

Auditor Workforce Diversity and Client Inclusiveness: Evidence on Financial Reporting Quality

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Abstract

This study examines whether diversity within audit offices and inclusiveness within client organizations jointly influence financial reporting quality. We analyze how auditor workforce diversity and client inclusiveness interact in shaping the likelihood of financial misstatements. Client inclusiveness is measured using the Human Rights Campaign's Corporate Equality Index (CEI), which captures firms' publicly disclosed diversity and inclusion policies. Using a sample of U.S. public companies audited by Big 4 firms between 2011 and 2017, we estimate logistic regression models of financial misstatements. Consistent with prior evidence, we find that audit office diversity—proxied by the presence of H-1B auditors using hand-collected data on audit-office workforce composition—is associated with a lower likelihood of financial misstatements. More importantly, the effect of auditor diversity varies with client inclusiveness. Additional analyses indicate that the misstatement-reducing effect of auditor diversity is concentrated among firms with lower CEI scores, while the association becomes weaker among firms with higher levels of client inclusiveness. These findings suggest that the benefits of auditor diversity are context-dependent and highlight the importance of considering both auditor characteristics and client organizational environments when evaluating audit quality.

Keywords: audit quality; financial misstatements; auditor diversity; corporate inclusiveness; Corporate Equality Index (CEI)

Introduction

High-quality financial reporting is fundamental to well-functioning capital markets because investors rely on credible information when allocating resources. External auditing plays a central role in sustaining this credibility by providing independent assurance that financial statements fairly reflect a firm's underlying economic performance. Traditional research on audit quality focuses on characteristics of auditors such as independence, expertise, and audit firm reputation. More recently, scholars have begun to examine how the composition of audit teams influences audit outcomes. In particular, emerging evidence suggests that diversity within audit teams may enhance judgment and decision-making in complex audit environments. Huang (2022), for example, shows that audit offices employing more H-1B auditors -- used as a proxy for workforce diversity -- are associated with fewer client financial misstatements.

While this emerging literature highlights the potential benefits of auditor diversity, it largely focuses on characteristics of the auditor rather than the organizational environment in which the audit takes place. Yet auditing is inherently an interorganizational process that involves interactions between auditors and client personnel. The governance climate, communication norms, and reporting culture of the client organization may therefore influence how effectively audit teams exercise their professional skepticism and analytical judgment. In particular, firms that publicly emphasize inclusiveness and transparency may create organizational environments that either reinforce or substitute for the monitoring benefits associated with diverse audit teams. Despite growing interest in both auditor diversity and corporate inclusiveness, little research examines how these two dimensions interact in shaping audit outcomes.

This study addresses that gap by examining the relationship between audit office diversity, client organizational inclusiveness, and financial reporting quality. We extend Huang (2022) by incorporating a measure of client inclusiveness based on the Human Rights Campaign's Corporate Equality Index (CEI), a widely used indicator of corporate policies related to diversity and inclusion. Specifically, we examine two related research questions. First, is audit office diversity associated with higher financial reporting quality in a sample of firms with observable inclusiveness policies? Second, does client organizational inclusiveness moderate the relationship between audit office diversity and audit outcomes?

To investigate these questions, we analyze a sample of U.S. public companies audited by Big 4 firms between 2011 and 2017. Audit office diversity is measured using the average number of H-1B auditors employed within an audit office, following Huang (2022), while client inclusiveness is proxied by firms' CEI scores. We examine whether these factors are associated with the likelihood of financial misstatements using logistic regression models that incorporate standard control variables from the audit quality literature along with year and industry fixed effects.

Our analyses indicate that audit office diversity is associated with a lower likelihood of financial misstatements, consistent with prior research linking workforce diversity to improved audit outcomes. More importantly, we find that the relationship between auditor diversity and reporting quality varies with the inclusiveness of the client organization. Additional analyses suggest that the beneficial effect of auditor diversity is concentrated among client firms with lower levels of inclusiveness, while the association is weaker in more inclusive client environments. This pattern is consistent with the idea that inclusive organizational climates may partially substitute for some of the monitoring benefits provided by diverse audit teams, highlighting the importance of considering both sides of the audit relationship when evaluating the effects of diversity.

This study contributes to the literature in three primary ways. First, we extend research on auditor diversity by examining how the organizational environment of the audited firm influences the effectiveness of diverse audit teams. Prior work, including Huang (2022), primarily focuses on the composition of audit teams themselves. Our study shows that the impact of auditor diversity can depend on characteristics of the client organization, highlighting the importance of considering the broader organizational context in which audits take place.

Second, we contribute to the broader literature on corporate diversity and governance by linking measures of organizational inclusiveness to financial reporting outcomes within the audit setting. While prior studies examine how diversity and inclusion policies relate to firm performance and corporate governance outcomes, less is known about how inclusiveness interacts with external monitoring mechanisms such as auditing. Our evidence suggests that client organizational environments may shape the effectiveness of auditor characteristics in influencing reporting quality.

Third, our findings provide insights relevant to ongoing discussions among regulators and policymakers regarding diversity within the auditing profession and corporate governance practices. As regulatory bodies consider diversity and transparency in governance frameworks, understanding how inclusiveness within client firms interacts with auditor characteristics may help inform debates about the role of diversity in promoting reliable financial reporting.

The next two sections review related literature and discuss the development of hypotheses. Then, the study's methodology and the results from our analyses are presented. The paper ends with a discussion of our conclusions.

Literature Review

Audit Quality and Auditor Diversity

Audit quality refers to the likelihood that auditors detect and report material misstatements in financial statements. Prior research identifies auditor competence, independence, and reputation as key determinants of audit quality (DeAngelo 1981; Francis 2004). More recent work expands this perspective by examining how characteristics of audit teams influence audit outcomes, including workforce diversity.

Research in accounting and organizational behavior suggests that diverse teams may enhance decision quality by bringing broader perspectives and greater cognitive resources to complex tasks. Organizational behavior studies document that identity diversity can improve problem-solving and analytical performance, particularly in environments that require judgment and critical evaluation (Phillips et al. 2006). In auditing, such benefits may be especially relevant because audit engagements frequently involve complex accounting estimates, ambiguous evidence, and judgment-intensive decisions.

