Designing Honesty into Your Organization

By Christian Mastilak, Linda Matuszewski, Fabienne Miller, and Alexander Woods

The past decade has provided ample evidence that some people don't behave honestly at work. While it's easy to blame individual factors such as greed or lack of an ethical compass, recent academic research paints a different picture. As a leader in your organization, you may have more influence than you realize about whether your employees act honestly or not. You can design honest behavior into an organization by using fair and properly aligned reward systems and simple communication strategies.

We know dishonesty is costly, and it may be on the rise. The Ethics Resource Center reports that the following percentages of employees surveyed in 2009 had observed these behaviors in the previous year: company resource abuse (23%), lying to employees (19%), lying to outside stakeholders (12%), falsifying time or expenses (10%), and stealing (9%). The Association of Certified Fraud Examiners suggests U.S. organizations may have lost as much as $994 billion to occupational fraud in 2008, and a PricewaterhouseCoopers global survey in 2009 suggests that recent economic pressures have increased the likelihood of fraud taking place. But how can this common problem be reduced?

Research suggests that integrity testing goes only so far in predicting honesty in the workplace. It turns out that most employees are neither consistent truth-tellers who can be completely trusted in the absence of controls nor consistent liars who can never be trusted. This means preventing dishonesty isn't just a matter of finding the right people. Some factors can motivate employees to be closer to the truth-telling end of the scale. Specifically, research shows that honest behavior is influenced by employees' beliefs about whether they are being treated fairly, whether expectations of honest behavior have been made explicit, and whether organizational control systems reward dishonest behavior. This suggests that honest behavior can be designed into—or out of—an organization. In this article, we first discuss some of the research findings, then draw on them to develop practical suggestions for how managers can create an environment that both discourages dishonest behavior and enables honest behavior.

Why Do Employees Behave Dishonestly?

We broadly define dishonest behavior as making a report known to contain lies or taking an action known to be unauthorized for personal gain. This excludes accidental errors but includes a variety of behaviors common to accounting and finance functions. Most research in accounting has focused primarily on budgeting behavior, such as padding requests in order to keep the extra funds. But research on more direct forms of theft, such as stealing company property, has led to similar conclusions about why employees steal.

Admittedly, the reasons for dishonest behavior are many and varied. Much has been written about the fraud triangle and how the presence of pressure, opportunity, and rationalization increases the chance of fraud. We can't do justice to the entire topic here, but we can discuss some organizational design and control choices that affect people's behavior. Two common themes that surface are *fairness* and *frame*.

Fairness

For years, economic theory has rested on the assumption that two important desires drive people's behavior: leisure and wealth. Business schools teach future managers to assume that employees will avoid working hard and will lie to increase their wealth. These assumptions then show up in practice as internal control systems are developed to help prevent and detect lack of effort and dishonesty.

Recent academic research has identified two other desires that influence behavior: honesty and fairness. So it isn't simply that people want to be as rich and put forth as little effort as possible; rather, most people also care about being honest and want to ensure that their treatment and outcomes are reasonable compared to the treatment and outcomes of others. More importantly, these desires affect honesty in the workplace.

> When employees believe they haven't received what they are due, they will look for ways to recover what they believe they're owed.

Several studies provide examples of how tradeoffs among desires for wealth, honesty, and fairness play out in organizational settings. Coauthor Linda Matuszewski conducted one such study with funding from the IMA® Foundation for Applied Research (now called IMA Research Foundation). Appearing in the 2010 issue (Volume 22) of the *Journal of Management Accounting Research*, "Honesty in Managerial Reporting: Is It Affected by Perceptions of Horizontal Equity?" is one of several studies in accounting in which student participants played the role of managers reporting to their employer. Participants knew the amount of actual costs that would be incurred on a project and were asked to submit a budget request. The employer would never know the actual costs. If the participant lied and the budget request exceeded actual costs, the participants kept the difference. This difference was personal gain for participants—at the expense of their employers. That is, the greater the lie, the more money the participants received.

Overall, Matuszewski's results are consistent with "Honesty in Managerial Reporitng," a study by John Evans, Lynn Hannan, Ranjani Krishnan, and Donald Moser in the October 2001 issue of *The Accounting Review*. Matuszewski's study shows that only a small proportion of people (15%) lied to maximize their wealth. A similar proportion of people were at the other end of the spectrum, with 19% behaving completely honestly. This left the vast majority (66%) in the middle—lying some and trading their desire to be honest against their desire for wealth.

