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Community Diversity and Earnings Management: Empirical Evidence

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Abstract

Local communities shape corporate activities and performance by pressuring firms to comply with their expectations. In this study, we assess whether firms headquartered in areas with more diverse communities, in terms of race, religion, gender, and age, are less prone to opportunistically manipulate their earnings. Drawing on institutional theory, we predict that greater community diversity is associated with lower earnings management, possibly due to broader and more diverse public pressure and scrutiny of firms activities. Using a sample of 12,973 U.S. firm-year observations from 2000 to 2016, we find that all four dimensions of community diversity are negatively and significantly associated with earnings management. This finding is robust to the use of three earnings management measures, considering the four dimensions of community diversity concurrently and controlling for a battery of firm-level factors. GMM and 2SLS models, as well as additional analyses, also support the existence of a negative association between earnings management and community diversity. We contribute to the accounting literature by providing evidence that a rarely studied institutional and multi-dimensional diversity characteristic (i.e., local community diversity) shapes firms earnings management.

Keywords

community diversity, earnings management, earnings quality, institutional theory, gender diversity

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Introduction

Increased mobility and globalization expose firms to more community diversity (Lu et al., 2018), as manifested in differences in cultural and social traits (e.g., race, religion, gender, and age). Diversity affects societal cohesion and harmony and influences firm efficiency (Lozano & Escrich, 2017) and behaviors. Firms face ongoing challenges in responding to public pressures to incorporate diversity (Cole & Salimath, 2013). Managing diversity involves satisfying broader social expectations (Dutton & Dukerich, 1991) and social norms (Chang et al., 2019), which influence firm behaviors (Cardinaels & Yin, 2015). If firms fail to acknowledge or respond to societal pressure to manage diversity, they risk a loss of legitimacy (Cole & Salimath, 2013) and several forms of community protests (Hanna et al., 2016), which may impact stock returns (King & Soule, 2007). These concerns and questions call for a broader understanding of the effects of community diversity on firm behaviors (Lozano & Escrich, 2017).

Previous studies focus on the positive consequences of firm-level diversity (e.g., Smulowitz et al., 2019; Van Peteghem et al., 2018) as well as its possible detrimental effects (Ali et al., 2014). However, the implications of external, community-level diversity are relatively absent from the accounting literature.

Drawing on institutional theory, we argue that firms in more diverse communities will attempt to consider the varied interests of their diverse stakeholders, and they will be subject to higher scrutiny from these diverse groups (Scott, 2013). In this respect, community diversity may bring important benefits to firms and society, possibly due to broader and more diversified public pressure on firms' opportunistic activities.[1]

The aim of this study is to understand whether community diversity is associated with earnings management. We expect that higher community diversity in the geographical area where a firm is headquartered is associated with less opportunistic behavior, that materializes in lower earnings management. Broader and more diverse communities impose stricter scrutiny of firm behaviors, discouraging actions that appear risky or opportunistic to stakeholders (Chourou et al., 2020). Individuals responsible for financial reporting decisions, whose personal beliefs and attitudes affect work decisions (Hilary & Hui, 2009), are thus likely to try to manage diverse public pressure and scrutiny of firm activities, minimizing questionable and unethical firm behaviors, including opportunistic earnings management (Chourou et al., 2020). Institutional pressures that lead to earnings management are commonly associated with external and internal sources (Vansant, 2016), and diverse communities can exert considerable pressure on firms (Kassinis & Vafeas, 2006).

To date, there has been no rigorous attempt in the academic literature, of which we are aware, to investigate the effects of community diversity on firm earnings management. We contribute to the accounting literature by addressing this research gap and by providing new insights into how local communities shape corporate opportunistic/unethical behaviors in the form of earnings management. By capturing multiple external dimensions of diversity (i.e., race, religion, age, and gender), we add to the literature on the effects of diversity on firm earnings management. Prior literature assess the influence of factors such as diverse employees, managers, and directors, captured at the firm level (Cai et al., 2019; Hsieh et al., 2018; Tee & Rassiah, 2020) or focus on a single dimension of diversity (e.g., gender).[2] However, to the best of our knowledge, our study is the first to examine different dimensions of community diversity (i.e., race, religion, age, and gender), extending understanding of the dynamics between firm and community components of diversity and their influences on firm behavior (Cai et al., 2019; Du et al., 2015; Srinidhi et al., 2011). Overall, we show that several aspects of community diversity influence the quality of reported earnings measures.

By using U.S. data, we take advantage of rapidly increasing diversity across the overall population and workforce (Triana & Garcia, 2009). The U.S. Bureau of Labor Statistics (2020) reports that more than 60% of the U.S. workforce consists of racial minorities and women, who also represent the bulk of new U.S. workers in recent decades. Moreover, census data reveal that the population identifying as non-white grew considerably (129%) between 2010 and 2020 (U.S. Census Bureau, 2020). People who identify as "other race," whether alone or in combination with another category, 49.9 million in total, surpass the "Black or African American" population (46.9 million) as the second-largest racial group. We gather 12,973 U.S. firm-year observations from 2000 to 2016. Concentrating on a single country avoids potential confounding effects of institutional differences across countries.

We consider four sources of community diversity in the county where each firm is headquartered: race, religion, age, and gender. To capture the levels of diversity, we construct indices using data from the U.S. Census Bureau and Association of Religion Data Archives (ARDA). Consistent with our predictions, we find that these four dimensions of community diversity are negatively associated with earnings management. Thus, firms that establish their headquarters in communities with a higher level of diversity report earnings of significantly higher quality. This relationship remains robust to alternative earnings management measures and after controlling for various firm characteristics and fixed effects. Due to the multidimensionality of community diversity, we also consider the four aspects simultaneously in additional analyses and confirm that several dimensions remain statistically significant.

Overall, our findings inform researchers on the importance of focusing on multiple dimensions of diversity. With a principal component analysis, we provide evidence of the complementarity of the studied dimensions. Here, we find that most of the variation in race, age, and gender diversity can be captured by one factor, whereas religious diversity is the primary variable in the second factor. The results that emerge when we apply these two factors are consistent with our main analysis.

Related Literature and Hypothesis Development

Institutional Theory and Social Norms

Institutional theory emphasizes the normative conditions in which firms exist (Yang & Konrad, 2011). Prior literature has recognized that examining firms structures, behaviors, and actions cannot be separated from examining their social environments (Martinez & Dacin, 1999). Three important elements of the social environment exert distinct pressures and induce firms isomorphism, such that firm structures evolve to conform with such expectations: (i) regulative institutions (i.e., laws, rules, and regulations); (ii) normative institutions (i.e., social norms); and (iii) cognitive institutions (i.e., ethics and culture) (Scott, 2013). Firms and society both employ coercive pressure: normative pressure arises when other firms hire professionals with similar social norms and training; and mimetic pressure exists if firms cope with uncertainty by imitating successful peers (Scott, 2013). In an environment where coercive, normative, and mimetic pressures interact, social expectations emerge, and firms likely develop similar administrative structures and emphasize their adherence to social norms to ensure legitimacy (Yang & Konrad, 2011). Marquis et al. (2007) theorize that communities thus influence corporate action, beyond the individual firm level, through community-based patterns. Because the community in which a firm is located exerts institutional pressures that give rise to and structure firms actions, community standards of appropriateness filter down to firm practices.

Diversity Management

Prior literature identifies diversity management as an important mechanism for aligning with social norms and maintaining firms legitimacy. Formal or informal diversity policies and programs function as key signals of legitimacy to external stakeholders (Nemetz & Christensen, 1996). An effective strategy requires firms to manage stakeholder diversity, including that of employees and leaders (Richard et al., 2013; Yang & Konrad, 2011), so it cannot be developed without careful consideration of a diversity identity (Cole & Salimath, 2013). Lozano and Escrich (2017) find that firms benefit from incorporating diversity management only when they perceive diversity as a core value in society.