Empirical accounting research provides emerging evidence on the relationship between auditor diversity and audit outcomes. Krishnan et al. (2023) examine the experiences of ethnically minoritized audit partners (EMAPs) and find that although these partners may face career disadvantages, they are associated with several indicators of higher audit quality, including more conservative financial reporting outcomes in certain contexts. At the same time, research suggests that the benefits of diversity are not unconditional. Annelin and Svanström (2024), studying audit teams in a Big 4 firm, find that diversity may improve inclusion and satisfaction while also introducing coordination challenges that can influence work outcomes. Similarly, Raddatz et al. (2024) highlight how minority auditors may experience reduced psychological safety in predominantly homogeneous environments, potentially affecting team dynamics and performance.

Huang (2022) provides large-sample evidence linking auditor workforce diversity to audit quality. Using the average number of H-1B auditors employed by audit offices as a proxy for workforce diversity, Huang (2022) finds that offices with higher levels of immigrant auditors are associated with lower client misstatement rates. The H-1B program allows U.S. employers to hire qualified foreign professionals in specialized fields (SEC 2012), and immigrant auditors often contribute additional diversity in nationality, educational background, and professional experience (New American Economy 2012). Huang's (2022) results suggest that diverse audit teams may enhance professional skepticism and analytical problem solving, particularly in complex engagements.

Collectively, this literature suggests that diversity within audit teams can influence audit effectiveness through mechanisms related to cognitive diversity, professional skepticism, and decision quality. However, existing research primarily focuses on characteristics of the audit team, leaving open the question of whether the audited firm's organizational environment also shapes how auditor diversity influences audit outcomes.

Corporate Inclusiveness and Financial Reporting

A separate stream of research examines diversity and inclusiveness within corporations and their implications for governance and financial reporting outcomes. Corporate governance studies suggest that organizations with more inclusive leadership and governance structures may demonstrate stronger ethical norms, transparency, and oversight (Adams and Ferreira 2009; Gul et al. 2013). These attributes can contribute to improved financial reporting quality.

Recent research uses the Human Rights Campaign (HRC) Foundation's Corporate Equality Index (CEI) to measure corporate inclusiveness. The CEI evaluates firms based on policies and practices related to LGBTQ+ inclusion and support. Foster and Preece (2024) document that firms with higher CEI scores are less likely to engage in financial statement manipulation as measured by Beneish (1999) M-scores. Related evidence suggests that firms with stronger diversity and inclusion policies may also experience positive outcomes such as improved innovation, financial performance, and long-term firm value (Hossain et al. 2020; Foster et al. 2022).

Although the CEI focuses specifically on LGBTQ+ inclusion policies, prior research suggests that such policies often reflect broader organizational commitments to diversity, equity, and inclusion (DEI) within firms. As a result, CEI scores may capture observable aspects of a firm's inclusiveness orientation and governance environment that can influence organizational behavior. In this study, we therefore interpret CEI as a proxy for the institutional and cultural environment supporting inclusiveness, rather than a direct measure of workforce demographic diversity.

Intersection of Auditor Diversity and Client Inclusiveness

Despite growing interest in both auditor diversity and corporate inclusiveness, little research examines how these two dimensions interact within the audit process. The effectiveness of diverse audit teams may depend not only on the composition of the audit office but also on the organizational environment of the client firm. Several conceptual mechanisms suggest that the interaction between auditor diversity and client inclusiveness may influence audit outcomes. These mechanisms include potential complementarity between organizational environments, substitution effects in monitoring incentives, and coordination frictions arising from differences in organizational norms.

First, diversity alignment between auditors and clients may generate complementary benefits. When both audit teams and client organizations emphasize inclusiveness, communication and information exchange may improve, potentially strengthening audit effectiveness and financial reporting quality. Second, corporate inclusiveness may act as a substitute for some monitoring benefits provided by diverse audit teams. Firms that maintain inclusive cultures and strong ethical norms may already promote transparent financial reporting practices, potentially reducing the incremental effect of auditor diversity on audit outcomes.

Finally, differences between auditor and client organizational environments may introduce frictions. Social identity theory suggests that interactions between groups with different identities or norms can generate in-group and out-group dynamics that hinder communication and cooperation (Tajfel and Turner 1979). If auditors and client personnel operate under different organizational norms regarding diversity and inclusion, such differences could complicate interactions during the audit process.

Taken together, these perspectives highlight the importance of examining auditor diversity and client inclusiveness jointly. Understanding how these factors interact can provide new insights into the organizational conditions under which audit team diversity influences audit effectiveness and financial reporting quality.

Hypothesis Development

Building on the two streams of literature reviewed above—auditor workforce diversity and corporate inclusiveness—we next develop hypotheses regarding how these factors jointly influence audit outcomes. The preceding literature suggests that diversity within audit teams can shape how auditors process information and evaluate complex reporting issues. Prior studies emphasize that heterogeneous teams bring broader informational resources and perspectives to complex decision environments (e.g., Phillips et al. 2006; Huang 2022).

Audit engagements frequently involve complex estimates, subjective reporting choices, and ambiguous evidential judgments in financial reporting settings. In this setting, the broader cognitive resources associated with diverse teams may increase the likelihood that problematic reporting is identified and addressed during the audit process. The key implication for this study is that workforce diversity may influence *how effectively auditors perform their core monitoring functions*. Diverse teams may draw on a wider range of cultural, educational, and professional perspectives when evaluating accounting estimates, challenging managerial explanations, or interpreting ambiguous audit evidence. When these cognitive and informational advantages translate into stronger professional skepticism, audit offices employing more diverse personnel may be better positioned to detect reporting irregularities and reduce the likelihood that financial misstatements remain undetected.

Importantly, this argument does not rest on diversity itself being inherently beneficial, but on its potential to influence the quality of judgment and information processing within audit teams (Nelson 2009; Knechel et al. 2013). Nelson (2009) conceptualizes professional skepticism as the auditor's tendency to question evidence and critically assess management representations, while Knechel et al. (2013) focuses on how auditor judgment and skepticism are central mechanisms through which audit quality is achieved.

