis might be more important than what is included.

Retaliation almost always increases a customer’s risk exposure. Expecting suppliers to respond in kind when a customer takes actions that affect their financial health is predictable according to reciprocity theory. This theory states that reciprocity is an expected response to perceived kindness and unkindness, where kindness is a function of distributional fairness as well as fairness intentions (Falk and Fischbacher, 2006). Individuals evaluate the kindness of an action not only by its consequences but also by the intention underlying the action. Reciprocity theory maintains that in response to friendly actions, individuals are frequently much nicer and cooperative than predicted by a self-interest model; conversely, in response to hostile actions they are frequently more punitive and even brutal (Ernest Fehr and Simon Gächter, 2000). This theory is well suited for predicting that suppliers will take steps to counteract the financial harm being inflicted upon them.

Examples of retaliatory behavior against customers are easy to find, particularly as it relates to customers prospering, at least in the short term, at the expense of their suppliers. A major U.S. company pays its invoices in 90 or more days (and still takes any discount offered by suppliers for early payment) even though suppliers typically quote payment terms of 30 days. Some suppliers admit privately they try to recoup the added costs of this customer’s behavior through higher prices. They also admit they have minimal desire to share innovations with this customer.

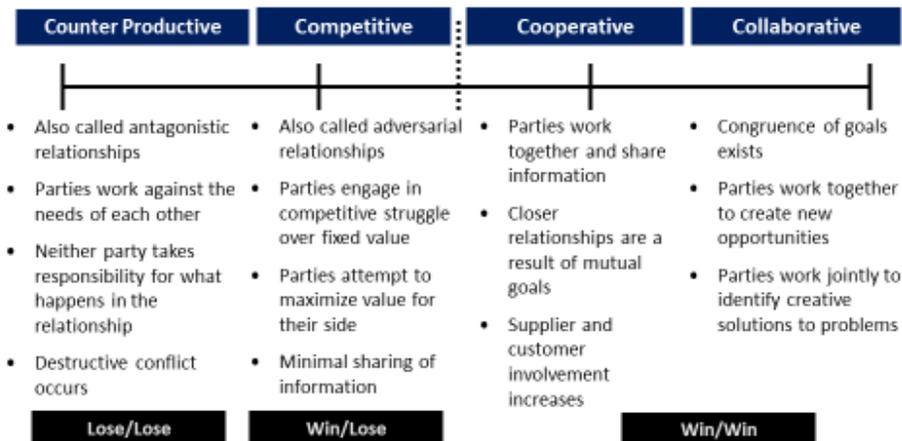
Raising prices, adding fees to customer invoices, and denying preferential treatment or sharing it with other customers are just several ways that suppliers counter financially myopic customers. Some suppliers will also forego business or seek new customers that are less likely to inflict financial pain, even when suppliers can absorb the additional costs. Even if a customer were to return to a normal payable cycle, suppliers will likely maintain a higher price or fail to rescind any cost adders. As reciprocity theory suggests, responses to hostile actions are often punitive. While self-interest theory may predict a customer’s behavior, the subsequent supplier response is predictable according to reciprocity theory.

As mentioned, earning a fair financial return is one of the most important outcomes that suppliers want from their customer relationships. Why would suppliers willingly accept behavior from customers that affect their ability to achieve a fair return, something that is so important to them? After Kellogg’s extended its payment period to suppliers to four months, a company spokeswoman said it gave the company and its suppliers more flexibility to manage their businesses through better cash flow management (Storm, 2015). One way or another, suppliers are paying for, and in all likelihood, retaliating against this flexibility.

Another indicator that retaliation will likely occur involves an unwelcome shift along a relationship continuum as suppliers become increasingly dissatisfied with a customer. Figure 3 links the concepts of win-win, win-lose, and lose-lose to specific types of commercial relationships. As this figure shows, cooperative and collaborative relationships are, by

definition, win-win relationships. Conversely, competitive relationships are win-lose. Counter-productive relationships are described as lose-lose relationships.

Figure 3
A Continuum of Supply Chain Relationships



The terms win-win or win-lose do not have universally accepted definitions. What most observers will likely agree on is that the amount of value that is available to different parties through a win-win relationship is variable rather than fixed. By working together parties can grow the amount of value they derive from their relationship. Conversely, win-lose relationships feature a fixed amount of value that the parties compete over as they pursue their own self-interests. Any gain by one party must come at the expense of another party. While win-win relationships seek to expand the value that is available, win-lose relationships focus on dividing a fixed amount of value.