Given the importance of diversity management, it is not surprising that several empirical studies have tested the effects of diversity on firm performance. For example, Kochan et al. (2003) suggest that firms that invest resources in diversity practices perform better than those that neglect such investments. Diversity also might make firms more productive, via teams (Horwitz & Horwitz, 2007), reduce their uncertainties and dependencies (Miller & Triana, 2009; Pfeffer & Salancik, 2003), increase their access to resources from diverse suppliers, support the development of products valued by diverse consumer groups, connect them with critical external stakeholders, and enhance their financial performance (Dezsö & Ross, 2012; Smulowitz et al., 2019). Yet Harrison and Klein (2007) note how diversity also might create divisions based on race, beliefs, values, ages, or gender, which in turn produce social categorization of in-groups versus out-groups. Because people inherently tend to develop "us vs. them" perceptions (Brown & Turner, 1981) and favor and trust in-group more than out-group members (Tajfel & Turner, 2004). Diversity, in this sense, could make teams more challenging to coordinate and potentially less effective (Smulowitz et al., 2019), hinder team cohesion and performance (Harrison & Klein, 2007), and undermine cooperation and decision-making (Maznevski & Chudoba, 2000). In support of this argument, Pless and Maak (2004) indicate that diversity diminishes the financial performance of firms that attempt to build an inclusive diversity culture solely for economic gain.

Whereas the strategies used, and the impact associated with managing firms diversity, have firms response to external diversity have received limited attention. Drawing on institutional theory, we study the community's influence on earnings management. Firms in more diverse communities will consider the varied interests of diverse stakeholders and will be subject to higher scrutiny from these diverse groups.

In this sense, Watts (2007) illustrates how community diversity exerts a decisive influence on corporate practices through pressure groups. Moreover, Brower and Mahajan (2013) find that firms facing greater diversity of stakeholder demands respond with a greater breadth of corporate social performance. Furthermore, Tilt (1994) shows that community pressure groups have significant influence on firms accounting practices.

Diversity Conceptualizations

As indicated, there is scarce evidence regarding the extent to which the pressure raised by a diverse community influences firm behaviors, attitudes, and financial performance. This pressure has received limited attention in prior research, despite its importance. Still, financial statements are generally prepared by accountants, managers, and consultants who reside in the same area as the firm, making them subject to local cultural values and social norms, and exposed to community influences through various social activities and interactions (Hilary & Hui, 2009).

In this respect, our study differs from prior research in important ways. First, prior research into the effects of diversity on the quantity and quality of earnings focused on firms' internal diversity (e.g., among employees, management, and the board of directors). In contrast, we focus on diversity that transcends firm boundaries, emphasizing the diversity of a firm's headquarters community and its implications for earnings management. Second, prior research has largely examined the intensity of specific demographic or cultural characteristics, such as the degree of religiosity in a geographic area and its influence on firms (e.g., van Aaken & Buchner, 2020). In contrast, we focus on the variability within such characteristics. Rather than investigating whether a region is more or less religious or predominantly composed of a particular ethnic group, we examine how variation across these demographic features shapes firm practices. Third, prior research tends to ignore the sources of diversity. In contrast, we consider racial, religious, age, and gender diversity.

A few prior studies indicate how racial diversity can shape corporate activities and outcomes, though with a different focus. For example, Richard et al. (2013) find that manager racial diversity is directly and positively associated with profitability. Smulowitz et al. (2019) analyze racial diversity across three hierarchical levels of U.S. law firms (associates, mid-level, and partners) and find it is associated with better financial performance. According to Sharma et al. (2020), pressure from stakeholders of diverse ethnic background directly influence firm performance. Specifically, a more diverse stakeholder base prompts firms to increase internal representation in ways that reflect a community-centered orientation. To address these varied expectations, firms tend to boost spending on social initiatives. Finally, Tee and Rassiah (2020) find a positive relationship between the ethnic diversity of members of the boards of directors of Malayan firms and earnings quality. Thus, racial diversity within firms is positively associated with the quantity and quality of earnings. We extend this line of inquiry by focusing on community diversity.

Religiosity drives morality and ethical behaviors by businesses (Vitell, 2009). Hilary and Hui (2009) find that the religiosity of the counties where firms are headquartered is negatively associated with return on equity and return on assets (ROA). Moreover, McGuire et al. (2012) find that firms located in areas with strong religious social norms tend to experience a lower incidence of financial reporting irregularities. In addition, Cai et al. (2019) show that firms with religious chief executive officers (CEOs) exhibit significantly less earnings management, and Kanagaretnam et al. (2015) find that firms based in more religious countries are less likely to engage in earnings management. Furthermore, research indicates that U.S. counties marked by higher levels of religious adherence contain firms that exhibit higher accruals quality, have less accounting risk, are less likely to restate their financial statements, exhibit higher accounting conservatism, and provide better quality earnings forecasts (Chourou et al., 2012, 2020; Dyreng et al., 2012; Ma et al., 2019). We extend this line of inquiry by focusing not on the intensity of religiosity but on its diversity.

According to Forte (2004), variance in moral judgment can be explained by variance in age because older people exhibit a higher level of moral reasoning. However, empirical results about the influence of age diversity on firm performance are inconsistent. Among studies that find a negative impact, Hafsi and Turgut (2013) cite the detrimental association between board age diversity and corporate social performance, and Ali et al. (2014) find a negative association between age diversity and ROA. They suggest that age diversity produces psychological groupings (younger versus older directors), which trigger negative group behaviors. In contrast, Mahadeo et al. (2012) find a positive association between board age diversity and ROA. We extend this literature by focusing on the age diversity of the community and its impact on earning quality, rather than on financial performance.

Finally, regarding gender diversity, prior research finds that U.S. firms with a higher percentage of women on boards and in senior management have higher earnings quality (Krishnan & Parsons, 2008; Srinidhi et al., 2011). Studies in this domain reason that female and male employees and directors possess different knowledge, perspectives, and skills, and integrating these differences contributes to better decision-making (Rogelberg & Rumery, 1996). For example, female employees and directors are more detail-focused (Stendardi et al., 2006), whereas male employees and directors tend to be less risk-averse (Hardies et al., 2016). Therefore, combining female and male employees' and directors' perspectives may contribute to a better balance of benefits and risks (Ali et al., 2014). We extend this body of literature by focusing on the gender diversity of the community, rather than on internal dimensions.

Based on prior research and our reasoning above, we expect a negative association between all four dimensions of community diversity and earnings management. We state our hypotheses as follows:

Hypothesis 1. (H1): Community racial diversity is negatively associated with earnings management.

Hypothesis 2. (H2): Community religious diversity is negatively associated with earnings management.

Hypothesis 3. (H3): Community age diversity is negatively associated with earnings management.

Hypothesis 4. (H4): Community gender diversity is negatively associated with earnings management.

Research Design

To examine the association between community diversity and earnings management, we use four measures of diversity (race, religion, age, and gender) as our main independent variables. We first consider the diversity measures individually, then assess them concurrently. Our regression models take the following general format:

$$\begin{aligned} Earnings\_Management_{i,t} = {} & \alpha_0 + \alpha_1 DIVERSITY_{j,t} + \alpha_2 SIZE_{i,t} + \alpha_3 MBR_{i,t-1} + \alpha_4 LEV_{i,t-1} \\ & + \alpha_5 ADJ\_ROA_{i,t-1} + \alpha_6 CAPEXA_{i,t-1} + \alpha_7 ADV_{i,t-1} + \alpha_8 RD_{i,t-1} \\ & + \alpha_9 BIG4_{i,t} + \alpha_{10} BRD\_IND_{i,t} + \alpha_{11} BRD\_DIV_{i,t} + \alpha_{12} CEO\_DUAL_{i,t} \\ & + \alpha_{13} CEO\_OWN_{i,t} + \alpha_{14} CEO\_GEND_{i,t} + \alpha_{15} CEO\_AGE_{i,t} \\ & + \alpha_{16} CEO\_COMP_{i,t} + \alpha_{17} LOSS_{i,t} + \alpha_{18} NEG\_GP_{i,t} + \varepsilon_{i,t} \end{aligned} \tag{1}$$