Consistent with this reasoning, the monitoring advantages associated with diverse audit teams should ultimately manifest in measurably improved reporting outcomes. If diversity enhances professional skepticism and the evaluation of ambiguous evidence, audit offices employing more diverse personnel should be more effective at identifying potential

reporting problems during the engagement, thereby reducing the likelihood that material misstatements remain undetected. To assess whether the findings in Huang (2022) hold in the much more restricted sample in this study, we first examine whether greater diversity within audit offices is associated with improved audit outcomes. Thus, we test the following hypothesis:

Hypothesis 1: Audit office diversity, as proxied by the presence of H-1B auditors, is associated with higher audit quality for firms that receive a CEI rating from the Human Rights Campaign.

Although the preceding discussion focuses on the independent effect of auditor diversity, auditing occurs within an organizational setting defined by the client firm. The governance climate, communication norms, and transparency practices of the audited organization may therefore influence how effectively diverse audit teams can apply their cognitive and informational advantages during the engagement. In particular, the inclusiveness of the client organization may shape the communication environment and reporting culture that auditors encounter, potentially affecting the extent to which auditor diversity translates into improved audit outcomes.

The interaction between auditor diversity and client organizational inclusiveness is less clear. One possibility is a *complementary effect*. When both audit teams and client organizations emphasize inclusiveness and diverse perspectives, communication and information exchange may improve, allowing diverse audit teams to utilize their broader cognitive resources more effectively during the audit process. Alternatively, client inclusiveness may act as a *substitute* for some of the monitoring benefits provided by diverse audit teams. Firms that maintain inclusive cultures may already promote unbiased financial reporting practices, potentially reducing the incremental impact of auditor diversity on audit outcomes.

Finally, differences in organizational environments between auditors and clients may introduce *coordination frictions*. Bennett and Hatfield (2013) show that demographic or cultural mismatches between auditors and client personnel can impede communication and audit evidence collection. If auditors and client personnel operate under different organizational norms regarding diversity and inclusiveness, such differences could complicate interactions during the audit process and weaken potential benefits of diversity.

Because these mechanisms suggest potential reinforcing or offsetting effects, the direction of the interaction between auditor diversity and client inclusiveness is theoretically ambiguous. Accordingly, we state the second hypothesis in a non-directional form.

Hypothesis 2: Client organizational inclusiveness, as proxied by CEI, moderates the relationship between audit office diversity and audit quality.

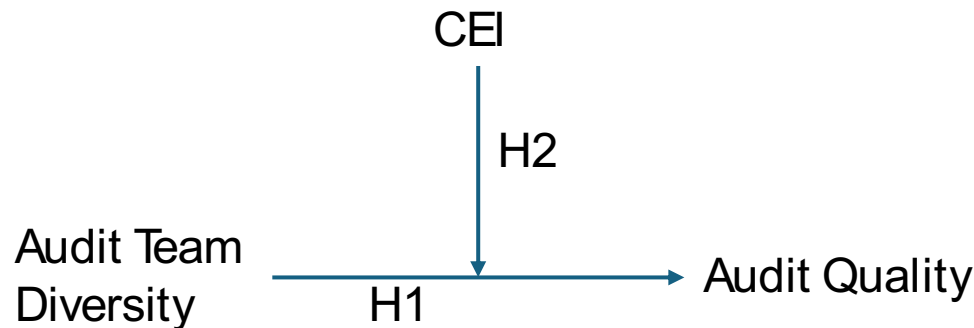


Figure 1. Hypotheses

To clarify the conceptual relationships described above, Figure 1 presents a visual summary of the study's theoretical framework. The figure illustrates the predicted direct association between audit office diversity and audit quality (Hypothesis 1) as well as the moderating role of client organizational inclusiveness (Hypothesis 2).

Methodology

To evaluate our hypotheses, we estimate cross-sectional logistic regression models that examine the likelihood of financial misstatements among U.S. public companies audited by Big 4 firms between 2011 and 2017. The logistic specification is appropriate because the dependent variable captures the occurrence of a financial misstatement. The empirical design evaluates whether the probability of misstatement varies with auditor workforce diversity and client organizational inclusiveness, while controlling for firm characteristics associated with financial reporting risk.

Consistent with prior literature on financial misstatements (e.g., Dechow et al. 2011; Huang 2022), the regression framework includes a comprehensive set of control variables capturing firm size, financial structure, performance, and other reporting risk factors. Our primary interest is the interaction between auditor diversity and client inclusiveness. Because interaction terms in nonlinear models such as logit cannot be interpreted directly from the coefficient alone (Ai and Norton 2003; Greene 2010), the results are interpreted using marginal effects and predicted probability analyses, and subsample analyses.

Sample Construction

Our sample is constructed by combining the audit office diversity dataset developed in Huang (2022) with client-level inclusiveness data from the Human Rights Campaign's Corporate Equality Index (CEI). Huang (2022) manually collected H-1B employment data for Big 4 audit firms from 2004 to 2017 to construct a proxy for workforce diversity within audit offices. In our study, this measure captures one observable dimension of auditor workforce diversity—specifically, the presence of foreign-born professionals working in audit offices.

To examine the interaction between auditor diversity and client organizational environment, we merge the Huang (2022) data with CEI ratings for the corresponding client firms. The

Corporate Equality Index, produced by the Human Rights Campaign (HRC) Foundation, evaluates corporate policies and practices related to workplace inclusiveness, particularly those affecting LGBTQ+ employees. Firms are scored based on criteria including nondiscrimination policies and publicly available information on discriminatory practices. CEI criteria also include benefits for LGBTQ+ employees and their families, organizational training and competency initiatives, and public engagement with inclusiveness-related advocacy. For many large organizations that do not voluntarily send information to the HRC, the CEI is constructed by HRC staff from information that is publicly available (Human Rights Campaign, 2025).

The Corporate Equality Index (CEI) is widely used in academic research as an observable signal of corporate inclusiveness policies and organizational climate. Prior studies document associations between higher CEI scores and outcomes such as innovation, financial performance, and long-term firm value (e.g., Hossain et al. 2020; Foster et al. 2022). While the index primarily captures formal policies and other publicly available information rather than realized workplace behavior, it nevertheless provides a measurable indicator of firms' public signals of inclusiveness practices.

The requirement that firms receive a CEI rating substantially restricts the available sample relative to the broader population of public companies. CEI participation is generally voluntary and is more common among large, publicly visible corporations that maintain formal diversity and inclusion programs. Consequently, the merged dataset comprises a subset of the observations used in Huang (2022), yielding a sample concentrated among larger firms from 20 two-digit SIC codes.