At the two extremes, managers could assume the worst and develop expensive management controls to prevent and detect dishonesty, or they could assume the best and not develop any controls. Since most employees don't fall into either extreme, neither of these solutions is likely to be the most cost effective. Managers are left with the challenge of designing control systems for the majority of employees—those who have some desire to be honest but are also willing to lie to some extent. This is where the results of several other studies can be helpful, as they shed some light on factors within a company's control that influence whether an employee's behavior is closer to the honest or the dishonest end of the scale.

One factor is *vertical* fairness. This represents the relationship between employees and their organizations. In "Stealing in the Name of Justice: Informational and Interpersonal Moderators of Theft Reactions to Underpayment Inequity," Jerald Greenberg describes a study in which he promised two groups of research participants a certain level of pay for performing a low-skilled task (*Organizational Behavior and Human Decision Processes*, Volume 54, Issue 1, February 1993). Participants who were treated unfairly by being paid less than they were originally promised "stole" from the researcher, likely rationalizing that they were due the stolen amount. Participants who were given a reasonable explanation for why their pay was less than promised and received an apology from the researcher, however, stole less. Greenberg's work shows that an explanation and empathy can go a long way toward soothing hurt feelings—and reducing retaliation in firms.

Vertical fairness is critical—but it isn't the only element that matters. Look no further than *Strategic Finance*'s Annual Salary Survey each June to know that horizontal fairness—how fairly people are treated compared to their peers—is also important. This was the main focus of Matuszewski's study, which demonstrated that participants' beliefs about changes in the *horizontal* fairness of their pay changed the honesty in their budgeting behavior. Participants in the study were paid a salary and received information about the salaries of other participants. When the horizontal fairness of pay declined, the change in honesty was the same, whether it occurred because of a decrease in the participant's own pay or an increase in others' pay. To make matters worse, this dishonest behavior is hard to undo. In Matuszewski's study, improvements in horizontal fairness resulting from decreases in others' pay didn't result in more honest behavior. Thus, being treated fairly right from the beginning is extremely important.

We aren't trying to minimize employees' personal responsibility for their actions. But research shows that when employees believe they haven't received what they are due, they will look for ways to recover what they believe they're owed. Accordingly, we believe that if top management designs fairness into its dealings with employees, it will eliminate this possible rationalization and cause employees to pursue honest behavior more frequently.

Frame

Another way to design honest behavior into organizations is to ensure that an organization clearly communicates that honesty is expected. When would an employee think that honest behavior isn't expected? Think of it this way: Imagine you're playing basketball. Is a head fake unethical? No, it's completely normal behavior because basketball is a competition, and misleading your opponent is expected. Imagine Kobe Bryant complaining that LeBron James cheated because he made a no-look pass. "Not fair! He looked the other way!" That isn't going to happen because Kobe understands they're competing against each other.

How is this relevant? Well, how often do your budgeting processes become framed as strategic competitions among employees and management rather than decisions with ethical implications? You're more likely to find dishonest behavior if employees believe that the budgeting process is expected to be competitive rather than collaborative, strategic rather than honest. That's what Frederick Rankin, Steven Schwartz, and Richard Young found in "The Effect of Honesty and Superior Authority on Budget Proposals" (*The Accounting Review*, July 2008). Participants completed a budgeting task similar to the task in

Matuszewski's study. Those who were asked to honestly share their information about actual costs were more honest than those who were simply asked what portion of the profits should be returned to the company. This study suggests that, in the absence of formal controls, people will be more honest if you simply ask them to be!

Rankin, Schwartz, and Young's finding is particularly important given recent research about the costs and benefits of formal controls. In "When Formal Controls Undermine Trust and Cooperation," Margaret Christ, Karen Sedatole, Kristy Towry, and Myra Thomas suggest that employees sometimes view formal controls as a sign that employers question their competence and integrity, and this may undermine trust and cooperation (*Strategic Finance*, January 2008). To be clear, we aren't advocating doing away with all explicit formal controls. In circumstances in which formal controls aren't present or are too costly, Rankin, Schwartz, and Young show that some of the same benefits can be achieved by describing a task as an ethical dilemma, rather than a strategic competition, and asking for honesty.

Another effect that framing has in determining whether honest behavior is expected showed up in the large-scale fraud at Enron. Bennett Stewart suggests in "The Real Reasons Enron Failed" that Enron's managers were, in fact, paid to do dishonest things (*Journal of Applied Corporate Finance*, Volume 18, Issue, 2, Spring 2006). Stewart documents that performance at Enron was framed as an accounting game rather than as increasing the company's true economic value. In part, this involved manipulating internal performance measures to exclude any costs of capital. Stewart documents the use of EBITDA—"the least accountable, most misleading indicator of corporate performance ever devised"—by Enron executives who clearly knew better.

