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Corporate Fraud and External Social Connectedness of Independent Directors*

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Abstract: We examine the effects of independent directors' external social connectedness on corporate fraud commission and detection. The results show that well-connected independent directors do not affect the likelihood of fraud commission but significantly reduce the likelihood of fraud detection given occurrence of a fraud. In particular, with a one-standard-deviation increase in independent directors' connectedness, the likelihood of fraud detection reduces by 22.5 percent. We also find that the consequences of fraud commission faced by firms with well-connected independent directors are less severe as fraud remains undetected for a longer period of time and fewer people are charged with fraud when independent directors are well connected. We further show that independent directors' connections to fraud firms significantly increase a firm's propensity to fraud commission and the likelihood of fraud detection is also higher. Overall, our results suggest that directors' personal networks have a "dark side". Regulators should be aware of unintended consequences associated with directors' external social connections when considering how to prevent and detect corporate fraud.

Keywords: Corporate Governance; Fraud Commission; Fraud Detection; Social Connectedness

JEL Code: M410

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