To ensure consistency of time frames for both datasets, the sample period is restricted to fiscal years 2011–2017. Although CEI ratings have existed since 2002, coverage among publicly traded firms became substantially broader by 2010. Focusing on the 2011–2017 period allows us to analyze a time frame in which CEI participation was sufficiently widespread while avoiding the most disruptive years of the global financial crisis and the Great Recession.

Several explanatory variables are measured using lagged values or year-to-year changes. Accordingly, the empirical specifications require financial statement information from the prior fiscal year to construct these variables for the first year of analysis. After applying these time frame and data requirements, including Huang's (2022) sample restriction to firms audited by Big 4 auditors, the final sample consists of 1,030 firm-year observations concentrated among large, publicly visible firms. As a result, the final sample represents approximately 5.6% of the observations in Huang (2022). This restriction may affect the distribution of certain control variables relative to the broader population of firms, and statistical results should be interpreted primarily as representing larger publicly visible firms rather than the full population of public companies.

Statistical Model Specification

We adapt the empirical framework developed in Huang (2022) to examine whether auditor workforce diversity and client organizational inclusiveness are associated with the likelihood of financial statement misstatements. Because the dependent variable captures the occurrence of a misstatement event, we estimate logistic regression models where the probability of misstatement is modeled as a function of auditor diversity, client inclusiveness, and their interaction. The key explanatory variables are audit office workforce diversity (measured using the H-1B-based proxy from Huang, 2022), client organizational inclusiveness (proxied by the Corporate Equality Index score), and the interaction between these two variables. The interaction term allows us to evaluate whether the association between auditor diversity and misstatement risk varies across different client inclusiveness environments.

Control variables follow the financial misstatement literature, particularly Dechow et al. (2011) and Huang (2022), and capture firm characteristics associated with reporting risk, financial performance, and audit engagement complexity. Year and industry fixed effects are included to absorb unobserved time-specific and sector-specific variation. Standard errors are clustered at the firm level. The baseline empirical specification is as follows:

$$\begin{aligned} \text{Prob}(\text{MISSTATE}_{it}=1) = & a_0 + a_1\text{Auditor_diversity}_{it} + a_2\text{Client_inclusive}_{it} + \\ & a_3\text{Auditor_diversity} \times \text{Client_Inclusive}_{it} \\ & + a_k\sum \text{CONTROLS}_{it} + a\sum \text{Year}_{it} + a\sum \text{Industry}_{it} + e \end{aligned} \quad (1)$$

Dependent Variable

MISSTATE is a binary indicator equal to 1 if a firm's financial statements for a given fiscal year are subsequently restated, and 0 otherwise. Financial statement restatements are widely used in the accounting literature as an observable proxy for financial reporting quality and audit effectiveness (Dechow et al., 2011; Huang, 2022). A restatement indicates that material misstatements were not detected during the initial audit process, suggesting weaknesses in financial reporting systems, audit procedures, or both.

Auditor Workforce Diversity

Auditor Diversity is measured as the average number of H-1B hires over a rolling three-year window divided by total audit fees (in millions of dollars) for a given audit office. Following Huang (2022), this measure captures one observable dimension of workforce diversity within audit offices, specifically the presence of foreign-born professionals. Prior research suggests that such diversity may introduce varied educational backgrounds, professional experiences, and perspectives that can influence audit judgment and problem-solving in complex engagements.

Client Organizational Inclusiveness

Client_Inclusive is proxied by the Corporate Equality Index (CEI) score published annually by the Human Rights Campaign. The CEI evaluates corporate policies and practices related to workplace inclusiveness for LGBTQ+ employees. In this study, CEI serves as an observable signal of a firm's inclusiveness policies and organizational climate rather than a direct measure of realized workplace behavior.

Interaction Between Auditor Diversity and Client Inclusiveness

The interaction term ($\text{Auditor_diversity} \times \text{Client_Inclusive}$) captures whether the relationship between auditor diversity and misstatement risk varies across client-inclusiveness environments. Because interaction effects in nonlinear models such as logistic regression cannot be interpreted directly from coefficient estimates alone (Ai and Norton 2003; Greene 2010), we conduct additional analyses to interpret the interaction.

Specifically, we examine marginal effects of auditor diversity conditional on different levels of client inclusiveness. In addition, we estimate subsample regressions separating firms with relatively higher and lower levels of client inclusiveness to further evaluate whether the association

between auditor diversity and misstatement risk differs across these environments. The full statistical model is as follows:

$$\text{Prob}(\text{MISSTATE}_{it}=1) = a_0 + a_1\text{Auditor_diversity}_{it} + a_2\text{Client_Inclusive}_{it} + a_3\text{Auditor_diversity} \times \text{Client_Inclusive}_{it} + a_4\text{rsst}_{it} + a_5\text{soft}_{it} + a_6\text{ch_cs}_{it} + a_7\text{ch_roa}_{it} + a_8\text{issue}_{it} + a_9\text{ch_emp}_{it} + a_{10}\text{lease}_{it} + a_{11}\text{ret}_{it} + a_{12}\text{ret_lag}_{it} + a_{13}\text{ind_spec}_{it} + a_{14}\text{officesize3}_{it} + a_{15}\log\text{Assets}_{it} + a\sum\text{Year}_{it} + a\sum\text{Industry}_{it} + e \quad (2)$$

All variables are defined in Table 1. Consistent with prior research on financial misstatements and reporting quality (e.g., Richardson et al., 2005; Dechow et al., 2011; Huang, 2022), we include several control variables capturing accrual characteristics, operating performance, financing activities, market performance, and audit office characteristics. In particular, we control for accrual-based reporting risk using **rsst**, a measure of total accruals based on changes in noncash net operating assets following Richardson et al. (2005). Higher RSST values reflect greater reliance on accrual adjustments in reported earnings and are commonly interpreted as indicating elevated financial reporting risk.

