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Gerard Hoberg, Craig Lewis

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ABSTRACT

Using text-based analysis of 10-K MD&A disclosures, we find that fraudulent firms produce verbal disclosure that is abnormal relative to strong counterfactuals. This abnormal text predicts fraud out of sample, has a verbal factor structure, and can be interpreted to reveal likely mechanisms that surround fraudulent behavior. Using a conservative difference-based approach, we find evidence that fraudulent managers discuss fewer details explaining the sources of the firm’s performance, while disclosing more information about positive aspects of firm performance. They also provide less content relating the disclosure to the managerial team itself. We also find new interpretable verbal support for the well-known hypothesis that managers commit fraud in order to artificially lower their cost of capital.

Key words: fraud, disclosure, text analytics, cost of capital

JEL codes: G30, G32, G38

*Corresponding author.
email addresses: hoberg@marshall.usc.edu (G. Hoberg), craig.lewis@owen.vanderbilt.edu (C. Lewis)
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