Referring to Table 1, a leftward shift along the relationship continuum occurs as suppliers become less satisfied with their customer's behavior (from a 5.15 average relationship rating to a 3.72 average rating). On the continuum featured in Figure 3, a score of 0 represents a counterproductive relationship, 3 is competitive; 5 is cooperative, and 7 is a collaborative relationship. A customer's myopic behavior correlates with a shift from the win-win side of the continuum toward the win-lose side. This shift increases the likelihood that suppliers will stress their own self-interests at the expense of the customer. Engaging in behavior that leads to retaliatory behavior along with a shift toward a win-lose environment are unwelcome but predictable consequences of myopic behavior. Both have the potential to increase a customer's risk exposure.

Loss of Preferential Treatment

As companies search for ways to grow they cannot ignore what is largely an untapped opportunity: the receipt of preferential treatment from suppliers. At times, this treatment is

specific and not available to other firms, particularly competitors. Make no mistake, preferential treatment, like trust, is earned rather than given. How an industrial customer engages with supply chain members can mean the difference between receiving game-changing advantages and watching from the sidelines as others prosper.

Supplier-provided preferential treatment almost always outweighs, sometimes dramatically, the dollar value received from mandated supplier piece-price concessions and other mandates such as extended payment terms (Henke, Stallkamp, and Yeniyurt, 2014). The challenge is to create an environment where suppliers willingly share innovation and other preferential treatment that is not necessarily available to other companies. Referring again to Table 1, lower satisfied suppliers are not as likely to view a customer as preferred as higher satisfied suppliers.

High profile examples suggest that a loss of preferential treatment can lead to strategic risk. Ten years ago Ford and Toyota were competing to become market leaders in the production of hybrid vehicles. As part of their product efforts both companies outsourced to the same supplier the production of a complex hybrid transmission system. As market demand for hybrid vehicles increased, Ford executives complained publicly that the transmission supplier favored Toyota when supplying transmission systems (Welch and Tashiro, 2006). Unfortunately, a demand for transmissions that exceeded the supply of transmissions prohibited the supplier from supporting the needs of both companies. What should be obvious is that one company was the preferred customer while the other was not.

A number of years ago an Airbus executive complained publicly about the relationship between Boeing and GE by saying, “The problem we have with GE is they go to Boeing and say ‘What kind of engine should we design for your airframe?’ Then they come to Airbus and say ‘Here is the kind of airframe you need to build to fit our engine.’” Complicating matters is that GE officials said they would not build a new engine for an Airbus plane that will compete directly against a Boeing plane where GE is the sole supplier (Michaels and Kranhold, 2007).

Interestingly, Boeing risks losing the goodwill of suppliers by engaging in financially myopic behavior. Operating under a friendly sounding program called *Partnering for Success*, Boeing has reaped a financial windfall largely at the expense of its suppliers. The company has demanded double-digit price reductions and is taking longer to pay suppliers. Those suppliers that do not cooperate risk being designed out of future aircraft designs. Commenting on the demands by Boeing, the CEO of a major aerospace supplier said this feels like walking down the street and being mugged (Johnsson and Robinson, 2018).

Moving beyond anecdotal accounts, Tables 2 and 3 provide a data-driven view of preferential treatment. Supplier satisfaction studies reveal a solid correlation between viewing a customer as preferred and the receipt of preferential treatment from suppliers. Conversely, less satisfied suppliers are less likely to view a customer as preferred, which means they are less likely to provide that customer with preferential treatment.

Table 2 identifies the three *lowest-rated* kinds of preferential treatment that suppliers are willing to provide to the OEM customer featured in Table 1. This data reveal that suppliers are least likely to provide preferential treatment that is financially related. Since this customer has a reputation for enhancing its financial standing at its suppliers' expense, reciprocity theory suggests that suppliers will likely not be willing to extend financially-related preferential treatment in return. Data collected from supplier satisfaction studies with customers from other industries reveal similar findings.

Table 2 further explores this data by segmenting the total sample into two groups: suppliers that have an overall satisfaction score with this customer of 1, 2, 3 or 4 (lower satisfied segment); and suppliers that have an overall satisfaction score with this customer of 5, 6, or 7 (higher satisfied segment). Even though the items in Table 2 are the least likely kinds of preferential treatment that suppliers are willing to provide, higher satisfied suppliers are more willing to provide some desirable kinds of preferential treatment compared with lower-satisfied suppliers.

