Rewarding Ethical Behavior

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For years, a discussion has raged in management circles about "rewarding" ethical behavior: Of course, people can be punished for bad behavior, but why and how should we reward people for doing the right thing? Should people be rewarded for being ethical?

But if other types of desired behavior are rewarded, why not reward ethical behavior? Should employees be rewarded similarly to the way people are rewarded when they meet financial targets, regardless of how those targets are met? Or should people be rewarded differently depending on how they make their targets?

Unintended Consequences

The link between rewards and ethical behavior is far from murky; it is, in fact, crystal clear. The link is so strong that ignoring the ethical ramifications of rewards can result in real disaster.

Consider the case of Sears Auto Centers in the early 1990s. Profit margins in the merchandising group collapsed under competitive pressures. The least profitable of the group's units were the auto centers. In an effort to spur performance, Sears introduced a cost-cutting and productivity-enhancing program that included, among other things, a productivity incentive for auto mechanics. Mechanics' base pay was reduced and replaced by a fixed dollar amount in addition to base salary for completing a job within a specified period of time. (This type of pay is also known as "piece rate.") Mechanics were given quotas, such as a certain number of brake jobs. Service advisers, who were responsible for consulting with mechanics on a vehicle's condition and then advising customers on potential repairs and parts, were put on a base salary plus commission plan. They also had to meet product-specific sales quotas.

The results are legendary.

In 1992, the California Department of Consumer Affairs' Bureau of Auto Repair (BAR) released the results of an 18-month investigation into the practices of Sears Auto Centers. BAR concluded that the auto centers habitually overcharged customers for repairs, recommended unnecessary repairs and charged for repairs that hadn't been done. The resulting class action suit focused on Sears' commission-and-quota compensation system as the culprit.

Sears provided compensatory relief in the form of $50 coupons issued to class members and paid class counsel costs of $3 million. The compensation system was redesigned and Sears' CEO apologized to customers in full-page newspaper ads. Unfortunately, the ill-conceived reward system – designed with the best intentions – had encouraged unethical behavior and damaged what had until then been a sterling corporate reputation for superb customer service.

Rewards: Where the Rubber Meets the Road

Smart companies have listened closely to what regulators, legislators, the courts and public sentiment have had to say about ethics programs. Many companies have inspirational corporate vision statements, clear corporate policies, lengthy codes of conduct, employee hotlines and comprehensive training and communication around ethics. They tout their high ethical standards in employee publications, on plaques hanging in corporate offices, in consumer advertising and on their Web sites. Enron had a wonderful values statement and a comprehensive ethics policy. All of that imploded as a result of wide-

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spread unethical behavior that extended up, down and across the organization.

Ethical behavior is really driven by how it is encouraged and rewarded. If companies are serious about ethics, they must have the elements of an ethics infrastructure and a real commitment from the leadership on the subject of ethics. But they also need to define ethical behavior in the corporate context and develop a strategy to reward the desired behavior.

Defining Ethical Behaviors

Based on experience, most employees in most organizations want to act ethically, but often they don't know the "rules." This might be a first job, or perhaps an employee is new to a particular industry or company. Or, like the majority of employees, they might learn policy only on a need-to-know basis. Communicating policy – the "rules" – is one of the biggest challenges organizations face.

But, for the sake of argument, assume that employees have the corporate policy committed to memory – they do know the rules. Employees still need to understand what ethical behavior looks like. They need clear descriptions of ethical behaviors in the context of their industry, their organization and their job. And they need to see their managers modeling this behavior.

For most professionals who have worked in the area of performance and rewards in the past 15 years, this is not a new concept. Precious time and money has been invested to help companies define competencies, then use them as criteria for selection, development, performance management and, yes sometimes, rewards. Isn't this really the same thing? Ethical behaviors can be defined the same way competencies have been defined.

The key to success, as with competencies, is to focus on the right ones, not a long list. Also, despite the fact that "acting ethically" has some universal themes, companies need to understand what the common ethical dilemmas are in their specific business environments and describe what employees can do to act ethically. "Acting ethically" could be described in behavioral terms such as:

Quick Quiz:

How Does Your Organization Rate

in Linking Ethical Behavior and Rewards?