We further control for firm operating characteristics and reporting incentives using the proportion of soft assets (**soft**), the percentage change in cash sales (**ch_cs**), changes in return on assets (**ch_roa**), and abnormal changes in employment (**ch_emp**). Additional controls capture financing and contractual incentives (**issue**, **lease**), market performance (**ret**, **ret_lag**), and audit market characteristics and client firm size, including industry specialist auditors (**ind_spec**) following Reichelt and Wang (2010), audit office size (**officesize3**), and the natural logarithm of client firm total assets (**logAssets**). All regressions include industry and year fixed effects, and continuous variables are winsorized at the 1st and 99th percentiles to mitigate the influence of extreme observations.

Empirical Results

Descriptive Statistics

Table 2 presents descriptive statistics for the primary variables used in the analysis. The average misstatement rate (MISSTATE) is 8 percent, indicating that 8 percent of firm-year observations in the sample are associated with subsequent financial statement restatements. The mean value of Auditor_diversity is 0.356, with substantial dispersion across audit offices (standard deviation = 1.055), suggesting meaningful variation in the level of foreign-born professionals across audit offices. Client_inclusive (CEI) has an average value of 68.10 with a standard deviation of 35.25, reflecting considerable cross-firm variation in inclusiveness policies among the sampled firms.

Pairwise correlations are examined as a diagnostic check for multicollinearity among the main explanatory variables (untabulated). The correlations do not indicate evidence of problematic multicollinearity among the independent variables used in the regression analyses.

Logistic Regression Results

Table 3 presents the main empirical tests of the study. The models estimate the likelihood of financial misstatements as a function of audit office diversity, client inclusiveness, and a set of control variables commonly used in the audit quality literature. The results provide initial evidence on whether diversity within audit offices is associated with observable differences in financial reporting outcomes.

In Column (1), we estimate the baseline specification. The coefficient on Auditor_diversity is negative and statistically significant ($p < 0.05$), indicating that clients audited by offices employing more diverse personnel exhibit a lower likelihood of financial misstatement. This finding is consistent with Hypothesis 1 and supports the argument developed earlier that diversity within audit teams may enhance professional skepticism and improve the evaluation of complex reporting issues.

Column (3) introduces the interaction between auditor workforce diversity and client organizational inclusiveness. The interaction coefficient is positive and marginally significant, suggesting that the association between auditor diversity and financial reporting outcomes varies with the inclusiveness of the client organization. The positive sign on the interaction term implies that the misstatement-reducing effect associated with auditor diversity becomes weaker as client inclusiveness increases.

Interpreting the interaction effect

Interaction effects in nonlinear models such as logistic regression cannot be interpreted directly from coefficient estimates alone (Ai and Norton 2003; Greene 2010). Thus, we further examine the economic interpretation of this relationship using marginal-effects analysis and subsample tests.

Marginal effects

To better understand the interaction between auditor diversity and client inclusiveness, we compute marginal effects of Auditor_diversity conditional on different levels of client inclusiveness. Table 4 reports the marginal effect of auditor workforce diversity on the probability of financial misstatement evaluated at several standardized levels of client inclusiveness.

The marginal effects results indicate that the negative association between auditor diversity and misstatement risk is strongest among firms with relatively lower CEI scores. At low levels of client inclusiveness, increases in auditor diversity are associated with statistically significant reductions in the predicted probability of financial misstatement. As client inclusiveness increases, however, the magnitude of this marginal effect declines and becomes statistically insignificant at higher levels of CEI.

These results suggest that the association between auditor workforce diversity and financial reporting quality is conditional on the client's organizational environment. In settings where firms exhibit relatively lower levels of inclusiveness, diversity within the audit office appears to play a stronger role in reducing misstatement risk. In contrast, when clients already operate within more inclusive organizational environments, the incremental effect of auditor workforce diversity on the likelihood of misstatements becomes less pronounced.

Subsample analyses by client inclusiveness.

To further examine whether the relationship between auditor diversity and financial misstatements differs across organizational environments, we partition the sample into subsamples based on the median value of client inclusiveness. Table 5 reports descriptive statistics for firms with CEI scores above and below the sample median. T-tests of the mean differences in the descriptive statistics indicate no significant difference in MISSTATE between the groups. However, firms with higher CEI scores tend to be larger, more frequently audited by larger audit offices, and more likely to employ industry specialist auditors. These patterns suggest that the CEI subsamples may reflect distinct organizational and audit environments.

Table 6 reports logistic regression results estimated separately for the high-CEI and low-CEI subsamples. Consistent with the marginal effects reported in Table 4, auditor workforce diversity is negatively associated with misstatement risk in the low-CEI subsample but is not

statistically significant in the high-CEI subsample. This pattern provides additional evidence that the association between auditor diversity and financial reporting quality is concentrated among firms with relatively lower levels of client inclusiveness.

Taken together, the evidence reported in Tables 3 through 6 provides support for Hypothesis 1 and evidence consistent with Hypothesis 2. Across the main specifications, auditor workforce diversity is associated with a lower likelihood of financial misstatement. More importantly, the interaction analyses indicate that the effectiveness of auditor diversity varies across client organizational environments. Both the marginal-effects analysis and the subsample regressions show that the negative association between auditor diversity and misstatement risk is concentrated among firms with relatively lower levels of client inclusiveness. As client inclusiveness increases, the incremental effect of auditor diversity becomes smaller and statistically insignificant. This pattern is consistent with the interpretation that inclusive client environments may partially substitute for the monitoring benefits provided by diverse audit teams, highlighting the conditional role of the client's organizational context in shaping the effectiveness of auditor workforce diversity.

These findings also have potential implications for audit regulation and debates on corporate governance and diversity and inclusiveness. If inclusive client environments partially substitute for the monitoring benefits associated with auditor workforce diversity, regulators and firms may need to consider how organizational environments influence audit team effectiveness.

Robustness Tests

To evaluate the robustness of the results, Tables 7 and 8 report additional regressions using standardized values of the primary independent variables. Standardizing the diversity and inclusiveness variables facilitates interpretation of interaction effects and mitigates potential scale differences across variables.

Table 7 reports the main regression results using standardized measures of auditor diversity and client inclusiveness. The overall pattern of results is consistent with the main specifications reported in Table 3. Auditor diversity remains significantly negatively associated with the likelihood of financial misstatement, while the interaction between auditor diversity and client inclusiveness is positive and even more statistically significant than in Table 3. These results indicate that the documented interaction is not driven by differences in variable scaling.

