How performance incentives can lead to corporate fraud

By Eric R. Feldman, CFE, CIG, CCEP-I

Eric Feldman (efeldman@affiliatedmonitors.com) is Senior Vice President and Managing Director of Corporate Ethics and Compliance Programs at Affiliated Monitors Inc. in Redondo Beach, California, USA.

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.

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, 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.

An incentive to cheat?

Unfortunately, performance incentives that are poorly designed without thoughtful consideration and alignment with the organization’s strategic goals and core values can put a company’s sustainability at risk. This can happen when incentives that appear completely rational in meeting financial goals are not appropriately balanced with ethics and integrity objectives. In many cases, performance incentives have had the unintended consequence of rewarding bad employee behavior that has led to unethical decisions, regulatory violations, fraud, and serious legal jeopardy for the company.

In order to avoid such unintended consequences, it is important to understand how performance objectives are viewed in an organization. As we know, both managers and employees are often overwhelmed with corporate
communications and policy pronouncements, emails from CEOs and senior leadership identifying the corporate priority du jour, ethics and compliance training, codes of conduct, performance evaluations, and other documents that are supposed to drive employee behavior and priorities. Many of these are not always consistent, nor are they accompanied with the time and resources to get them all done. Often, employees are forced to prioritize their attentions on those things that are measured by their superiors in a definitive way in order to avoid failure. It is in this intense working environment where the saying “what gets measured, gets done” holds true.

Performance incentives for promotion and bonuses often come with metrics that send a loud, unspoken message to a workforce about “what management really wants.” Other informal incentives, such as the promise of promotion, the threat of losing one’s job, or the prospects of special recognition that separates employees from their peers are also potent drivers of behavior. Absent more constant, specific, and balanced messaging about ethics, integrity, and other corporate core values, performance incentives with their accompanying metrics can drive good people to do things they might later look back on with regret. Performance incentives can transform into incentives to cheat when:

- The incentives are not properly balanced with communications on the “how” performance goals are achieved;
- The incentives solely comprise financial metrics, such as sales goals without explicit alignment to an organization’s core values and ethics objectives; and
- When the goals linked to things such as “reasonable sales growth” start to “stretch and run ahead of market realities,” becoming unreasonable and requiring the “cutting of corners” or outright cheating to achieve.

Performance incentives and government guidelines

In 1991, in recognition of the fact that an organization’s culture can either positively or negatively influence individual behavior, the U.S. Sentencing Commission (USSC) expanded the Federal Sentencing Guidelines Manual to include a new chapter on organizational crime. The intent was to provide a consistent set of organizational guidelines to both deter and to punish corporate crime, and to encourage positive behavior through the establishment of effective ethics and compliance programs. In fact, one of the primary stated aims of the Sentencing Guidelines is to “promote an organizational culture that encourages ethical conduct and a commitment to compliance.”

In the two decades since the guidelines were established, one of the principal shared goals of industry, law enforcement, and federal regulators has been to effect basic cultural change within organizations in ways that might reduce both criminal and ethical risk. An effective compliance program is more of a commitment and a process that supports employees in making the right decisions, rather than an exact blueprint for ethical conduct.

One of the seven elements required by the Sentencing Guidelines for Organizations in order for companies to achieve more favorable consideration and a less punitive disposition when facing criminal prosecution is “Effective Incentives and Discipline.” Organizations are expected to implement a consistent and appropriate disciplinary process that demonstrates that the company is serious about the rules when an employee is found to have violated those rules. But more challenging to many companies is the requirement to promote ethical behavior and the compliance and ethics program through “appropriate incentives to perform” in accordance with its organizational core values and ethics objectives.

In November 2010, the USSC amended the Sentencing Guidelines, providing additional guidance surrounding what constitutes an effective corporate ethics and compliance program. The amendments address two critical areas: (1) the steps that a company needs to take when responding to the discovery of criminal conduct; and (2) the corporate governance surrounding the ethics and compliance function, including performance incentives.

