Year-end bonus is an incentive to cheat

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(PhysOrg.com) -- You don't have to look far these days to find examples of corporate scandals involving fraud. But Judi McLean Parks, the Reuben C. and Anne Carpenter Taylor Professor of Organizational Behavior at Olin Business School at Washington University in St. Louis, wanted to find out what actually motivates people to "cook the books."

McLean Parks and co-author James W. Hesford had a hunch that compensation packages had something to do with the rising tide in fraud, estimated to total $994 billion annually in the U.S. Specifically, they suspected the type of compensation plans — contingent versus non-contingent — (and the form of that contingency, as a bonus or penalty based on performance), might be related to fraudulent reporting and the misappropriation of assets.

To test their hypothesis, McLean Parks and Hesford conducted a controlled laboratory study using a random sample of students who were paid for solving anagrams according to one of three different compensation plans, although in all cases the expected value of the compensation — regardless of the form of the compensation — was identical. The students self-scored their work and in half of the cases signed a statement attesting to the veracity of their reported results.

• Participants receiving a 'flat salary' for their work were the most honest about reporting their scores.

• Many participants who received a performance based bonus cheated when reporting their results.

• Participants who were penalized based on low performance not only cheated but also stole the nice pens that were to be returned at the end of the study!

Professor McLean Parks sums up the most obvious results of the study this way, "if you pay someone contingent on their performance, you have motivated them to perform. However, if they are unable to perform well because the task is hard, because of economic conditions or whatever, you have also given them an incentive to cook the books!"

McLean Parks believes the study's results have implications for CEO compensation plans and the financial difficulties many companies are experiencing today. "All I have to do is look at Enron, Fannie Mae, Freddie Mac to know that this does happen. And now we've demonstrated the causal link to contingent pay." Fraud uncovered at Fannie Mae alone from 1998-2004 has been estimated to be in excess of $10.6 billion.

"For years we have touted the basic mantra of pay for performance because that's the way you get the best performance," observes McLean Parks. "Maybe you get the best performance reported, but what's the underlying performance?" The study suggests that incentives like pay based on performance may not be the foil for unethical behavior they were created to be. In fact, the authors conclude that, " the use of contingent contracts… may be short sighted in that such contingencies may encourage behaviors such that the cure itself may be worse than the disease."

Study results are reported in a paper currently under review and titled: Give & Take: Incentive Framing in Compensation Contract, by James W. Hesford, Cornell University and Judi McLean Parks, Olin Business School,Washington University in St Louis.

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