Table 8 further examines the robustness of the findings by estimating the standardized specification separately for the high-CEI and low-CEI subsamples. Consistent with the subsample analyses reported in Table 6, the association between auditor workforce diversity and misstatement risk is concentrated among firms with lower levels of client inclusiveness, while the relationship is weaker and statistically insignificant among firms with higher CEI scores. Although the estimates vary across subsamples, the overall pattern remains consistent with the interpretation that the influence of auditor diversity depends on the client's organizational environment.

Conclusions

This study examines how diversity within audit offices and inclusiveness within client organizations jointly relate to financial reporting quality. Consistent with prior research, we find that audit office diversity, proxied by the presence of H-1B auditors, is associated with a lower likelihood of financial misstatements. This result supports the view that diverse audit teams may enhance professional skepticism and decision quality when evaluating complex financial reporting issues.

More importantly, our findings indicate that the association between auditor diversity and audit outcomes depends on the organizational environment of the audited firm. Specifically, the misstatement-reducing effect associated with auditor diversity is concentrated among firms with lower levels of client inclusiveness. In organizations with relatively high CEI scores, the incremental association between auditor diversity and financial reporting quality becomes weaker. This pattern suggests that inclusive organizational climates within client firms may partially substitute for some of the monitoring benefits provided by diverse audit teams.

These results also highlight the importance of viewing audit quality as the outcome of an interaction between auditors and their clients rather than solely as a function of auditor characteristics. While audit regulation traditionally focuses on auditor independence, expertise, and firm reputation, our results suggest that client organizational inclusiveness may also influence reporting outcomes under certain organizational conditions. From a practical perspective, the findings suggest that the client firm's organizational context may influence how effectively diverse audit teams translate their informational and cognitive advantages into improved audit outcomes. Similarly, discussions of corporate governance surrounding inclusiveness and transparency may benefit from recognizing how internal organizational environments interact with external audit oversight.

Avenues for Further Research

Future research could extend this analysis by examining broader samples of firms, exploring additional dimensions of workforce diversity such as gender or racial representation, or investigating whether similar interaction effects appear in different regulatory or international settings. Additional work may also examine how changes in organizational diversity practices over time influence the dynamics between auditors and clients during the audit process.

Another promising avenue for future research relates to the broader institutional and policy environment in which auditor labor markets and corporate diversity policies evolve. The period examined in this study spans years during which immigration policies and corporate diversity initiatives were relatively stable; however, both auditor workforce composition and corporate inclusiveness practices may be influenced by changes in the political and regulatory climate. Future research could therefore examine whether the relationship between auditor diversity, client organizational inclusiveness, and financial reporting outcomes varies across different political environments or policy regimes.

Limitations

This study is subject to several limitations that should be considered when interpreting the findings. First, the empirical measures capture only observable dimensions of the broader constructs of auditor diversity and client inclusiveness. The auditor diversity measure is based on the presence of H-1B auditors employed by audit offices, which reflects one observable source of workforce diversity but does not capture the full range of demographic or experiential diversity among audit team members. Similarly, the CEI reflects firms' publicly reported inclusiveness policies and related signals rather than a direct measure of realized organizational culture and behavior. Although prior research suggests that these measures provide informative signals about diversity and inclusiveness practices, they necessarily represent partial proxies for the broader constructs examined in this study.

In addition, because the empirical design is observational, the results should be interpreted as documenting associations rather than causal effects. Unobserved firm characteristics -- such as governance quality, internal control strength, or industry reporting norms -- may influence both client inclusiveness measures and financial reporting outcomes. While the empirical models

include a range of firm-level controls and industry and year fixed effects to mitigate these concerns, it is not possible to fully rule out the influence of unobserved correlated factors. Consequently, the findings should be interpreted as evidence consistent with the proposed relationships rather than definitive causal effects.

A second limitation relates to the composition of the sample. The analysis is restricted to firms audited by Big 4 audit firms that also receive CEI ratings provided by the Human Rights Campaign. Because CEI coverage is concentrated among relatively large and publicly visible firms, the resulting sample may reflect characteristics specific to larger organizations and may not fully represent smaller firms or firms outside the Big 4 audit environment. As a result, the findings should be interpreted primarily within the context of large public companies.

Overall, our findings suggest that the relationship between diversity and audit quality may depend on the interaction between auditor characteristics and the organizational environment of client firms. Understanding how diversity within audit teams interacts with client organizational contexts can provide additional insight into the conditions under which diversity contributes to financial reporting integrity.

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Table 1
Variable Definitions

<i>Dependent Variable</i>	
MISSTATE	= An indicator variable set equal to 1 if the client's current year financial statement is restated in the future, and 0 otherwise.
<i>Test Variables</i>	
Auditor_diversity	= The average number of H-1B hires in a rolling 3-year window, scaled by the total office-specific audit fees revenue, in million dollars.
Client_inclusive	= Human Rights Campaign Foundation's Corporate Equality Index (CEI) for the calendar year.
Interaction_effect	= Interaction between Auditor_diversity and Client_inclusive.
<i>Control Variables</i>	
rsst	= A measure of accrual-based earnings management, captures the change in noncash net operating assets following Richardson et al. (2005) and Dechow et al. (2011). It is calculated as $(\Delta WC + \Delta NCO + \Delta FIN) / \text{Average total assets}$, where $WC = [\text{Current Assets} - \text{Cash and Short-term Investments}] - [\text{Current Liabilities} - \text{Debt in Current Liabilities}]$; $NCO = [\text{Total Assets} - \text{Current Assets} - \text{Investments and Advances}] - [\text{Total Liabilities} - \text{Current Liabilities} - \text{Long-term Debt}]$; $FIN = [\text{Short-term Investments} + \text{Long-term Investments}] - [\text{Long-term Debt} + \text{Debt in Current Liabilities} + \text{Preferred stock}]$.
soft	= Percentage of soft assets, calculated as $(\text{Total Assets} - \text{PP\&E} - \text{Cash and Cash Equivalent}) / \text{Total Assets}$.
ch_cs	= Percentage change in cash sales, as cash sales calculated as $[\text{Sales} - \Delta \text{Accounts Receivable}]$.
ch_roa	= Change in return on assets, calculated as $[\text{Earnings}_t / \text{Average total assets}_t] / \text{or} - [\text{Earnings}_{t-1} / \text{Average total assets}_{t-1}]$.
issue	= An indicator variable set to one if the firm issued securities during year t (i.e., an indicator variable coded 1 if Sale of Common and Preferred Stock (sstk) > 0 or Long-Term Debt -Issuance (dltis) > 0)
ch_emp	= Abnormal change in employees, calculated as the percentage change in the number of employees - percentage change in assets.
lease	= An indicator variable set equal to one if future operating lease obligations are greater than zero.
ret	= Annual buy-and-hold return inclusive of delisting returns minus the annual buy-and-hold value-weighted market return
ret_lag	= Previous year's annual buy-and-hold return inclusive of delisting returns minus the annual buy-and-hold value-weighted market return
ind_spec	= An indicator variable set to one if the auditor is an industry specialist within a two-digit SIC category for a particular Metropolitan Statistical Area (MSA) in a given year, and zero otherwise. An