Why did they use this measure? Simple: Enron's performance measurement and compensation system, which included stock-based compensation, paid them to do so. Increases in Enron's stock price were driven in large part by—you guessed it—accounting performance. And we shouldn't be surprised when people do what firms pay them to do.

The greatest problem with poorly framed control systems is that, even when employees intend to be honest, a bad control system may discourage that employee from acting on that honest urge and *disable* that honesty. The challenge is for top managers to design control systems that *enable* honesty.

The Designed Honesty Model

Putting these research results together, we present the designed honesty model of organizational behavior (see Figure 1). The model shows that both fairness and frame contribute to designed honesty. Where should top management look to understand why employees aren't behaving honestly? That depends. If employees are grumbling about their working conditions or their pay—especially their pay relative to others within the organization—then they probably believe they aren't being treated fairly and may well be working the system to get what they believe is due them. On the other hand, if employees report conflicts between what they believe they should do and what they believe they're being asked and paid to do, then the culture and control system frame are probably the culprits, leading otherwise honest employees to feel like they are being encouraged to behave dishonestly.

Figure 1: **The Designed Honesty Model**

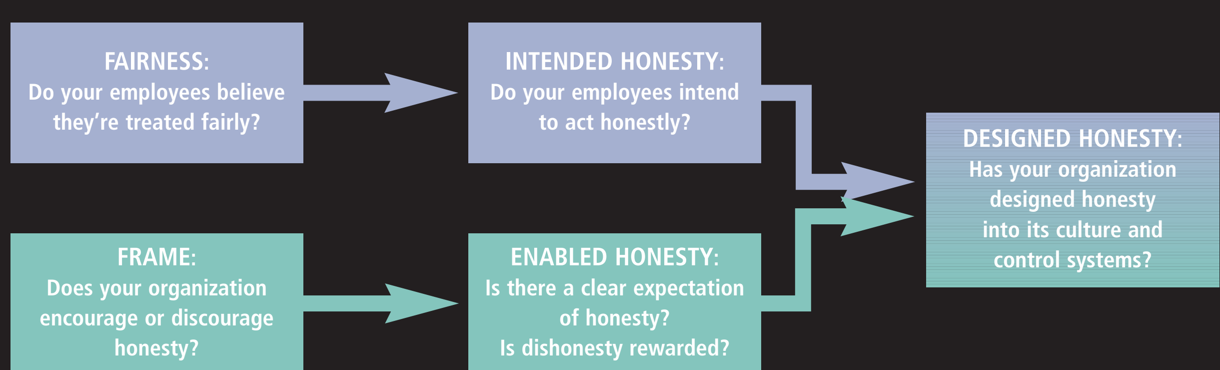

Table 1: Six Key Steps toward Designing Honesty into Your Organization

1. Consider vertical and horizontal fairness when making compensation decisions.
2. Fully explain compensation policies and procedures.
3. Determine whether employees believe they are being paid fairly.
4. Show (and feel!) empathy when tough compensation choices need to be implemented.
5. Ask employees to be honest, and describe routine decisions as ethical dilemmas rather than strategic competitions.
6. Review incentive plans to ensure they reward honest reporting of economic results.

The designed honesty model isn't intended to be complete—the factors that influence honesty and dishonesty are many and varied. As the research shows, most employees value honesty and fairness in addition to wealth and leisure and are influenced by all of these values when deciding whether to behave honestly. Since fairness and frame are within an organization's control to some extent, it's important for management to understand how these factors can contribute to honest behavior.

Therefore, in addition to attempting to hire the right people, we recommend that companies take the following steps to encourage employees to act on their intentions to be honest (see Table 1):

1. Consider vertical and horizontal fairness when making compensation decisions.

Employees consider the fairness of their compensation from two perspectives—relative to their exchange with the company (vertical) and relative to the compensation of their peers (horizontal). Managers may be able to get a sense of the perceptions about the vertical fairness of compensation by considering employees' alternative employment opportunities. In today's culture of high turnover, it's reasonable to assume that employees are keeping their eye on the job market and asking "What could I make elsewhere?" But how often do managers consider their subordinates' opportunities when making compensation decisions? Incorporating this practice into the firm's periodic performance review system could help avoid the costs of dishonesty motivated by perceptions of vertical unfairness.

From the horizontal perspective, although firms often have policies that discourage peers from sharing information about pay, we believe managers should assume that employees know how much money their peers are making so should make an effort to compensate employees fairly compared to their peers.