As noted earlier, the USSC has long made clear its intention that the seven elements of an effective ethics and
compliance program are designed to “promote an organizational culture that encourages ethical conduct and a commitment to compliance.”[6] In May 2012, the RAND Corporation brought together a group of public company directors and executives; corporate ethics and compliance officers; and representatives of government, academia, and nonprofit organizations to discuss organizational culture, including the progress of compliance initiatives; the barriers to achieving a strong ethical culture; and the current thinking about corporate boards, executives, and policymakers on what can be done to strengthen ethical culture in corporate America.[7] Some of the key findings of this symposium were:

- Organizations are unlikely to have successful compliance programs without a solid ethical culture, and successful compliance programs are critical to fostering an ethical culture among corporate leadership and employees.
- Corporate boards, top executives, and corporate ethics and compliance officers all have a central role to play in building a stronger ethical culture.
- Culture is the “missing link” that drives internal whistleblowers either to come forward or to stay silent.
- The only way to effectively reduce risk is to ensure that compliance and ethics programs are prioritized throughout the organization; some measures to achieve this goal include empowering the corporate ethics and compliance officer, offering performance incentives, and committing to periodic corporate self-assessment.
- Policymakers can play a role by punishing ethical deficiencies while rewarding companies that implement effective compliance and ethics programs.[8]

**Corporate culture and internal controls**

A robust compliance, ethics, and control environment is a critical piece of ensuring that performance incentives are properly executed. However, internal controls that work well can sometimes come at the cost of achieving short-term performance objectives, such as sales and quarterly profits. Often, the conflict between short-term results that drive performance incentives and long-term corporate goals and values can create conflict between management and the compliance and ethics personnel. Controls that are ignored, overridden, or distorted to achieve financial performance goals contained in performance incentives can lead to deceptive, unethical, and/or illegal business practices. In some cases, supervisors and managers are aware of such practices but they are not incentivized to stop them. When controls are ignored to achieve a temporary improvement of financial results, it erodes the ethical culture of the company, creating long-term damage. For example, during the 2008 economic crisis, many of the most profitable divisions of the companies found to have engaged in unethical conduct achieved profitability and hit their bonus-incentivized financial targets by ignoring compliance policies and overriding controls. When senior leadership was warned of such practices in one company, the documented email response was “don’t kill the golden goose.”

Although we normally think about standard antifraud/anti-corruption, contracting, finance, and accounting processes as an organization’s key internal controls, the strength of the corporate ethical culture can be a critical, foundational control without which all other controls will ultimately fail. This is because the strength of a corporate culture drives whether employees feel they are working in an environment that compels them to comply with existing rules, regulations, and controls. Some of the hallmarks of a strong corporate ethical culture include:

- Open, transparent, and timely communication;
- Management that is held to a higher standard of integrity and models ethical behavior;
- Employees’ comfort level in asking questions, communicating bad news, and reporting misconduct without a fear of retaliation;
• Realistic and achievable performance objectives without unreasonable pressure; and
• Incentives, rewards, and recognition for “doing the right thing.”

The 2018 Global Ethics Survey by the Ethics and Compliance Initiative found that corporate ethical culture has a significant impact on employee misconduct. In those organizations with a strong corporate culture:

• 88% of those employees who observed misconduct actually reported it, versus 52% in organizations with a weak culture;
• 12% of employees experienced pressure to do the wrong thing, versus 34% in organizations with a weak culture;
• 43% experienced retaliation, versus 55% in an organizations with a weak culture; and
• 28% observed unethical behavior, versus 83% in organizations with a weak culture.

Next month, in part two of this article, I will look at performance incentives through the prism of the Fraud Triangle, and how the design of incentives and performance metrics can directly affect employee behavior. This sets the stage to look at some lessons learned on how perverse incentives can put organizations at risk and have unintended consequences.

Takeaways

• Incentives that appear rational in meeting financial goals may not be appropriately balanced with ethics and integrity objectives and may reward improper employee behavior.
• Improperly balanced incentives comprise financial metrics, such as sales goals without explicit alignment to an organization’s core values and ethics objectives.
• Incentive goals linked to “reasonable” sales growth may start to run ahead of market realities, requiring the cutting of corners or outright cheating to achieve.
• Culture is the missing link that drives internal whistleblowers either to come forward or to stay silent.
• When controls are ignored to achieve a temporary improvement of financial results, it erodes the ethical culture of the company, creating long-term damage.

6 Idem.
8 Idem.