Table 2
Lowest-Rated Preferential Treatment Items in Terms of Supplier Willingness to Provide

Lowest-Rated Preferential Treatment Items	Total Sample Willingness to Provide	Lower Satisfied* Segment Willingness to Provide	Higher Satisfied* Segment Willingness to Provide
Provide more favorable payment terms to the customer	3.14	2.53	3.53
Provide direct financial support to the customer if needed	3.39	2.75	3.80
Provide better pricing to the customer	3.73	3.00	4.20
Average rating across 26 preferential treatment areas	4.81	4.55	4.97

* Refers to overall satisfaction with a customer.

Scale: 1 = not willing to provide to this customer; 4 = somewhat willing to provide; 7 = very willing to provide to this customer

N = 113

Table 3 extends this analysis further by presenting the highest correlations between *overall supplier satisfaction* with this customer and *supplier willingness to provide preferential treatment*. The kinds of preferential treatment that suppliers are the least willing to provide in Table 2 are actually the items that correlate the highest with supplier satisfaction. In other words, as suppliers are increasingly satisfied with their customer they are more willing to provide financially-related preferential treatment, something that Table 2 revealed the total sample is least likely to provide. Conversely, as suppliers become less satisfied with their

customer they are less likely to provide financially-related preferential treatment. As an aside, *holding inventory to support the customer's needs* also offers a direct financial benefit to the customer.

Table 3
Highest Correlations between Supplier Satisfaction and Willingness to Provide Preferential Treatment

Preferential Treatment Item	Correlation— Total Sample*
Provide direct financial support to the customer if needed	.42
Provide better pricing to the customer	.41
Hold inventory to support the customer's needs	.36
Provide more favorable payment terms to the customer	.35
Average correlation across 26 preferential treatment items	.19

* Represents the correlation between overall supplier satisfaction with the customer and supplier willingness to provide a specific preferential treatment item;

N = 113

A direct relationship exists between supplier satisfaction with a customer and the willingness of a supplier to provide certain (and valuable) kinds of preferential treatment. Losing preferred customer status, which is a likely result when practicing myopic behavior, can create substantial risk for a customer as it foregoes any advantages that may be derived from preferential treatment.

While suppliers often resort to cost adders as a response to myopic behavior, this often pales in comparison when suppliers are unwilling to share innovation, make direct investments in the supplier-buyer relationship, or provide preferential treatment. Financial myopia can create strategic disadvantages as others prosper from the preferential treatment your company is not receiving.

Loss of Service

It should come as no surprise that suppliers have choices regarding which customers they will serve. When the decision is made to forego a customer's business, a loss of service from suppliers can occur in ways that are subtle rather than dramatic or public. It may involve a supplier deciding to no longer bid on a customer's business. Or, a supplier may terminate an agreement according to the terms and conditions of a contract. As an example, a corporate trainer was surprised to find that his client, a large aerospace company that he had been working with for 12 years, decided without any notice to begin paying suppliers in 90 days or longer. When the time came to re-bid a sole-source contract with this client the trainer

decided not to participate. This loss of service created a problem since the training program was developed partly around this trainer's skill set. The trainer concluded that working with this client had simply become too difficult.

While data concerning the frequency or magnitude of suppliers no longer serving a customer are hard to come by, anecdotal accounts reveal this to be a real risk. A plastics company that produced precision parts for the automotive industry stopped serving, except for one customer, automotive customers because of their short-sighted behavior. It is possible to become so unattractive as a customer that suppliers simply walk away (Ellram, 2018). In another example, the CEO of a major supplier commented publicly that he was willing to forego business if his company could not achieve the margins or terms that were reasonable for his organization (Ng, 2013). A supplier of valves, processing instrumentation, and mechanical systems to Anheuser-Busch was not pleased when, after Anheuser-Busch was purchased by InBev, payment terms shifted from 30 days to 120 days. The CEO stated publicly that his company could afford to lose Anheuser-Busch's business rather than wait four months to receive payment.

These examples illustrate the importance that suppliers place on earning a fair financial return, a requirement that will always be one of the most important expectations that suppliers have from their supplier-customer relationship. The failure to earn a fair financial return can cause a customer to lose service.

A loss of service represents a type of supply chain disruption. Not all disruptions are linked to natural hazards or other visible occurrences such as strikes or fires. At times the disruption is due simply to a decision that it is no longer in the best interests of a supplier to serve a customer. Suppliers may not even reveal the reason why they made a decision to no longer conduct business with a customer.

