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.

**Perverse incentives can put organizations at risk**
Several of the companies that have suffered significant and very public ethical failures used certain types of performance incentives and compensation structures that contributed significantly to their misconduct. These lessons can be used to better design incentives and avoid unintended negative consequences that drive the wrong behaviors.

**Target awards**

One of the most common compensation structures used in the corporate world is to have between 25% and 50% of target awards suddenly kick in when a threshold level of financial performance is achieved. To managers, that might mean millions of bonus dollars for hitting their numbers, or zero if they fall a dollar short of those goals. About half of corporate scandals over the past two decades have happened with performance in a range right around an all-or-nothing threshold level. In such systems, it is not uncommon to see decisions to “cut corners,” such as deferring maintenance or temporary layoffs to decrease payroll costs. Such systems can also drive unethical behavior such as channel stuffing (i.e., inflating sales and earnings figures by deliberately sending more products than retailers along the distribution channel are realistically able to sell), manipulation of accounting reserves, or flat-out illegal behavior such as bribery or fraud. It has been reported that Enron, WorldCom, Rite Aid, and Sunbeam all used all-or-nothing target awards that motivated bad employee behavior that led to scandal and/or bankruptcy.

Likewise, the seeds of the Mylan EpiPen scandal were planted when management became eligible for millions of dollars if they hit 90% of their cumulative earnings targets. If they achieved 89.9% of their goal, they would lose out on all of it. Mylan settled claims with the federal government for more than $465 million[1] that it overcharged the government for its EpiPen allergy treatment by using a scheme to misclassify the EpiPen as generic rather than a branded product. That allowed Mylan to underpay rebates to state Medicaid programs to boost its sales, and allowed its managers to meet their bonus targets.

**Unrealistic cross-selling sales goals**

The Wells Fargo scandal offers some insightful lessons about unrealistic performance incentives and the destructive impact of management pressure.[2] When Wells Fargo imposed a “cross-selling” performance target of eight
accounts per customer for its branch customer relationship managers, it may have been intended as an aspirational goal. Cross-selling is a proven method of encouraging growth and maximizing profitability with little incremental marketing expense. However, bonuses were made completely dependent on achieving this sales goal absent specific guidance or communications on “how” such goals had to be achieved. The situation was further inflamed by managers reportedly checking progress up to twice per day, creating what employees called “a pressure cooker.” Some employees lost their jobs for falling short of the goals, and others observed the berating and/or termination of their peers. Those who complained were sidelined or terminated. Managers failed to shut down the bad practices (i.e., inappropriate and illegal opening of accounts) that they knew were occurring, because their own performance incentives depended on reaching these targets. The company has paid billions in penalties and fines, and the reputational damage to the bank has been significant and lasting.

**Falsification of performance metrics**

The Department of Veterans Affairs (VA) scandal in 2014 revealed long delays in veteran care at VA hospitals around the country. Some of these delays reportedly contributed to the deaths of veterans. In an attempt to address the problem, employee bonuses were linked to patient wait times at hospitals. Because insufficient resources were added to actually address the wait times in a meaningful fashion, rendering the 14-day goal unrealistic, staff falsified appointment records to meet the 14-day standard. The VA did not begin reviewing and validating the data supporting the incentive payments until after the organization had already paid out $400 million for bonuses in 2011. In addition, a decision had been made earlier to eliminate performance bonuses for VA leadership, removing the incentive for them to pay attention to what was happening.

**Incentivizing employee empowerment**

The United Airlines scandal involving the mistreatment of a passenger offers a lesson in why performance incentives should work to empower employee decision-making. At O’Hare International Airport, United staff asked for four volunteers to give up their seats to make room for a crew that needed to get to their destination for another flight. When no passengers accepted the airline’s offer of $800, overnight accommodations and a flight 24 hours later, the staff followed written procedures by randomly selecting four passengers by
computer. A 69-year old physician refused to give up his seat, so United staff
followed written procedures and called airport police, who were then recorded
by cell phones forcibly removing the man and dragging his bloodied body down
the airplane aisle. United’s CEO Oscar Munoz initially chose to see the incident
from the worker’s viewpoint: the staff treated the man politely, he was
disruptive and belligerent, and agents had no choice but to call the police.