We estimate firm fixed effects regressions to address time-invariant firm-specific characteristics, and we cluster standard errors by firm.[3]

Diversity Measures

To address the four dimensions of community diversity, we construct four independent variables: (i) *RACE_DIV* represents the U.S. race diversity index, which includes White, Black or African American, Asian, Native Hawaiian, other Pacific Islander, American Indian and Alaska

Native, and others in the population; (ii) *REL_DIV* is based on the U.S. religious diversity index, for which the main religions and denominations are Mainline Protestantism, Catholicism, Evangelicalism, Eastern Orthodoxy, Mormonism, Judaism, Islam, Buddhism, Hinduism, and others; (iii) *AGE_DIV* represents the U.S. age diversity index, which includes four categories (1–17 years, 18–44 years, 45–64 years, and 65 years and older); and (iv) *GEND_DIV* reflects the U.S. gender diversity index. For *RACE_DIV*, *AGE_DIV*, and *GEND_DIV*, we use county-level data provided by the U.S. Census following Kochan et al. (2003). For *REL_DIV,* we extract data, by U.S. county, from the Association of Religion Data Archives (ARDA) following Christensen et al. (2018) and Hilary and Hui (2009). The ARDA reports the total number of adherents to major religions and denominations per county. For the 2000–2016 sample period, some diversity data are not consistently available, so following previous research, we interpolate (for 2000 to 2010) and extrapolate (after 2010) data gathered in the 2000 and 2010 censuses to obtain missing annual values.[4]

We adopt the Shannon diversity index (H), considered "one of the most enduring of all diversity measures" (Magurran, 2013, p. 106) and a commonly used diversity index in ecology and biology (Spellerberg & Fedor, 2003), to measure race, religious and age diversity. According to Lande (1996), this index is nonparametric and statistically accurate, and it can be applied to any community, regardless of category distribution. It makes it possible to capture integrated measures of the number and abundance of race, religion, and age categories (Maley et al., 2006) for different counties.[5] The index calculation involves dividing the individual members of each race, religion, or age category (i) by the total number of all race, religion, or age categories (P), then multiplying the fraction of (P_i) by its natural logarithm $(\ln P_i)$. We repeat this step for the maximum number of different races, religions, or age categories in the sample. Finally, we sum all $-(P_i * In\, P_i)$ to obtain the value of (H), as follows:

$$H = \sum_{i=1}^{s} -(P_i * In\, P_i) \tag{2}$$

Because we include only two alternatives (male and female) when analyzing gender diversity, we do not use the Shannon index to measure it. Instead, Williams and Meân (2004) review different measures and conclude that the most appropriate, in such cases, is a proportional measure. It yields a value between 0 and 1, which indicates the distance from equality for each variable, such that a value of 1 indicates 50% female and 50% male representation to any given indicator. The index is calculated as follows:

$$\gamma_{i,t} = 1 - |1 - \frac{x^{w}_{i,t}}{0.5}| \tag{3}$$

for county i at time t, and where w refers to individual observations x for women.

Earnings Management Measures

We consider three alternative earnings management measures: discretionary accruals, discretionary revenue, and discretionary current accruals. First, following prior research (e.g., Dechow et al., 1995; Hsieh et al., 2018; Kim et al., 2012), we use discretionary accruals (*DACC*). Earnings management can occur in accruals, which reflect in measurement choices and period-end adjustments, that can exploit the flexibility inherent in accounting (Christodoulou et al., 2018). We use a cross-sectional version of the modified Jones model, which provides a superior specification and less restrictive data requirements. It also can adjust

for changes in industry economic conditions that can affect accruals independent of earnings management (Cai et al., 2019). We compute *DACC* as follows:

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha_0 + \alpha_1\left(\frac{1}{A_{i,t-1}}\right) + \alpha_2\frac{(\Delta REV_{i,t} - \Delta REC_{i,t})}{A_{i,t-1}} + \alpha_3\left(\frac{PPE_{i,t}}{A_{i,t-1}}\right) + \varepsilon_{i,t} \tag{4}$$

where $TA_{i,t}$ is total accruals, measured as the change in current assets minus the change in cash and cash equivalents, together with the change in current liabilities plus the change in debt in current liabilities minus depreciation and amortization expenses in year *t;* $\Delta REV_{i,t}$ is the change in sales from year $t-1$ to year *t;* $\Delta REC_{i,t}$ is the change in accounts receivable from year $t-1$ to year *t;* and $PPE_{i,t}$ is gross property, plant, and equipment in year *t.* All variables are scaled by lagged total assets ($A_{i,t-1}$). *DACC* is the residual from estimating equation (4) by industry with more than 10 observations.

Despite the popularity of discretionary accruals in prior accounting literature (Chen et al., 2018), their use as a proxy for earnings management may be subject to some limitations. For example, Jackson et al. (2018) point out that the activities of peer firms have a significant impact on measurements of discretionary accruals, and Stubben (2010) cautions that an aggregate measure cannot clarify which component of the firm's earnings is being managed. These criticisms prompt new models focused on specific accounts. Stubben (2010) suggests identifying an account that is common across industries, subject to managerial discretion, and constitutes a substantial portion of the earnings discretion available to firms. According to these criteria, revenue is a natural candidate (McNichols & Stubben, 2018). Thus, as a second measure of earnings management, we consider discretionary revenue (*DREV*), which we calculate as follows (Stubben, 2010; Tang, 2015):

$$\frac{\Delta REC_{i,t}}{A_{i,t-1}} = \alpha_0 + \alpha_1\left(\frac{\Delta REV_{i,t}}{A_{i,t-1}}\right) + \varepsilon_{i,t} \tag{5}$$

where $\Delta REC_{i,t}$ is the change in accounts receivable from year $t-1$ to year *t*, and $\Delta REV_{i,t}$ is the change in sales from year $t-1$ to year *t*. Both variables are scaled by lagged total assets ($A_{i,t-1}$). Therefore, *DREV* refers to residuals estimated from equation (5) by the industry for each industry with at least 10 observations.

Finally, because firms may have more flexibility in managing their earnings using current accruals instead of total accruals, we also estimate our models focusing on current accruals. Thus, our last measure of earnings management is discretionary current accruals (*DCACC*), originally developed by Dechow and Dichev (2002) and subsequently modified by Francis et al. (2005).

DCACC is computed using the following equation:

$$\begin{aligned}\frac{CURACC_{i,t}}{A_{i,t-1}} = {} & \alpha_0 + \alpha_1\left(\frac{OCF_{i,t-1}}{A_{i,t-1}}\right) + \alpha_2\left(\frac{OCF_{i,t}}{A_{i,t-1}}\right) + \alpha_3\left(\frac{OCF_{i,t+1}}{A_{i,t-1}}\right) \\ & + \alpha_4\left(\frac{\Delta REV_{i,t}}{A_{i,t-1}}\right) + \alpha_5\left(\frac{PPE_{i,t}}{A_{i,t-1}}\right) + \varepsilon_{i,t}\end{aligned} \tag{6}$$

where $CURACC_{i,t}$ is total current accruals, measured as the change in current assets minus the change in current liabilities plus the change in debt in current liabilities; $OCF_{i,t}$ is the cash flow from operations, measured as net income minus the change in current assets plus the change in current liabilities minus the change in debt in current liabilities plus depreciation and amortization expenses in year *t*; $\Delta REV_{i,t}$ is the change in sales from year $t-1$ to year *t;* and $PPE_{i,t}$ is gross property, plant, and equipment. All variables are scaled by lagged total assets ($A_{i,t-1}$).

DCACC is residuals from estimating the equation above, by industry, for each industry-year with more than 10 observations.

