

Booms, Busts, and Fraud

Abstract

We show that the incentives of managers to commit financial fraud depend critically on the business climate of their sector. Fraud incentives are highest when business conditions are good, but not too good: in exceptionally good times, even weaker firms can get funded without committing fraud, and in bad times investors are more vigilant and it is harder to commit fraud successfully. The actual incidence of fraud is highest when a business expansion turns to a downturn. If business conditions are sufficiently strong, a decrease in monitoring costs actually increases the prevalence of fraud. Finally, increased disclosure requirements can exacerbate fraud.