At the extreme, a supplier can abruptly decide to no longer serve a customer, possibly leaving the customer in a precarious position as it is forced to replace that supplier's output. When a loss of service occurs the customer may have to go through a lengthy process to qualify a new supplier, particularly for customers who have already reduced the size of their supply base. A supplier to the pool and spa industry had a customer that had no regard for quoted lead times, quantities, or payment terms. This customer became so difficult to work with that the supplier's CEO decided to, in his words, "fire the customer." After the customer was unable to find a suitable replacement, it reconnected with the original supplier. The CEO says "now it is business on our terms, not the customer's." This loss of service, which was eventually restored, was followed by retaliatory terms as dictated by the supplier.

Part of what contributes to a loss of service is a metric called the *cost-to-serve*. This metric involves calculating the profitability of a customer account based on actual business activities and overhead costs incurred to service that customer. This metric helps identify how costs are generated across the supply chain and reveals how each product and customer affects a cost profile. This profile shows which customers contribute the most to a company's profit and those that contribute the least.

Customers often ask suppliers to perform various activities on their behalf, such as providing product design support or holding inventory. At times suppliers simply view these requests as a cost of doing business. At some point, however, these requests can affect a supplier's profitability through a higher cost-to-serve. Cost-to-serve is also affected by customer attributes. Customers that pay on time create lower costs than customers that delay their payments; customers that conduct transactions electronically have lower ordering costs than customers that conduct business manually; and customers that are closer in distance will have lower logistics costs than customers that are located further away.

Poor behavior can also increase a customer's cost-to-serve. As an example, a supplier informed its customer, a global chemical company, that it could reduce invoice amounts by 5% if it did not make quantity changes within 10 days of scheduled due dates. While the customer was celebrating the opportunity to realize a price reduction, the reality soon set in that the supplier had been including a cost adder to compensate for this customer's frequent schedule changes, a behavior that increased the customer's cost-to-serve. An irony is that this customer viewed this as a cost savings opportunity rather than the elimination of a penalty that the supplier had been assessing.

At times a supplier will eliminate customers as part of its rationalization process. Rationalization is the process of identifying the right mix and number of something to maintain. In this case it involves identifying the right mix and number of customers to serve. It is safe to conclude that financially myopic actions make a customer less attractive to serve, something that a customer rationalization analysis will likely reveal.

The principal reason for calculating the cost-to-serve is to reposition customers and services, and to better understand how a supplier should serve these customers to improve overall profit margins. This helps mitigate the risk of committing too many resources to less profitable customers. The cost-to-serve analysis may reveal that a customer no longer warrants being served. Customers that practice financially myopic behavior increase their cost-to-serve, which increases their risk of disrupted service.

WHAT CUSTOMERS SHOULD DO

The preceding sections described the unintended consequences that are likely when a customer engages in financially myopic behavior. Each consequence has the potential to increase corporate risk. Ensuring these consequences do not become a reality requires educating personnel about the harm that myopic actions can inflict upon other supply chain members. Organizational leaders must communicate internally that others in the supply chain have a need to earn a fair financial return, one of the most important outcomes expected from supply chain relationships. And, they must ensure that performance measures are not driving short-sighted behavior.



The party engaging in myopic behavior must recognize that retaliation by supply chain members is a distinct possibility. Suppliers have a range of options available to counter a customer's myopic behavior, almost of all which are unpleasant for the customer. They can raise price; include cost adders in their price; forego a customer's business; search for new customers to replace less desirable customers; demand payment on or even before delivery; withhold preferential treatment; provide preferential treatment to other customers, including competitors; curtail the amount of credit extended to a customer; withhold the sharing of savings from improvements; and refuse to provide service that is above and beyond what is required contractually. The list of retaliatory actions is long, something that customers are advised to remember.

Customers should try and understand what is most important to their suppliers, something that increase the likelihood that a customer can initiate the chain of events that lead to preferential treatment. Supplier satisfaction surveys are designed specifically to measure the sentiments of suppliers. Customers that put forth the effort to understand the needs of supply chain members should be better off because of that effort.

Customers who are unwilling to modify their behavior should attempt to mitigate any negative effects on supply chain members. This involves taking action or offering consideration that lessens the impact of that behavior. After Unilever extended its payment terms to suppliers from 30 days to 90 days, supplier protests were relatively muted as Unilever passed along to suppliers the funds freed up in the form of higher order volumes, which shifted the narrative from a win-lose to a win-win environment (Lekakos, 2016).

Customers can offset negative effects on suppliers by offering longer-term contracts; designating a supplier as preferred; inviting suppliers to be early participants during product development; sharing savings from supplier-provided improvement suggestions; offering larger volumes that allow a supplier to gain cost efficiencies; sharing material cost increases; and providing improvement incentives and rewards. These actions convey a commitment by the customer to the financial well-being of suppliers. Instead of taking actions that benefit only one party, customers can mitigate the harm caused by their actions.