Control Variables

To address the possibility that correlated omitted variables may affect the association between diversity and earnings management, we follow extant literature (e.g., Guo et al., 2019; Hsieh et al., 2018; Kim et al., 2012; Tang, 2015; Whited et al., 2022) and control for several firm characteristics from the Compustat database.[6] Specifically, we account for firm size (*SIZE*), measured by the natural logarithm of total assets; investment growth opportunities, measured by firm market-to-book ratio (*MBR*); financial leverage (*LEV*), measured as long-term debt divided by total assets; adjusted ROA (*ADJ_ROA)*; and capital expenditure ratio (*CAPEXA*). We also control for advertising expense (*ADV*) and research and development expense (*RD*) ratios because these are discretionary expenses. In addition, because earnings management might differ from one auditor to another, we use an indicator variable (*BIG4)* of whether firms hire one of the Big 4 auditors. To consider internal diversity aspects and desirable corporate governance practices, we focus on the diversity of the board of directors, and the characteristics of the CEO. We control for board independence (*BRD_IND*), board diversity (*BRD_DIV*)[7], CEO duality (*CEO_DUAL*), CEO ownership (*CEO_OWN*), CEO gender (*CEO_GEND*), CEO age (*CEO_AGE*), and CEO compensation (*CEO_COMP*), using data from BoardEx and ExecuComp. Finally, we include two variables to control for factors that may motivate firms to incur in earnings management: *LOSS* (an indicator variable coded as one when net income is negative and zero otherwise) and NEG_GP (coded as one when gross profit is negative, and zero otherwise). The Appendix defines all the variables.

Sample and Findings

Sample

Panel A of Table 1 outlines the sample selection process. We start by identifying firms in Compustat for which diversity data are available, which leads to a potential sample of 51,466 firm-year observations. Following Chourou et al. (2020), we require at least 10 observations for each industry-year. Next, we eliminate observations with missing data for the control variables lagged variables. Thus, we obtain a final (unbalanced) data set containing 12,973 firm-year observations, representing 2,143 unique firms, from 2000 to 2016.

Panel B presents the means of the four diversity dimensions, across states, for states that include at least 100 observations. California (3,317 observations), New York (989 observations), and Texas (949 observations) are heavily represented. Regarding racial race diversity, the top means are 0.743 for Tennessee and 0.714 for Ohio. These states exhibit a good mix of different racial groups, so firms in the sample headquartered in these states likely feel the influence of a diverse community. The bottom means for racial diversity are 0.221 for Pennsylvania, and 0.225 for Utah, such that different racial groups are not evenly distributed, where one or two racial groups likely dominate their communities. For religious diversity, the most diverse states are Nevada (1.169) and Texas (1.107), whereas the least religiously diverse states are Connecticut (0.875) and Massachusetts (0.913). Regarding age diversity, the top states are Oregon and Washington (both 0.734). The bottom states are Tennessee (0.718), Massachusetts, and

Table 1. Sample.

Panel A: Sample Selection

	Number of observations
Sample from Compustat 2000–2017 after merging with ARDA for years 2000 and 2010	51,466
Sample after industry restrictions (at least 10 observations in each industry-year)	41,867
Sample after constructing firm control variables and removing missing values	15,818
Sample after constructed lag of the firm control variables	12,973

Panel B: Distribution of Sample by State

State	*N*	Race diversity	Religious diversity	Age diversity	Gender diversity
Arizona	163	0.298	1.060	0.731	0.975
California	3,317	0.383	1.083	0.731	0.978
Colorado	329	0.229	1.065	0.732	0.978
Connecticut	182	0.557	0.875	0.724	0.967
Florida	575	0.683	1.100	0.722	0.971
Georgia	370	0.651	1.022	0.727	0.970
Illinois	432	0.375	1.105	0.724	0.979
Indiana	128	0.544	1.066	0.723	0.973
Maryland	155	0.397	1.004	0.730	0.979
Massachusetts	191	0.507	0.913	0.720	0.965
Michigan	213	0.526	1.044	0.728	0.983
Minnesota	514	0.463	1.065	0.726	0.972
Missouri	176	0.580	1.060	0.729	0.968
Nevada	124	0.351	1.169	0.721	0.973
New Jersey	615	0.582	0.919	0.722	0.966
New York	989	0.419	0.941	0.724	0.974
North Carolina	340	0.706	1.065	0.724	0.972
Ohio	454	0.714	0.987	0.725	0.973
Oregon	143	0.328	0.928	0.734	0.975
Pennsylvania	455	0.221	1.060	0.728	0.979
Tennessee	186	0.743	1.015	0.718	0.965
Texas	949	0.337	1.107	0.730	0.973
Utah	181	0.225	1.100	0.732	0.980
Virginia	218	0.579	0.997	0.725	0.977
Washington	379	0.277	0.981	0.734	0.978
Wisconsin	284	0.480	0.939	0.720	0.972

Wisconsin (both 0.720). Given the minor differences in the means for the top and bottom states, different age groups appear relatively evenly distributed across all U.S. states. Finally, gender diversity is quite evenly spread throughout the states, according to the similarity in the means of the top states (0.983 for Michigan, 0.980 for Utah) and the bottom states (0.965 for both Massachusetts and Tennessee, 0.966 for New Jersey).

Table 2. Summary Statistics.

Variables	N	Mean	SD	25th percentile	Median	75th percentile
DACC	12,973	0.001	0.040	−0.032	0.004	0.033
DREV	12,973	−0.000	0.011	−0.011	−0.001	0.010
DCACC	12,973	−0.000	0.023	−0.019	0.000	0.018
RACE_DIV	12,973	0.445	0.217	0.238	0.413	0.637
REL_DIV	12,973	1.041	0.126	0.934	1.049	1.160
AGE_DIV	12,973	0.727	0.007	0.721	0.729	0.735
GEND_DIV	12,973	0.974	0.010	0.965	0.975	0.984
SIZE	12,973	5.436	1.894	3.872	5.536	7.108
MBR	12,973	4.246	1.057	3.349	4.492	5.251
LEV	12,973	0.104	0.119	0.000	0.036	0.234
ADJ_ROA	12,973	0.014	0.056	−0.020	0.030	0.064
CAPEXA	12,973	0.042	0.027	0.017	0.036	0.057
ADV	12,973	0.018	0.012	0.006	0.016	0.023
RD	12,973	0.054	0.060	0.000	0.025	0.099
BIG4	12,973	0.677	0.468	0.000	1.000	1.000
BRD_IND	12,973	0.380	0.039	0.333	0.375	0.429
BRD_DIV	12,973	0.001	0.002	0.000	0.000	0.003
CEO_DUAL	12,973	0.004	0.066	0.000	0.000	0.000
CEO_OWN	12,973	3.001	2.005	1.872	3.190	4.667
CEO_GEND	12,973	0.064	0.246	0.000	0.000	0.000
CEO_AGE	12,973	60.594	11.664	51.000	60.000	73.000
CEO_COMP	12,973	7.058	1.296	6.093	6.870	7.843
LOSS	12,973	0.379	0.485	0.000	0.000	1.000
NEG_GP	12,973	0.025	0.157	0.000	0.000	0.000

Note. This table presents descriptive statistics on key variables. All variables are defined in the Appendix.

Descriptive Statistics

In Table 2, we present summary statistics for measures of (i) earnings management, (ii) community diversity, and (iii) the control variables. The first dependent variable, discretionary accruals (*DACC*), takes a mean value of 0.001 and a median of 0.004, comparable to prior studies (e.g., Kim et al., 2012). The second earnings management measure, discretionary revenue (*DREV*), has a mean of −0.000 and a median of −0.001, also comparable to prior studies (e.g., Huang et al., 2017). The mean and median values of discretionary current accruals, the third earnings management measure (*DCACC*), are −0.000 and 0.000, respectively. These values are also comparable with prior studies (e.g., Lobo & Zhou, 2005).