Munoz’s reaction glossed over the constraints placed on the employees to
manage glitches. When no one took the offer to give up their seat, the gate
agents had exhausted the procedures they were required to follow and did not
know (nor were they incentivized) to think outside the box and independently
come up with other solutions to protect the airline and its customers. The
corporate culture of many US airlines has been described as scripted, rote, and
procedural, and workers are reportedly disincentivized from thinking
creatively. Alternative solutions might have included:

- Drive the crew to their destination, which was less than five hours away.
- Charter a plane, if necessary.
- Offer more than $800 to find passengers to give up their seats.

Any of these options would require empowering the employees on the ground
and developing incentives for employees to creatively problem solve without a
fear of retaliation.

**What questions should you ask about your performance incentives?**

In 2017, the Department of Justice Fraud Section issued guidance on how it
evaluates the effectiveness of corporate compliance programs. This guidance
was updated in April 2019 and contains many of the same criteria. Several of the
evaluation questions relate to the use of performance incentives to drive
ethical behavior and strengthen the corporate ethical culture. For example:

- What role has compliance played in the company’s strategic and
  operational decisions?

- How has the company incentivized compliance and ethical behavior?
Has the company considered the potential negative compliance implications of its incentives and rewards?

Have there been specific examples of actions taken (e.g., promotions or awards denied) as a result of compliance and ethics considerations?

Each of these questions has an underlying implication that the compliance and ethics officer is involved in the performance management and incentive process. However, an April 2017 survey by the Society of Corporate Compliance and Ethics[5] found that only 23% of compliance officers review management incentive plans to identify and mitigate risk prior to rollout. More than half (52%) don’t review the plans at all. Similarly, only 25% of compliance officers review rank-and-file employee incentive plans prior to rollout; 46% do not review these plans at all.

Clearly, the compliance and ethics officer can and should play a critical role in ensuring that performance incentives are properly designed and balanced with ethics, integrity, and other core values in order to drive the desired employee behavior. Compliance officers should:

1. Check the company’s performance management and incentive plans prior to rollout for:
   - Alignment with core values and ethics objectives
   - The percentage of total compensation at risk
   - Metrics driving rewards (individual versus group)
   - Potential cliffs (all or nothing rewards)

2. “Wargame” the possible unintended consequences of financial performance metrics:
   - Develop counter strategies to communicate the company’s intentions
   - Focus training and other resources on the “how” in achieving performance metrics
   - Institute oversight mechanisms to ensure that performance incentives are being properly pursued and metrics accurately reported
Conclusions and lessons learned

Perverse incentives are named that for a reason. They can be counterproductive to a company and lead to fraudulent employee behavior, erosion of the corporate culture, and damage to the bottom line. There are creative ways to use positive incentives that take into account financial and organizational realities, while promoting ethics and integrity objectives. Companies should consider the lessons learned by organizations that have experienced ethical failures due to the unintended consequences of performance incentives and conduct an assessment to ensure that current performance incentives don’t have hidden pitfalls that can create unnecessary fraud risk. Incorporating ethics, compliance, and integrity goals into the performance management system requires forethought, careful planning, and active participation of the compliance and ethics officer, and it should be a key component of your anti-fraud plan.

Takeaways

- Opportunities to commit fraud are greatest when an employee perceives that the behavior is an accepted way of doing business.

- Rationalization of employee entitlement is greatest in poor corporate cultures with low morale where employees feel unappreciated and rewards often promote the wrong behaviors.

- Pressure to commit fraud is often greatest in organizations where performance incentives are singularly focused on financial goals that aren’t in line with core values.

- The United Airlines scandal involving the mistreatment of a passenger offers a lesson in why performance incentives should work to empower employee decision making.

- The 2017 Department of Justice Fraud Section’s Evaluation of Corporate Compliance Programs guidance and the April 2019 update discuss performance incentives related to ethical behavior.

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