2. Fully explain compensation policies and procedures.

Fair doesn't necessarily imply equal. In cases where compensation isn't equal to an alternative employment opportunity or the pay a peer is receiving, detailed explanations may be especially important in helping employees evaluate whether their pay is fair. Communication strategies that help employees understand the justification for compensation policies can be extremely valuable. For instance, employees may be more likely to consider their compensation fair if managers explain the connection between the resources of their division and employee compensation.

3. Determine whether employees believe they are being paid fairly.

Most large companies have periodic performance review systems in place, and it's through these systems that compensation decisions get communicated. Yet how many of these systems are two-way communication devices designed to determine whether employees believe they are being paid fairly? This data may be challenging to get, especially if employees fear retaliation if they admit they don't believe they are being paid fairly. Managers may need to put themselves in their employees' shoes and pursue indirect methods for answering this question, such as anonymous surveys or hotline methods.

4. Show (and feel!) empathy when tough compensation choices need to be implemented.

Of course, managers won't always have the resources to give employees the compensation they want and feel they deserve. But empathy can have an impact on honesty, even when employees face an outcome they believe is unfair.

5. Ask employees to be honest, and describe routine decisions as ethical dilemmas rather than strategic competitions.

A logical first step in making it clear that you expect employees to be honest is the establishment of a corporate code of ethics, but even the best code won't be effective unless employees can see the connection between the code and their everyday activities. Think of it this way: Corporate planning doesn't stop with the development of a vision statement. Firms work toward the vision by identifying core competencies, developing organizational strategies, and translating these strategies into operating plans. In the same way, a company must develop strategies for ensuring honest behavior. The research suggests that one successful strategy would be to identify tasks that provide employees with opportunities to benefit from dishonesty and describe these tasks as ethical dilemmas rather than strategic competitions.

This suggestion is consistent with the findings in two 2011 studies published in the *Journal of Business Ethics* that identify factors that contribute to the effectiveness of corporate codes of ethics. Muel Kaptein found in "Toward Effective Codes: Testing the Relationship with Unethical Behavior" (Volume 99, No. 2, March 2011) that the quality of communication regarding a corporate code of ethics has a greater impact on reducing unethical behavior than the quantity of communication about the code. Put simply, it isn't enough to establish a code and talk about it a lot. The code must be accessible, clear, easy to understand, and useful for decision making. In the other study, "Determinants of the Effectiveness of Corporate Codes of Ethics: An Empirical Study" (Volume 101, No. 3, July 2011), Jang Singh found that a code's impact on behavior is determined in part by whether the code guides strategic planning and is useful in resolving ethical dilemmas in the marketplace.

6. Review incentive plans to ensure they reward honest reporting of economic results.

Both Kaptein's and Singh's studies also provide insight into the steps managers should take to ensure that their incentive plans promote honesty in the workplace. Singh found that codes are more effective when compliance with their provisions is a part of performance reviews and when there are real consequences for violations. Kaptein found that the most important factor in reducing unethical behavior was senior and local management's embedding of the corporate code of ethics within an organization. More specifically, employees are more likely to be honest when their managers are approachable positive role models who set reasonable performance targets that promote, rather than undermine, compliance with the corporate code of ethics. In addition, it's important that managers don't authorize violations of the code to meet business goals, are aware of the extent to which employees comply with (or violate) the code, and respond to violations appropriately.

To prevent the kind of financial reporting dishonesty that occurred at Enron and many other companies, we suggest that managers should also consider whether performance targets based on economic results are using measures less subject to manipulation than traditional financial accounting measures may be.

Steps Will Go a Long Way

While we can't guarantee that these steps will eliminate all dishonesty in the workplace, we believe that paying attention to the fairness of employees' compensation and highlighting the ethical dimension of certain decisions will go a long way toward designing honesty into your organization. **SF**

Christian Mastilak, Ph.D., is an assistant professor of accountancy and business law in the Williams College of Business at Xavier University and a member of the North Cincinnati Chapter of IMA. You can reach Christian at (513) 745-3290 or mastilakc@xavier.edu.

Linda Matuszewski, Ph.D., is an assistant professor of accountancy in the College of Business at Northern Illinois University and a member of the Rockford Chapter of IMA. You can reach Linda at (815) 753-6379 or lmatus@niu.edu.

Fabienne Miller, Ph.D., is an assistant professor of accounting in the School of Business at Worcester Polytechnic Institute and a member of the Worcester Chapter of IMA. You can reach Fabienne at (508) 831-6128 or fabienne@wpi.edu.

Alexander Woods, Ph.D., is an assistant professor of accounting in the Mason School of Business at The College of William & Mary. You can reach Alex at (757) 221-2967 or alex.woods@mason.wm.edu.