For the main independent variables, we find a mean value of *RACE_DIV* of 0.445 and a median of 0.413, indicating that, on average, our sample firms are headquartered in counties with a moderate level of racial diversity. *REL_DIV* has a mean of 1.041 and a median of 1.049; so, our sample firms tend to be headquartered in counties with a higher level of religious diversity than race diversity. We find that *AGE_DIV* has a mean of 0.727 and a median of 0.729, wheras *GEND_DIV* has a mean of 0.974 and a median of 0.975. Thus, on average, firms in our sample are in counties with moderate levels of age diversity and where the two genders are almost balanced. For the firm-level control variables, we note that 68% of observations are audited by Big4 auditors and the mean *ADJ_ROA* of 0.014 indicates that our sample firms tend to be more profitable than their

Table 3. Pairwise Correlations.

Panel A: Earnings Management, Community Diversity, and Financial Controls

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
(1) DACC	1.000														
(2) DREV	0.152*	1.000													
(3) DCACC	0.374*	0.120*	1.000												
(4) RACE_DIV	−0.008	−0.023*	−0.004	1.000											
(5) REL_DIV	−0.005	−0.004	0.008	0.083*	1.000										
(6) AGE_DIV	−0.001	0.020*	−0.014	−0.461*	0.019*	1.000									
(7) GEND_DIV	0.013	0.026*	0.014	−0.463*	0.043*	0.249*	1.000								
(8) SIZE	0.084*	0.048*	0.075*	0.069*	−0.016	0.046*	0.023*	1.000							
(9) MBR	0.084*	0.064*	0.056*	−0.017	0.021*	0.119*	0.070*	0.453*	1.000						
(10) LEV	0.015	−0.025*	−0.005	0.122*	−0.038*	−0.070*	−0.042*	0.434*	0.107*	1.000					
(11) ADJ_ROA	0.186*	0.057*	0.231*	0.021*	−0.013	−0.022*	0.007	0.289*	0.072*	0.037*	1.000				
(12) CAPEXA	−0.062*	−0.004	−0.065*	−0.042*	−0.030*	0.002	−0.011	0.248*	0.207*	0.129*	−0.038*	1.000			
(13) ADV	−0.026*	−0.025*	−0.061*	0.012	−0.054*	−0.062*	−0.061*	0.010	0.058*	0.036*	−0.136*	0.160*	1.000		
(14) RD	−0.081*	0.014	−0.118*	−0.149*	−0.021*	0.131*	0.091*	−0.353*	0.092*	−0.368*	−0.239*	0.066*	−0.016	1.000	
(15) BIG4	−0.002	0.018*	0.000	−0.021*	−0.057*	0.029*	0.024*	0.619*	0.310*	0.191*	0.146*	0.236*	0.046*	−0.077*	1.000

Panel B: Earnings Management, Community Diversity, and Governance Controls

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
(1) DACC	1.000															
(2) DREV	0.152*	1.000														
(3) DCACC	0.374*	0.120*	1.000													
(4) RACE_DIV	−0.008	−0.023*	−0.004	1.000												
(5) REL_DIV	−0.005	−0.004	0.008	0.083*	1.000											
(6) AGE_DIV	−0.001	0.020*	−0.014	−0.461*	0.019*	1.000										
(7) GEND_DIV	0.013	0.026*	0.014	−0.463*	0.043*	0.249*	1.000									
(8) BRD_IND	0.001	0.009	0.019*	0.010	0.006	0.023*	−0.010	1.000								
(9) BRD_DIV	0.006	−0.014	0.003	0.005	−0.006	−0.019*	−0.009	−0.032*	1.000							
(10) CEO_DUAL	0.014	−0.002	0.003	0.012	0.001	0.004	−0.006	−0.012	0.003	1.000						

(continued)

Table 3. (continued)

Panel B: Earnings Management, Community Diversity, and Governance Controls

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
(11) CEO_OWN	0.001	0.003	−0.009	0.035*	−0.012	−0.021*	−0.038*	0.000	−0.015	0.059*	1.000					
(12) CEO_GEND	−0.010	0.003	−0.005	−0.012	−0.028*	0.007	−0.017	−0.023*	0.001	−0.017*	−0.030*	1.000				
(13) CEO_AGE	0.002	0.002	0.017*	−0.009	0.003	0.009	0.022*	0.059*	−0.002	−0.014	−0.272*	−0.099*	1.000			
(14) CEO_COMP	−0.002	−0.006	0.003	0.013	0.007	−0.040*	−0.013	−0.011	−0.032*	0.050*	0.359*	0.019*	−0.290*	1.000		
(15) LOSS	−0.210*	−0.093*	−0.360*	−0.083*	−0.016	0.043*	0.004	−0.005	−0.013	−0.008	0.008	−0.007	−0.011	−0.003	1.000	
(16) NEG_GP	−0.015	−0.011	−0.060*	−0.018*	−0.031*	−0.023*	−0.014	−0.002	0.001	−0.003	0.000	0.007	−0.008	−0.014	0.197*	1.000

*denote statistical significance at the 5% level.

industry peers. In addition, we find that *BRD_DIV* has a mean 0.001 and a median of 0.000, indicating that, on average, firms in our sample enjoy a relatively high level of board of directors diversity. Finally, only about 6% (mean of 0.064) of CEOs are female, and most are older with a mean and median age around 60 years.

According to the Pearson pairwise correlation coefficients in Table 3, the correlations between our proxies for earnings management are statistically significant but only between 0.120 and 0.374, which highlights the importance of considering different proxies to ensure the robustness of the findings. The correlations between our community diversity measures are also statistically significant, with values between −0.463 and 0.249. The highest absolute value of these correlations is −0.494 (involving race and gender diversity). Thus, the measures clearly capture different sources of community diversity.

Hypothesis Testing

Table 4 contains the multivariate regression results of our analyses of the association between diversity and earnings management. Consistent with H1, the findings indicate that *RACE_DIV* is significantly and negatively associated with our three alternative measures of earnings management. Thus, firms with headquarters in more racially diverse counties exhibit less earnings management. This is consistent with our prediction that a diverse community can influence a firm's behavior through its expectations and monitoring.

The second set of results refers to the relation between religious diversity and earnings management. The results are consistent with H2 because they reveal a negative and statistically significant association between religious diversity (*REL_DIV*) and the three measures of earnings management. This result supports our conjecture that religiously diverse communities can mitigate firm earnings management.

We report tests on the association between age diversity and earnings management in the third set of results. In this case, two of the three alternative earnings management measures are negatively and significantly associated with age diversity (*AGE_DIV*), with the estimation of *DACC* being the exception. This evidence supports H3 because firms headquartered in counties with a high level of age diversity report higher quality earnings.

Finally, we present the results of our analysis of the association between gender diversity and earnings management. Our findings support H4 because gender diversity (*GEND_DIV*) is negatively and statistically associated with two of the three earnings management measures. Thus, firms located in counties with a high level of gender diversity engage in less earnings management.

Regarding the firm-specific control variables, we note that firm size is positively associated with *DREV* in all sets of results, consistent with previous studies (Klein, 2002; Tang, 2015). Moreover, in all sets of results, we find a positive coefficient for *MBR,* consistent with Srinidhi et al. (2011). We also observe that all measures of earnings management are negatively associated with *LEV*, which is consistent with the results of Dhole et al. (2016). Similar coefficients are found for *LOSS*, suggesting this is a determinant of earnings management.[8]

Because internal diversity characteristics can affect firm decisions, we control for board diversity (*BRD_DIV*). We find a negative and statistically significant association between this variable and discretionary revenues (*DREV*). These results provide some evidence that more diverse boards engage less in earning management, supporting Gull et al. (2018).[9] However, we do not find an association between board independence and earnings management. This lack of association is unexpected because prior studies document it (e.g., Chen et al., 2015; Ferreira et al., 2011).

