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Rationalization of financial statement fraud in government: An Austrian perspective

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Abstract

This paper develops a conceptual framework that explains how existing opportunities and incentives for committing financial statement fraud in government translate into the rationalization of such fraud. The analytical approach is theoretical. The rationalization of financial statement fraud is analyzed through the lenses of a theory of entrepreneurship rooted in Austrian economics. Entrepreneurship, while generally seen as a positive force for economic productivity, is viewed as a source of deception. The framework illustrates that financial statement fraud has its origins in political, rather than economic incentives, and that it is rationalized by elected rather than non-elected officials. Due to a lower proportion of creditors and investors with vested interests in the framework, it is also concluded that the detection process of financial statement fraud in government tend to exhibit less "alertness" than in private sector contexts. Specific techniques associated with financial statement fraud therefore tend to persist over relatively long periods of time.

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1. Introduction

Fraudulent activities relating to the preparation and presentation of corporate financial statements have received a considerable amount of attention in the post-Enron era (Clarke et al., 2003; Inanga and Schneider, 2005; Reinstein and McMillan, 2004). Financial statement fraud, however, is not isolated to the corporate sector. It may be found within entities in all sectors of the economy, including governmental, quasi-governmental and non-profit entities. This paper is focused on financial statement fraud within governmental entities in the US at the state and local levels. Explicitly stated, it seeks to explain how existing opportunities and incentives for committing financial statement fraud in government translate into the rationalization of the fraudulent acts. Included too, is a discussion of the potential losses that might result from such fraud. These losses extend to loss of personal income, opportunity costs and denigrated living conditions. For instance, manipulation of financial numbers can result in deterioration of infrastructure, as was evidenced in places such as New York City in the early 1970s (Herzlinger and Sherman, 1980).

An analytical approach rooted in the Austrian economic tradition is used. The methodology underlying this tradition is referred to as praxeology. Praxeology places emphasis on the nature of explaining social phenomenon and is based on those aspects of human action that can be understood a priori. A fundamental appreciation of human action is therefore a basis for theory building. A resulting tenet of the Austrian economic framework that is of specific use for the purposes of this paper is the emphasis it places on the entrepreneur. The entrepreneur is viewed, in Austrian economics, as the ultimate source of human action. The entrepreneurial function is described in terms of "alertness" toward "unexploited" profit opportunities (Kirzner, 1973). The "profit" element, borrowing in part from Niskanen, can provide benefits for public employees or "profits" to special interest groups. Using the above terminology, the prospect of financial statement fraud can usefully be described in terms of government officials' alertness to opportunities for engaging in financial statement fraud, as well as their willingness to seize them. Entrepreneurship, while generally seen as a positive force for economic productivity is, thus, viewed as a source of deception.

2. Financial statement fraud: empirical context

The American Institute of Certified Public Accountants (AICPA) SAS No. 99 defines *fraud* as an intentional act that results in a material misstatement in financial statements. AICPA's definition considers two categories of misstatements (AICPA Auditing Standards Board, 2002). These include misstatements arising from fraudulent financial reporting (e.g., falsification of accounting records) and misstatements arising from misappropriation of assets (e.g., theft of assets or fraudulent expenditures). Definitions of *financial statement fraud* tend to be confined to the former of these. The gist of these defines financial statement fraud as a deliberate attempt to deceive or mislead another person or group by misrepresenting or omitting the amounts and disclosures of financial statements (Rezaee, 2002; Thornhill and Wells, 1993). Rezaee summarizes the schemes typically associated with financial statement fraud as follows (Rezaee, 2002, p. 4):

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