	Strength	Neutral	Weakness
Our performance management program includes ethical behavior/ integrity as a performance expectation.	❑	❑	❑
Employees in my organization are rewarded not only for the results they achieve, but also for how they achieve those results.	❑	❑	❑
Executives' pay levels in my organization are tested for reasonableness using a rigorous process of competitive compensation analysis.	❑	❑	❑
Our board members receive clear, complete and accurate information well in advance of meetings in which they have to approve executive pay recommendations.	❑	❑	❑
Our board is free of undue management influence when it makes executive pay decisions (e.g., the CEO is not a voting member of the board).	❑	❑	❑
My organization swiftly deals with unethical behavior.	❑	❑	❑
Our stated organizational values are reinforced and reflected in our performance management system.	❑	❑	❑

- Maintains confidentiality
- Is truthful
- Confronts potentially unethical behavior (does not look the other way)
- Avoids conflicts of interest

In health care, however, it would be far more powerful to define "acting ethically" in more specific terms. For example:

- Maintains confidentiality of patient and other sensitive information
- Is truthful in recordkeeping and reporting
- Confronts and counsels others who could be jeopardizing a patient's dignity (does not look the other way)
- Treats all patients equally according to the level of care needed for their condition, regardless of who they are or who they know.

Incorporating Ethical Behavior into Performance and Rewards

Note that these behaviors are observable – people can be seen doing or saying them. Because they are observable, the occasions on which people demonstrate them (or fail to demonstrate them) can be tracked, and positive reinforcement or corrective feedback can be provided. In short, people can be held accountable for their achievements as well as their behaviors, and success in both areas can be rewarded.

Importantly, there also must be consequences for failure to act ethically, just as there are, or should be, consequences for failure to achieve results. At Sears Auto Centers, there was a consequence for not achieving quota: the mechanics made less money than they had under the base salary-only system. Suppose the compensation professionals at Sears also had designed the mechanics' incentive program with a consequence for failing to act ethically; in other words, if they had defined specific behavior criteria that described how the mechanics should achieve their results.

For example, one behavioral criterion might be, "determine if brakes are likely to be a hazard or fail before the next service interval before recommending replacement." Obviously, Sears would have had to enforce this by inspecting the brake parts coming off customers' cars to ensure they were worn, but it would have prevented the precipitous drop in customer confidence and loss of business that resulted from the unethical behavior encouraged by the incentive program.

Building ethical standards into an incentive program isn't the only way to link ethical behavior and rewards. Here are other ways smart companies can forge the link:

Incorporate both the *what* and the *how* into performance expectations. Results are the *what*. Ethics and other values, such as teamwork and open communication, are the *how*. Make achievement of results and demonstration of values equal considerations in determining the size of merit salary increases. This is becoming increasingly common, too. Of the clients we have worked with to design performance management programs, 70 percent incorporate ethical behavior/integrity into performance expectations.

Build ethics and other values into non-cash rewards programs. An outstanding and courageous demonstration of ethics, such as blowing the whistle on a suspicious accounting practice or suggesting a novel approach to safeguarding confidential data, can be an award-worthy event in a recognition program that has significant non-cash rewards.

Ensure managers are committed to modeling ethical behavior, encouraging that behavior and praising employees who demonstrate it.

Compensation Professionals' Obligations

Whether managing compensation in a for-profit or non-profit organization, there are certain ethical responsibilities that come with the job.

In designing incentive programs, think about whether there are any unethical or otherwise undesirable behaviors that the program might encourage. If so, build in behavioral expectations that will make it clear how the results should be achieved.

Push toward a performance culture. This means getting acceptance for a rigorous process of setting meaningful performance expectations – both results and behaviors – and for holding people accountable for meeting these expectations.

Ensure that pay, especially for executives, is reasonable from a competitive perspective. Use a process for testing reasonableness that is rigorous and transparent. Present information to the board of directors in an easy-to-understand fashion and ensure it is complete, so the board can make informed decisions.

As performance and rewards professionals, we have an important role to play in ensuring that company employees demonstrate high ethical standards, and that role is as important as that of the "official" ethical watchdogs: general counsel and the compliance officer. We have an opportunity to go beyond reinforcing compliance. Well-articulated, well-structured programs can enlighten and encourage a higher standard of ethics and values.