# Chapter 57
# Do Bankers Use Managerial Discretion With Regard to CSR and Earnings Management to Rebuild Their Reputation in the Aftermath of the Financial Crisis?

**Ada Sneekes**
*University of Amsterdam, The Netherlands*

**Georgios Georgakopoulos**
*University of Strathclyde, UK*

**Alexandros Sikalidis**
*University of Amsterdam, The Netherlands*

**Maria Rodosthenous**
*Piraeus University of Applied Sciences (TEI of Piraeus), Greece*

## ABSTRACT

*In this paper the authors examine the relationship between CSR (Corporate Social Responsibility) performance and earning management in the banking industry from 2008 to 2012 having a specific focus on managerial behaviour and its impact on banks' reputation. They propose that when managers opportunistically engage in CSR, they will also engage in opportunistic earnings management but if they engage in CSR practices because it is the socially 'right thing to do' then earnings will better reflect banks' true economic performance. Finally, they expect that when bank managers recognize the importance of societal trust they use their discretion to regain trust and to rebuild reputation. Their results show that in general, banks that perform high on CSR indicators behave more transparently with regard to the presentation of earnings. Banks that engage in CSR activities to improve their reputation, use managerial discretion to show socially desirable earnings numbers. For banks that value their reputation, pursuing societal trust is more important than the fulfilling of self-interest.*

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## 1. INTRODUCTION

During the last two decades, corporate social responsibility has increasingly drawn the attention from business, society, media and academics (Malik, 2014). In the wake of large corporate scandals since the start of the millennium, public opinion leaders were ever more advocating that businesses should not merely be aimed towards profit at the expense of fulfilling their responsibilities to employees, society and the environment (Chih, Chih, & Chen, 2010; Chih, Shen, & Kang, 2008; Hong & Andersen, 2011). Investors, customers and other stakeholders demand greater transparency on corporate responsibilities in all aspects of business (Kim, Park, & Wier, 2012).

As the importance placed by society on socially responsible activities increased, CSR has attracted the attention of bank managers as well. Even before the arrival of the financial crisis, banks came up with the idea of socially responsible investments (O'Sullivan & O'Dwyer, 2009; Scholtens, 2009). These investments included the offering of microcredits to the poor and deprived (Hermes, Lensink, & Mehrteab, 2005; Morduch, 1999)[1]. However, there are arguments which suggest that banks were significant contributors to the onset of the global financial crisis of 2007 and 2008 (hereafter 'financial crisis') (Barth & Landsman, 2010; Wu & Shen, 2013).

A great deal of commentary is attributed to the understanding of the financial crisis and the role banks played (e.g. André, Cazavan-Jeny, Dick, Richard, & Walton, 2009; Fiechter, 2011). Academics argue that at the core of the financial crisis lies a lack of transparency of information and an insufficient amount of disclosure for users of financial statements (Barth & Landsman, 2010; Laux & Leuz, 2009). As a result, users of financial statements were not properly informed and could not assess the values and riskiness of bank assets and liabilities (Mian & Sufi, 2009).

In contrast to the poor quality of information that banks delivered to users of financial statements, bank profitability and market optimism were very high before the beginning of the financial crisis. Bonus plans were composed in such a way that managers were encouraged to adopt risky strategies (Scott, 2011) and as a result, managers showed excessive risk-taking behaviour. Risky strategies were deemed very successful; banking was ranked second in profitability (after pharmaceuticals) among Fortune 500 firms in 2001 (Public Citizen, 2002) and third in return on revenues in 2005 (CNNMoney.com, 2006). However, success did not last and the recent financial crisis has shown that, in fact, bank managers took these risks at the expense of society at large (Chih et al., 2008). Here was a moral hazard situation[2]; bankers were fulfilling their opportunistic, self-interested goals and were failing to meet their social responsibility for economic stability (Decker & Sale, 2010); the banking industry has the exceptional ability to privatise gains and socialise losses (Wolf, 2008). In addition, when serious distress, governments are called to bail them out or take them over at the expense of taxpayers (Wu & Shen, 2013). To gain societal trust, or confidence (Decker & Sale, 2010), banks are required to provide feedback to the community relatively more than other industries do. The bank's reputation represents the degree to which trust is acquired (Schanz, 2006).

At the time that banks collapsed, some critics argued that there was a serious decay in business morality (e.g. Friedman, 2008). They stated that banks not only needed a financial bailout, they also needed an ethical bailout, as banks were preaching their CSR credentials at the same time as they engaged in reckless risk taking. Driven by opportunistic incentives, bank managers abused their inside information to show high income numbers. In an attempt to better understand bank managers' motivations to engage in CSR activities as well as earnings management since the onset of the financial crisis, this study empirically scrutinizes that relationship in the period between 2008 and 2012. Our research question examines the