Table 4. Main Model—OLS Estimation.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
	DACC	DREV	DCACC	DACC	DREV	DCACC	DACC	DREV	DCACC	DACC	DREV	DCACC
RACE_DIV	**−0.040*** (0.013)**	**−0.014*** (0.004)**	**−0.031*** (0.007)**									
REL_DIV				**−0.028*** (0.010)**	**−0.008*** (0.003)**	**−0.015*** (0.006)**						
AGE_DIV							**−0.242 (0.161)**	**−0.148*** (0.045)**	**−0.325*** (0.097)**			
GEND_DIV										**−0.170*** (0.065)**	**−0.061*** (0.019)**	**−0.043 (0.039)**
SIZE	0.000 (0.001)	0.001*** (0.000)	0.000 (0.001)	0.000 (0.001)	0.001*** (0.000)	0.000 (0.001)	0.000 (0.001)	0.001*** (0.000)	0.000 (0.001)	−0.001 (0.001)	0.001*** (0.000)	0.000 (0.001)
MBR	0.004*** (0.001)	0.001*** (0.000)	0.001*** (0.000)	0.004*** (0.001)	0.001*** (0.000)	0.002*** (0.000)	0.004*** (0.001)	0.001*** (0.000)	0.002*** (0.000)	0.004*** (0.001)	0.001*** (0.000)	0.002*** (0.000)
LEV	−0.018*** (0.007)	−0.009*** (0.002)	−0.007* (0.004)	−0.019*** (0.007)	−0.009*** (0.002)	−0.008** (0.004)	−0.019*** (0.007)	−0.009*** (0.002)	−0.008** (0.004)	−0.019*** (0.007)	−0.009*** (0.002)	−0.008** (0.004)
ADJ_ROA	0.154*** (0.019)	0.006 (0.005)	−0.005 (0.010)	.0155*** (0.019)	0.007 (0.005)	−0.003 (0.010)	.0157*** (0.019)	0.007 (0.005)	−0.004 (0.010)	0.158*** (0.019)	0.008 (0.005)	−0.001 (0.010)
CAPEXA	−0.092*** (0.024)	−0.019*** (0.006)	−0.022 (0.013)	−0.091*** (0.024)	−0.018*** (0.006)	−0.019 (0.013)	−0.086*** (0.024)	−0.018*** (0.006)	−0.019 (0.013)	−0.087*** (0.024)	−0.018*** (0.006)	−0.016 (0.013)
ADV	−0.151** (0.074)	0.015 (0.020)	−0.128*** (0.043)	−0.151** (0.074)	0.016 (0.020)	−0.125*** (0.043)	−0.142* (0.074)	0.016 (0.020)	−0.126*** (0.042)	−0.142* (0.074)	0.018 (0.020)	−0.118*** (0.043)
RD	−0.040* (0.023)	0.025*** (0.006)	−0.044*** (0.012)	−0.039* (0.024)	0.026*** (0.006)	−0.043*** (0.012)	−0.038 (0.023)	0.026*** (0.006)	−0.042*** (0.012)	−0.036 (0.024)	0.027*** (0.006)	−0.041*** (0.012)
BIG4	−0.003 (0.002)	0.000 (0.001)	−0.002** (0.001)	−0.002 (0.002)	0.000 (0.001)	−0.002 (0.001)	−0.002 (0.002)	0.000 (0.001)	−0.002* (0.001)	−0.002 (0.002)	0.000 (0.001)	−0.001 (0.001)
BRD_IND	−0.022 (0.324)	−0.083 (0.127)	−0.367 (0.408)	−0.004 (0.328)	−0.082 (0.126)	−0.375 (0.429)	−0.063 (0.331)	−0.090 (0.134)	−0.384 (0.409)	−0.035 (0.339)	−0.087 (0.143)	−0.408 (0.426)
BRD_DIV	0.049 (0.232)	−0.110* (0.064)	−0.157 (0.123)	0.063 (0.232)	−0.105* (0.064)	−0.145 (0.123)	0.062 (0.232)	−0.107* (0.064)	−0.151 (0.123)	0.063 (0.232)	−0.105* (0.064)	−0.144 (0.123)
CEO_DUAL	0.007 (0.005)	0.001 (0.001)	0.000 (0.004)	0.007 (0.005)	0.001 (0.001)	0.000 (0.004)	0.007 (0.005)	0.001 (0.001)	0.000 (0.004)	0.006 (0.005)	0.001 (0.001)	0.000 (0.004)

(continued)

Table 4. (continued)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
	DACC	DREV	DCACC	DACC	DREV	DCACC	DACC	DREV	DCACC	DACC	DREV	DCACC
CEO_OWN	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
CEO_GEND	−0.003**	0.000	0.000	−0.003**	0.000	0.000	−0.003**	0.000	0.000	−0.003**	0.000	0.000
	(0.002)	(0.000)	(0.001)	(0.002)	(0.000)	(0.001)	(0.002)	(0.000)	(0.001)	(0.002)	(0.000)	(0.001)
CEO_AGE	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
CEO_COMP	−0.001**	0.000	0.000	−0.001**	0.000	0.000	−0.001**	0.000	0.000	−0.001**	0.000	0.000
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
LOSS	−0.013***	−0.002***	−0.018***	−0.013***	−0.002***	−0.018***	−0.013***	−0.002***	−0.018***	−0.013***	−0.002***	−0.018***
	(0.001)	(0.000)	(0.001)	(0.001)	(0.000)	(0.001)	(0.001)	(0.000)	(0.001)	(0.001)	(0.000)	(0.001)
NEG_GP	0.007	−0.001	0.002	0.007	−0.001	0.002	0.007	−0.001	0.002	0.006	−0.001	0.002
	(0.005)	(0.001)	(0.002)	(0.005)	(0.001)	(0.002)	(0.005)	(0.001)	(0.002)	(0.005)	(0.001)	(0.002)
Constant	0.025	0.028	0.158	0.032	0.031	0.164	0.200	0.133**	0.387**	0.181	0.084	0.203
	(0.120)	(0.047)	(0.152)	(0.122)	(0.047)	(0.161)	(0.163)	(0.058)	(0.171)	(0.137)	(0.054)	(0.161)
Observations	12,973	12,973	12,973	12,973	12,973	12,973	12,973	12,973	12,973	12,973	12,973	12,973
R-squared	0.048	0.017	0.106	0.048	0.016	0.105	0.048	0.017	0.105	0.048	0.016	0.104
Adj R^2	0.047	0.016	0.105	0.047	0.015	0.104	0.046	0.015	0.104	0.047	0.015	0.103
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Note. Robust standard errors are in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Concerning the CEO characteristics, we find that CEO gender and CEO compensation are negatively and significantly associated with *DACC*, across the four dimensions of community diversity. This result suggests that firms with female CEOs and higher levels of CEO compensation may revert to less earnings management. These results are consistent with the findings of prior studies (e.g., Harris et al., 2019; Na & Hong, 2017).

In summary, our multivariate regression analyses support our hypotheses, providing consistent evidence that firms headquartered in more diverse counties manage their earnings less and, in turn, provide better quality earnings reports.

To address endogeneity concerns, we use two alternative estimation methods. Specifically, we use the 2-step Generalized Method of Moments (GMM), and a two-stage least squares (2SLS) model. Both sets of untabulated results support the existence of an association between community diversity and earnings management. We use two instrumental variables: county population and education level. These instruments should be strongly correlated with our endogenous explanatory variables (i.e., diversity dimensions) but they should not have a direct association with the dependent variable (earnings management).[10] In the GMM estimation (which includes the lag of the dependent variable), nine of the twelve estimated coefficients on our independent variables of interest are negative and statistically significant. The results are similar when we estimate a 2SLS model with the same variables.[11]

Additional Tests

Considering the multidimensionality of community diversity, we also analyze the four aspects of community diversity simultaneously, with two approaches. First, we include the four diversity measures in the same model and present these results in Panel A of Table 5. The three columns, reflecting the three alternative measures of earnings management, reveal negative and significant associations with racial diversity. We also find a negative and significant association between religious diversity and two of the earnings management proxies (*DACC* and *DREV*). In contrast, age diversity is not significantly associated with any of the earnings management proxies, suggesting this aspect is less relevant for earnings management when combined with the other diversity measures. Finally, we observe a negative and significant association between gender diversity and DACC and *DREV*. The results, in terms of significant coefficients, are consistent with our main analysis.

