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How performance incentives can lead to corporate fraud

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This is the first of a two-part series examining performance incentives and their link to corporate fraud.

The fraud examination profession has traditionally (and rightfully) focused the bulk of its attention on the tools required to detect fraud in organizations: interviewing skills, data analysis, data mining, investigations, and report writing. In recent years, increasing focus has been given to fraud prevention activities, particularly those involving risk assessment, corporate compliance, and the basic elements of anti-fraud programs. In fact, many common corporate compliance and ethics processes, such as corporate codes of conduct, hiring due diligence, ethics training and communication, anonymous reporting hotlines, and internal investigative capabilities are considered critical anti-fraud controls that, according to the Association of Certified Fraud Examiners *Report to the Nations*, can significantly reduce the costs and impact of organizational fraud.[1]

One of the most significant factors that influences employee behavior in an organization is its corporate ethical culture as defined and driven by an organization's core values. Core values such as integrity, ethics, and respect are commonplace terms that can be found on corporate websites. These words, however, are aspirational at best, and require leadership, policies, internal controls, and the right performance incentives to achieve. Unfortunately, many highly publicized corporate frauds and ethical failures, and our own case studies in conducting both proactive and government-mandated monitoring, point to the unanticipated consequences of poorly designed and ill-conceived performance incentives as a key contributor to bad employee behavior and corporate fraud.

What are performance incentives?

US companies spend an estimated $38 billion each year on bonuses and incentives,[2] but there has been much debate in the business community about how effective they really are. When designed intentionally and properly, performance incentive programs can motivate employee behavior and performance and drive organizational success. Performance incentives send strong signals to both managers and employees about what is important to the organization, and can be used to shape priorities, as well as provide positive reinforcement of the desired behaviors. The most common of these incentives are employee bonuses, criteria for promotion consideration, and other awards and recognition for achieving identified organizational goals.