CONCLUDING THOUGHTS

The true impact of myopic behavior is rarely understood given the lack of accounting and measurement systems designed to capture such data. What are the costs when suppliers lose trust in a customer? What is the effect on a customer's financial performance when suppliers include cost adders in their price? What is the opportunity cost when suppliers provide preferential treatment to other companies, some of whom may be direct competitors? Are there any accounting systems that capture the cost of supplier retaliation? And, what is the impact of a supply chain disruption when a supplier decides to no longer serve a customer?

An inability to quantify the impact of myopic behavior is not a reason to discount the risks presented here. For whatever reason, many customers are not anticipating the longer-term

consequences of their actions. One supply chain expert notes that companies have become much more dependent on their suppliers. They outsource a major portion of their requirements, they depend on suppliers for carrying inventory, and they rely on suppliers for new ideas. Why do these customers think it is a good idea to forcibly push financial burdens onto their suppliers (Ellram, 2018)? Companies are not thinking holistically when they focus purely on their own cash flow. In short, they are being financially myopic, something that can create risks that far outweigh the benefits.

Endnotes

S.M.R. Covey, *The speed of trust*, New York: Free Press, 2006.

Ramon Dzinkowski, Working Capital Scorecard: Suppliers Can Wait, July 10, 2018, <https://www.cfo.com/cash-flow/2018/07/working-capital-scorecard-cash-conversion-cycle/>. Bridget McCrea, "Leveraging Supply Chain Finance," *Supply Chain Management Review*, 22, no. 2 (March/April 2018): S57-59.

Armin Falk and Urs Fischbacher, "A Theory of Reciprocity," *Games and Economic Behavior* 54, no. 2 (February 2006): 293–315.

Lia Ellram, "The Delusion of Extending Payment Terms," *SCF Briefing*, retrieved from <https://www.scfbriefing.com/viewpoint-the-delusion-of-extending-payment-terms/>, November 2017.

Ernest Fehr and Simon Gächter, "Fairness and Retaliation: The Economics of Reciprocity," *Journal of Economic Perspectives* 14, no. 3 (Summer 2000): 159-181.

John Henke, Thomas Stallkamp, and Sengun Yenyurt, "Lost Supplier Trust: How Chrysler Missed Out on \$24 billion in Profits over the Past 12 Years," *Supply Chain Management Review* 18, no. 3 (May/June 2014): 24-32.

Julie Johnsson and Peter Robison, "Boeing is Killing It by Squeezing Its Suppliers," *Bloomberg Businessweek*, (February 14, 2018), retrieved from <https://www.bloomberg.com/news/features/2018-02-14/boeing-is-killing-it-by-squeezing-its-suppliers>.

Keith, B., Vitasek, K. Manrodt, K, and Kling, J. (2016). *Strategic sourcing in the new economy: Harnessing the potential of sourcing business models for modern procurement*, New York: Palgrave MacMillan.

D. Michaels and K. Kranhold, "Engine Spat Could Slow Airbus," *The Wall Street Journal*, July 10, 2007, sec. A, p. 10. Serena Ng, "Firms Pinch Payments to Suppliers," *The Wall Street Journal*, (April 17, 2013): A1.

Spyros Lekkakos, "How Delaying Payments Can Help Suppliers," August 12, 2016, retrieved from <https://www.cfo.com/supply-chain/2016/08/delaying-payments-can-help-suppliers/>.

Michael E. Porter, *The Competitive Advantage of Nations*. New York: Free Press, 1990.

Stephanie Storm, "Big Companies Pay Later, Squeezing Their Suppliers," *The New York Times*, April 7, 2015, p. B1.

R. Trent, and Z. Zacharia, "The Wisdom of Becoming a Preferred Customer," *Supply Chain Management Review*, November 2012, pp. 10-18.

D. Welch, and H. Tashiro, "Japan Takes a New Bite Out of Detroit," *Business Week*, July 24, 2006, 41.

About the Author

Dr. Robert J. Trent is a professor of management at Lehigh University. Prior to entering academia, he worked for the Chrysler Corporation in the company's aftermarket division. Dr. Trent has authored/coauthored eight books and over 50 articles appearing in a range of publications. His most recent book *Strategic Supply Management Revisited—Competing in an Era of Rapid Change and Disruption* was published in 2018. He has also coauthored eight major research monographs published by *CAPS Research* and has made presentations at dozens of conferences and seminars.

