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Uncovering performance incentives that can lead to corporate fraud

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

Last month, in the first part of this series, I looked at how many highly publicized corporate frauds and ethical failures were driven by unanticipated consequences of poorly designed and ill-conceived performance incentives as a key contributor to bad employee behavior and corporate fraud. This month, I continue my exploration of perverse incentives and how they can unintentionally lead to corporate fraud and reputational harm for an organization.

Performance incentives and the fraud triangle

As we know, fraud is a *human* problem, and an employee's decision to engage in such misconduct can be driven by a number of factors. The Association of Certified Fraud Examiners' Fraud Triangle explains fraud from the standpoint of employee's perceptions of their *opportunity* to commit fraud because of weak controls (including a weak corporate culture that allows such activity to occur), *rationalization* that their unethical actions are somehow justified, and *pressure* (both internally and externally driven) that may push an otherwise ethical person to cross the line. Interestingly, each of these can be mitigated to varying degrees through organizational efforts to strengthen the ethical culture. For example:

- **Opportunities** to commit fraud are greatest when an employee perceives that the behavior is an accepted way of doing business; in other words, cheating can become a part of our culture that is reinforced by supervisor and peer behavior. Further, opportunities are greatest when the likelihood of detection or reporting (often stymied by a culture of retaliation) is lowest.
- **Rationalization** of employee entitlement, or of unfair treatment, is greatest in poor corporate cultures with low morale where employees feel unappreciated, there is a sense of disparity of treatment, and the systems of performance incentives and rewards often favor the ethically challenged and promote the wrong behaviors.
- **Pressure** to commit fraud is often greatest in organizations where performance incentives are singularly focused on the financial; the organization's goals, objectives, and values are based on unrealistic business metrics that are not adequately balanced with the organization's core values; and the pressure to meet financial performance targets outweighs all other considerations.

Realignment of performance incentives

Most organizations use performance incentives and financial metrics with the intention to drive success, and obviously don't set out to create incentives and managerial pressure that drive employees to shortcuts, overriding of controls, or fraudulent behavior. Some planning and forethought upfront can help properly align incentives with the strategic goal of remaining true to the company's core values in the pursuit of financial success.

The proper alignment of performance incentives begins with attention to ethics and integrity objectives in performance appraisals. Supervisors in particular need to be held accountable for communicating the organization's ethics and integrity message and translating the message into day-to-day actions and decision-making in their business units. Constant emphasis on the "how" we achieve business goals at all levels, backed up by accountability for ethical behavior in annual reviews, is critical.

Likewise, bonus determination criteria should encompass both financial metrics and balancing ethics and integrity requirements (the "how" we made the numbers). These can include compliance with organizational policies and procedures, serving as a role model for coworkers and subordinates, and protecting the organization from misconduct or other inappropriate behaviors that can place the company at risk.

In addition to bonuses, clear links between high-integrity behavior and promotion decisions can help incentivize the right behavior. Too often, employees are promoted to senior positions based solely on tenure, financial or sales performance, or even favoritism. This can weaken the corporate culture and incentivize the wrong employee behavior. Promoting those who have exhibited high-integrity behaviors in their business dealings and relationships with other employees and customers, and who have contributed to strengthening the corporate culture, will send a strong signal to the workforce on what kind of performance is valued and recognized.

In addition to bonuses and promotions, organizations can take a variety of additional steps to incentivize ethical behavior and strengthen the corporate culture, for example:

- Incorporate significant fraud, compliance, and ethics risks into the internal reporting metrics of key business units.
- Ensure that organizational and individual performance goals are realistic and do not foster pressure for unethical conduct.
- Reward teams and managers who achieve full compliance and avoid ethical failures.
- Publicly recognize employees who display ethical leadership and openly cultivate a culture of integrity and ethics.
- Recognize and show appreciation for employees who speak up and report inappropriate behavior that contradicts the core values of the organization.