Second, we conduct a principal component analysis to identify factors that explain the variance of the four community diversity variables. Most of the variation of *RACE_DIV, AGE_DIV*, and *GEND_DIV* is captured in one factor, which we call *DIV_FACTOR*. Then a second factor is primarily determined by *REL_DIV,* so we refer to this second factor as *REL_FACTOR*.[12] In Panel B of Table 4, we report the results of the models when we use these two factors, which include a negative and significant association between *DIV_FACTOR* and one of the proxies for earnings management (*DREV*) and negative and significant associations of *REL_FACTOR* with the three proxies. These findings complement the evidence of Panel A and suggest that religious diversity might be the most important dimension to consider when it comes to reducing earnings management.[13]

By using industry-adjusted earnings management proxies we control for the impact of industry in our regression model, but we also analyze whether diversity factors vary across industries. In untabulated descriptives, we find that the *DIV_FACTOR* has its highest values for SIC codes 64 – Insurance agents, brokers and service and 13 – Oil and gas extraction, and its lowest values are for SIC codes 07 – Agricultural services and

Table 5. Community Diversity and Earnings Management Results.

Panel A: Combined Analysis			
	(1)	(2)	(3)
Variables	DACC	DREV	DCACC
RACE_DIV	−0.030* (0.016)	−0.008* (0.004)	−0.023** (0.010)
REL_DIV	−0.020* (0.011)	−0.005* (0.003)	−0.007 (0.006)
AGE_DIV	0.056 (0.194)	−0.072 (0.052)	−0.134 (0.120)
GEND_DIV	−0.138** (0.064)	−0.052*** (0.019)	−0.019 (0.039)
Control variables	Yes	Yes	Yes
Firm F.E.	Yes	Yes	Yes
Year F.E.	Yes	Yes	Yes
Constant	.17 (0.197)	0.115* (0.061)	0.216 (0.172)
N	12,973	12,973	12,973
R^2	0.049	0.018	0.106
Adj. R^2	0.047	0.016	0.105
Prob > F	0.000	0.000	0.000
Panel B. Principal components analysis			
DIV_FACTOR	−0.001 (0.001)	−0.001** (0.000)	−0.001 (0.001)
REL_FACTOR	−0.004*** (0.001)	−0.001*** (0.000)	−0.002*** (0.001)
Control variables	Yes	Yes	Yes
Firm F.E.	Yes	Yes	Yes
Year F.E.	Yes	Yes	Yes
Constant	0.051 (0.135)	0.008 (0.048)	0.090 (0.151)
N	12,973	12,973	12,973
R^2	0.048	0.017	0.105
Adj. R^2	0.047	0.016	0.104
Prob > F	0.000	0.000	0.000

Note. Panel A reports the firm fixed effects estimates of the impact of racial, religious, age, and gender diversity on earnings management. Panel B reports the results using a principal components analysis (PCA). The sample consists of 12,973 firm-year observations representing 2,143 unique U.S. firms over the period 2000–2016. Standard errors are (in parentheses), robust to firm-level clustering and heteroskedasticity. In Panel A, for column (1), the mean VIF is 1.28, and the maximum VIF is 2.77, for column (2), the mean VIF is 1.28, and the maximum VIF is 2.77, and for column (3), the mean VIF is 1.28, and the maximum VIF is 2.77.
***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

08 – Forestry. As for the *REL_FACTOR*, we find its highest values for SIC codes 07 – Agricultural services and 15 – Builders and its lowest values for SIC codes 62 – Security & Commodity brokers, dealers, exchanges & services, and 08 – Forestry. Thus, the same industry may be considered highly diverse in one aspect but not in another, reinforcing the idea that several dimensions of community diversity should be taken into account.[14]

As a separate analysis, we assess whether the impact of four diversity variables is explained by specific groups that are part of each dimension of diversity: (i) White race (*WHITE*), (ii) Catholic religion (*CATH*), (iii) age group older than 65 years (*AGE_65*), and (iv) female gender (*FEMALE*). We report the results in Table 6. Whereas *WHITE, CATH*, and *AGE_65* are not consistently and significantly associated with the earnings management proxies, *FEMALE* is consistently and positively associated with them. This analysis confirms that considering only

Table 6. Community Categories and Earnings Management Results.

	(1)	(2)	(3)
Variables	DACC	DREV	DCACC
WHITE	0.059 (0.043)	0.018 (0.012)	0.050** (0.025)
CATH	−0.004 (0.013)	0.002 (0.004)	−0.005 (0.008)
AGE_65	−0.062 (0.112)	−0.044 (0.028)	−0.226*** (0.064)
FEMALE	0.740* (0.426)	0.347*** (0.100)	0.602*** (0.216)
SIZE	0.000 (0.001)	0.002*** (0.000)	0.000 (0.001)
MBR	0.004*** (0.001)	0.001*** (0.000)	0.002*** (0.000)
LEV	−0.019*** (0.007)	−0.009*** (0.002)	−0.008** (0.004)
ADJ_ROA	0.153*** (0.019)	0.006 (0.005)	−0.006 (0.010)
CAPEXA	−0.092*** (0.024)	−0.020*** (0.006)	−0.022* (0.013)
ADV	−0.155** (0.074)	0.011 (0.020)	−0.136*** (0.042)
RD	−0.038 (0.024)	0.026*** (0.006)	−0.041*** (0.012)
BIG4	−0.003 (0.002)	0.000 (0.001)	−0.002** (0.001)
BRD_IND	−0.159 (0.359)	−0.034 (0.118)	−0.231 (0.380)
BRD_DIV	0.045 (0.232)	−0.114* (0.063)	−0.168 (0.123)
CEO_DUAL	0.007 (0.005)	0.001 (0.001)	0.000 (0.004)
CEO_OWN	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
CEO_GEND	−0.003** 0 (.002)	0.000 (0.000)	0.000 (0.001)
CEO_AGE	0.000 (0.000)	0.000 (0.000)	0.000 (0.000)
CEO_COMP	−.001** (0.000)	0.000 (0.000)	0.000 (0.000)
LOSS	−0.013*** (0.001)	−0.002*** (0.000)	−0.018*** (0.001)
NEG_GP	0.006 (0.005)	−0.001 (0.001)	0.002 (0.002)
Constant	−0.360 (0.259)	−0.183*** (0.068)	−0.222 (0.186)
Firm F.E.	Yes	Yes	Yes
Year F.E.	Yes	Yes	Yes
N	12,973	12,973	12,973
R^2	0.048	0.018	0.108
dj. R^2	0.047	0.017	0.106
Prob > F	0.000	0.000	0.000

Note. This table reports the firm fixed effects estimates of the impact of specific community categories on earnings management. The sample consists of 12,973 firm-year observations representing 2,143 unique U.S. firms over the period 2000–2016. Standard errors are (in parentheses), robust to firm-level clustering and heteroskedasticity. For column (1), the mean VIF is 1.41, and the maximum VIF is 2.83, for column (2), the mean VIF is 1.41, and the maximum VIF is 2.83, and for column (3), the mean VIF is 1.41, and the maximum VIF is 2.83.
***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

one race, religion, age group, or gender cannot provide an accurate assessment of the impact of community diversity on earnings management.

We perform two additional sensitivity analyses to ensure that our results are not driven by states with great representation in the sample. First, we estimate our main model excluding California. Results presented in Table 7 corroborate our main results. The only difference is that the coefficients on age diversity and gender diversity are not statistically significant when earnings management is measured using *DACC* and *DCACC,* respectively. Second, we exclude firms headquartered in California, New York, and Texas, which represent 40% of the sample. Again, only the coefficients for age diversity and gender diversity are not statistically significant when using *DACC* and *DCACC,* respectively.