auditor is an industry specialist if (1) it has the largest annual market share in a two-digit SIC industry and (2) its annual market share is at least 10 percentage points greater than its closest competitor in that MSA-level audit market, following Reichelt and Wang (2010). This measure requires observations to have fee and opinion data in the Audit Analytics database and requires at least ten companies within corresponding two-digit primary SIC codes.

officesize3	=	The natural log of the number of publicly traded clients audited by the company's audit office during the year.
logAssets	=	The natural logarithm of the client's total assets.
Yr	=	Dummy variables for each year of the sample.
Industry	=	Dummy variables for each two-digit primary SIC code.

Table 2
Descriptive Statistics

Variables	N	Mean	Std Dev	Minimum	Maximum
MISSTATE	1,030	0.0800	0.2710	0.0000	1.0000
Auditor_diversity	1,030	0.3560	1.0550	0.0000	16.4500
Client_inclusive	1,030	68.102	35.252	0.000	100.000
High_Client_inclusive	1,030	0.4710	0.4990	0.0000	1.0000
Rsst	1,030	0.0040	0.0880	-0.5100	0.6800
Soft	1,030	0.5870	0.2250	0.0600	0.9700
ch_cs	1,030	0.0170	0.2040	-0.9900	1.8500
ch_roa	1,030	-0.0010	0.0550	-0.3800	0.5300
Issue	1,030	0.9630	0.1890	0.0000	1.0000
ch_emp	1,030	-0.0270	0.1520	-1.2100	0.7600
Lease	1,030	0.8910	0.3110	0.0000	1.0000
Ret	1,030	0.1930	0.6650	-0.8700	9.2000
ret_lag	1,030	0.2160	0.6360	-0.8700	9.2000
ind_spec	1,030	0.2870	0.4530	0.0000	1.0000
officesize3	1,030	3.6140	1.1970	0.6900	5.7700
logAssets	1,030	9.4510	1.2710	5.6700	12.730

This table reports descriptive statistics for the variables used in the empirical analyses. Continuous variables are winsorized at the 1st and 99th percentiles. Variable definitions are provided in Table 1.

Table 3
MISSTATE Logistic Regression Results

Variables	Exp.	Base Model			Interaction Effects	
		(1) Estimate	(2) Wald Chi-Square		(3) Estimate	(4) Wald Chi-Square
Intercept	+/-	-1.0760	0.393		-0.7260	0.175
Auditor_diversity	-	-1.0670	4.671	**	-1.8700	5.962 ***
Client_inclusive	-	-0.0010	0.130		-0.0040	0.993
Auditor_diversity x Client_inclusive	+/-				1.5360	3.112 *
rsst	+	1.5400	0.933		1.5220	0.914
soft	+	0.0400	0.004		0.0880	0.017
ch_cs	+	0.8920	0.902		0.7180	0.572
ch_roa	-	0.3990	0.027		0.4270	0.03
issue	+	0.6540	0.712		0.6660	0.738
ch_emp	-	-0.3700	0.211		-0.4430	0.309
lease	+	2.4950	5.816	**	2.4360	5.603 **
ret	+	-0.5480	1.479		-0.4940	1.232
ret_lag	+	0.2320	0.391		0.2490	0.445
ind_spec	-	0.1050	0.132		0.0350	0.014
officesize3	-	-0.0230	0.04		-0.0250	0.049
logAssets	-	-0.3680	9.748	***	-0.3770	10.071 ***
Yr and Industry Controls		Yes	Yes		Yes	Yes

N = 1030 | Misstate = 82, No misstate = 948

This table reports the results of logistic regression models estimating the likelihood of financial statement misstatements. The dependent variable, MISSTATE, equals one if a firm-year observation is associated with a financial statement restatement and zero otherwise. Column (1) reports the baseline model including auditor workforce diversity (Auditor_diversity), client organizational inclusiveness (Client_inclusive), and control variables. Column (3) introduces the interaction term between Auditor_diversity and Client_inclusive. Control variables follow Dechow et al. (2011) and Huang (2022). Industry and year fixed effects are included in all specifications. Wald chi-square statistics are reported. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively (two-tailed tests).

Table 4
Marginal Effects of Auditor Workforce Diversity on the Probability of Financial Misstatement Conditional on Client Inclusiveness

Level of Client Inclusiveness	Marginal Effect of Auditor Diversity	Std. Error	z-statistic	p-value	
-2.0	-4.4749	1.7510	-2.56	0.011	**
-1.5	-3.7210	1.4340	-2.59	0.01	**
-1.0	-2.9680	1.1240	-2.64	0.008	***
0.0	-1.4600	0.5600	-2.61	0.009	***
1.0	0.0470	0.4670	0.1	0.919	
1.5	0.8010	0.7010	1.14	0.253	
2.0	1.5550	0.9890	1.57	0.116	

This table reports the marginal effects of auditor workforce diversity on the probability of financial misstatement evaluated at different standardized levels of client inclusiveness (CEIstd). Marginal effects are computed from the logit model reported in Table 3. CEIstd represents standardized values of client inclusiveness, measured in standard deviations from the mean. Reported estimates represent the change in predicted misstatement probability associated with a one-unit increase in auditor diversity evaluated at the indicated level of CEIstd.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively (two-tailed tests).

Table 5
High- and Low-Client Inclusiveness Subsample Analyses, Descriptive Statistics

Variables	CEI > Median		CEI ≤ Median		Diff. in Mean	Sig.
	Mean	Std Dev	Mean	Std Dev	t-statistic	
MISSTATE	0.0700	0.2560	0.0880	0.2840	-1.06	
Auditor_diversity	0.3410	1.0070	0.3690	1.0970	-0.42	
Client_inclusive	97.5460	4.0610	41.8990	29.5840	41.08	***
rsst	0.0030	0.0980	0.0060	0.0790	-0.56	
soft	0.5880	0.2190	0.5850	0.2300	-0.60	
ch_cs	0.0210	0.2100	0.0130	0.1990	-0.03	
ch_roa	0.0000	0.0450	-0.0010	0.0630	0.34	
issue	0.9590	0.1990	0.9670	0.1790	-0.70	
ch_emp	-0.0280	0.1530	-0.0260	0.1500	-0.17	
lease	0.9030	0.2960	0.8810	0.3240	1.15	
ret	0.1910	0.4700	0.1960	0.8000	-0.11	
ret_lag	0.2170	0.4630	0.2150	0.7570	0.05	
ind_spec	0.3280	0.4700	0.2510	0.4340	2.71	***
officesize3	3.7500	1.1950	3.4920	1.1870	3.47	***
logAssets	9.6710	1.3570	9.2550	1.1560	5.31	***

This table reports descriptive statistics for subsamples partitioned by the median value of client inclusiveness (CEI). Firms with CEI scores above the sample median are classified as high-inclusiveness firms, while firms with CEI scores at or below the median are classified as low-inclusiveness firms. The table also reports t-tests for differences in means between the two subsamples.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively (two-tailed tests).

Table 6
High- and Low-Client Inclusiveness Subsamples Analyses, Logistic Regression Results

Probability of MISSTATE

Variables	Exp .	<u>High CEI Firms</u>		<u>Low CEI Firms</u>	
		Estimate	Wald Chi-Square	Estimate	Wald Chi-Square
Intercept	+/-	-6.200	0.001	-2.8710	1.705
Auditor_diversity	-	-0.568	0.511	-2.0410	5.602 **
rsst	+	0.110	0.002	1.6450	0.448
soft	+	0.939	0.474	-0.1500	0.029
ch_cs	+	1.709	1.23	0.2570	0.042
ch_roa	-	-3.535	0.366	2.5540	0.741
issue	+	0.277	0.056	0.8500	0.576
ch_emp	-	-2.815	3.253 *	1.2220	1.006
lease	+	10.587	0.002	2.3120	4.693 **
ret	+	-0.724	0.725	-0.3150	0.331
ret_lag	+	0.302	0.122	0.8060	2.372
ind_spec	-	0.318	0.372	-0.1180	0.082
officesize3	-	-0.046	0.047	0.0390	0.064
logAssets	-	-0.901	14.476 ***	-0.1100	0.488
Yr and Industry Controls		Yes	Yes	Yes	Yes

This table reports logistic regression results separately for firms with high and low levels of client inclusiveness. The dependent variable is MISSTATE. The regressions include the same control variables and fixed effects as the main specification. The subsample analysis examines whether the association between auditor workforce diversity and financial misstatements differs across client inclusiveness environments.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively (two-tailed tests).

Table 7
Robustness Test - MISSTATE Logistic Regression Results Using Standardized Variables

Variables	Exp.	<u>Base Model</u>		-	<u>Interaction Effects</u>		
		Estimate	Wald Chi-Square		Estimate	Wald Chi-Square	
Intercept	+/-	-1.545	0.818		-1.449	0.713	
Auditor_diversity_std	-	-1.126	4.671	**	-1.46	6.802	***
Client_inclusive_std	-	-0.046	0.130		0.267	1.776	
Interaction_effects_std	+/-				1.507	5.321	**
rsst	+	1.540	0.933		1.485	0.869	
soft	+	0.040	0.004		0.123	0.033	
ch_cs	+	0.892	0.902		0.745	0.626	
ch_roa	-	0.399	0.027		0.356	0.021	
issue	+	0.654	0.712		0.704	0.817	
ch_emp	-	-0.370	0.211		-0.425	0.283	
lease	+	2.495	5.816	**	2.444	5.632	**
ret	+	-0.548	1.479		-0.475	1.151	
ret_lag	+	0.232	0.391		0.252	0.458	
ind_spec	-	0.105	0.132		0.031	0.011	
officesize3	-	-0.023	0.040		-0.03	0.072	
logAssets	-	-0.368	9.748	***	-0.384	10.383	***
Yr and Industry Controls		Yes	Yes		Yes	Yes	

This table reports robustness tests where the primary independent variables (Auditor_diversity and Client_inclusive) are standardized prior to estimation. Standardization facilitates the interpretation of interaction effects and reduces the influence of scale differences across variables. The regression specification follows the baseline model reported in Table 3.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively (two-tailed tests).

Table 8

Robustness Test - MISSTATE Logistic Regression Results for High versus Low CEI Firms

Variables	<u>High CEI Firms</u>			<u>Low CEI Firms</u>		
	Exp.	Estimate	Wald Chi-Square	Estimate	Wald Chi-Square	
Intercept	+/-	-6.402	0.001	-3.599	2.696	
Auditor_diversity_std	-	-0.599	0.511	-2.154	5.602	**
rsst	+	0.110	0.002	1.645	0.448	
soft	+	0.939	0.474	-0.150	0.029	
ch_cs	+	1.709	1.230	0.257	0.042	
ch_roa	-	-3.535	0.366	2.554	0.741	
issue	+	0.277	0.056	0.850	0.576	
ch_emp	-	-2.815	3.253	1.222	1.006	
lease	+	10.587	0.002	2.312	4.693	**
ret	+	-0.724	0.725	-0.315	0.331	
ret_lag	+	0.302	0.122	0.806	2.372	
ind_spec	-	0.318	0.372	-0.118	0.082	
officesize3	-	-0.046	0.047	0.039	0.064	
logAssets	-	-0.901	14.476	-0.110	0.488	***
Yr and Industry Controls		Yes	Yes	Yes	Yes	

This table reports additional robustness analyses using standardized variables within the high- and low-CEI subsamples. The specification follows Table 5, Panel B, but uses standardized measures of auditor diversity and client inclusiveness.

***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively (two-tailed tests).