Table 7. Regression Results Without Observations from California.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Variables	DACC	DREV	DCACC	DACC	DREV	DCACC	DACC	DREV	DCACC	DACC	DREV	DCACC
RACE_DIV	−0.045*** (0.017)	−0.013*** (0.005)	−0.031*** (0.011)									
REL_DIV				−0.022* (0.011)	−0.006** (0.003)	−0.009 (0.006)						
AGE_DIV							−0.052 (0.180)	−0.124*** (0.046)	−0.227** (0.111)			
GEND_DIV										−0.213*** (0.072)	−0.076*** (0.022)	−0.026 (0.042)
Constant	0.148 (0.158)	0.003 (0.022)	0.088 (0.136)	0.154 (0.159)	0.005 (0.021)	0.092 (0.143)	0.190 (0.203)	0.088** (0.039)	0.244 (0.161)	0.328* (0.176)	0.067** (0.030)	0.114 (0.142)
Control variables	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	9,656	9,656	9,656	9,656	9,656	9,656	9,656	9,656	9,656	9,656	9,656	9,656
R^2	0.050	0.020	0.105	0.050	0.019	0.104	0.049	0.020	0.104	0.050	0.020	0.104
Adj. R^2	0.048	0.018	0.103	0.048	0.018	0.102	0.048	0.018	0.102	0.048	0.018	0.102
Prob > F	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Note: This table reports the firm fixed effects estimates of the impact of diversity on earnings management without observations in California. The sample consists of 9,656 firm-year observations representing 1,575 unique U.S. firms over the period 2000–2016. Standard errors are (in parentheses) robust to firm-level clustering and heteroskedasticity. When the independent variable is racial diversity (RACE_DIV) the mean variance inflation factor (VIF) is 1.29, and the maximum VIF is 2.75. When the independent variable is religious diversity (REL_DIV) the mean VIF is 1.29, and the maximum VIF is 2.75. When the independent variable is age diversity (AGE_DIV) the mean VIF is 1.29, and the maximum VIF is 2.75. When the independent variable is gender diversity (GEND_DIV) the mean VIF is 1.29, and the maximum VIF is 2.75.***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Finally, we examine whether the litigation environment can explain our findings (e.g., less earnings management in diverse communities is driven by litigation costs in these communities). Specifically, in July 1999, the Ninth Circuit Court of Appeals issued a ruling that severely limited the rights of shareholders to bring class action litigation against a firm and after this ruling, shareholder lawsuit filings decreased substantially in the Ninth Circuit (Huang et al., 2020). Therefore, we focus on the period 2000 to 2007 and investigate potential differences between the influence of community diversity in the Ninth Circuit states and other states. Untabulated results show that the inferences are robust for all community diversity measures, although slightly weaker for religious and gender diversity.[15]

Conclusion

Our study shows that community diversity is negatively associated with earnings management. Our focus on the community level distinguishes the present research from several previous studies, as does our inclusion of more than one diversity category. Prior studies examine the consequences of diversity among top management teams or link the presence of a single race, religion, age group, or gender variable to earnings management, whereas we investigate multiple components of community diversity. We address the gap in prior research by focusing on communities in which firms operate, and by applying institutional theory to argue that firms headquartered in communities with high levels of diversity feel pressured to satisfy the social expectations of these communities. Because more diverse communities tend to impose more strict constraints or guidelines on firm actions, firms headquartered in such diverse communities should practice less earnings management.

Using a large sample of U.S. firms, we find that the diversity in race, religion, age, and gender is significantly associated with less earnings management. Therefore, firms that have their headquarters in communities with a high level of diversity report earnings of a significantly higher quality. This relationship is robust to the use of three alternative earnings management measures and to controls for various firm characteristics and fixed effects. A principal component analysis provides even more evidence regarding the associations and complementarity of these variables and the positive role played by diversity in shaping firm earnings management behaviors. These results have important practical implications because they can inform firm stakeholders about the relevance of community diversity for earnings management.

This study has some limitations. First, the explanatory power of our models, although similar to values in previous studies, is relatively low (Francis et al., 2016; Hsieh et al., 2018; Ramalingegowda et al., 2021). This suggests that there is a lack of understanding regarding earnings management. Second, in our sample we do not find an association between board independence and earnings management. Further research can test whether this is because board independence has become standard practice. Finally, omitted variables and more generally endogeneity concerns may affect our analysis. Therefore, we employ a fixed effects model, a 2-step GMM, and a 2SLS model and all specifications provide evidence of a negative association between community diversity and earnings management.

Some limitations of this study also offer opportunities for further research. For example, to build on and augment our focus on diversity at the community level, further research might address various forms of diversity at the firm level. Future studies could also examine the effects of other institutional features at the firm level. Another option would be to explore the impact of community diversity on a broader set of variables related to accounting quality or opportunistic behaviors.

Appendix

Variable name	Definition
Dependent variables	
DACC	Discretionary accruals, used to measure earnings management
DREV	Discretionary revenue, used to measure earnings management
DCACC	Discretionary current accruals, used to measure earnings management
Independent variables	
RACE_DIV	U.S. race diversity index, which is the number of white, black or African American, Asian, native Hawaiian and other pacific Islander, American Indian and Alaska native, and others per county, constructed using Shannon diversity index, linearly interpolated and extrapolated based on 2000 and 2010 data (source: U.S. Censub Bureau)
REL_DIV	U.S. religion diversity index, which is the number of main Christian denominations (protestant, Catholic, evangelical, Orthodox, and other minorities) and other religions and denominations in the county in which the firm is headquartered, constructed using Shannon diversity index, linearly interpolated and extrapolated based on 2000 and 2010 data (source: Association of religion data Archives ARDA)
AGE_DIV	U.S. age diversity of residents per county, linearly interpolated and extrapolated (source: U.S. Censub Bureau)
GEND_DIV	U.S. gender diversity per county, linearly interpolated and extrapolated, constructed using the proportional index (source: U.S. Censub Bureau)
WHITE	Number of U.S. White race to total population per county, linearly interpolated and extrapolated based on the 2000 and 2010 data (source: ARDA)
CATH	Number of U.S. Catholics to total population per county, linearly interpolated and extrapolated based on the 2000 and 2010 data (source: ARDA)
AGE_65	Age of U.S. residents per county who are 65 years and older, linearly interpolated and extrapolated based on the 2000 and 2010 data (source: ARDA)
FEMALE	Number of U.S. female residents to total population per county, linearly interpolated and extrapolated based on the 2000 and 2010 data (source: ARDA)
Control variables	
SIZE	Natural logarithm of total assets (source: Compustat)
MBR	Growth opportunity measured by natural logarithm of (market value of equity divided by book value of equity) for year $t - 1$ (source: Compustat)
LEV	Long-term debt divided by total asset for year $t - 1$ (source: Compustat)
ADJ_ROA	Industry-adjusted return on assets, measured as income before extraordinary items, scaled by lagged total assets for year t – 1 (source: Compustat)
CAPEXA	Capital expenditure expense divided by total sales for year $t - 1$ (source: Compustat)
ADV	Advertising expense divided by total sales for year $t - 1$ (source: Compustat)
RD	R&D expense divided by total sales for year $t - 1$ (source: Compustat)
BIG4	Indicator variable that takes a value of 1 if the firm is audited by a Big4 auditor and 0 otherwise (source: Compustat)
BRD_IND	The ratio of the non-executive director to the total number of directors (source: BoardEx)
BRD_DIV	Measured using gender ratio (represents male/female at board), constructed using the proportional index (source: BoardEx)
CEO_DUAL	Indicator variable that takes a value of 1 if the CEO is a board chair and 0 otherwise (source: BoardEx)
CEO_OWN	The percentage of shares owned by the CEO (source: ExecuComp)

(continued)

(continued)

Variable name	Definition
CEO_GEND	Indicator variable that takes a value of 1 if the CEO is female and 0 otherwise (source: ExecuComp)
CEO_AGE	Age of CEO (source: ExecuComp)
CEO_COMP	Total CEO compensation (source: ExecuComp)
LOSS	Negative net income that takes a value of 1 when net income is negative and 0 otherwise. (Source: Compustat)
NEG_GP	Negative gross profit that takes a value of 1 when gross profit is negative and 0 otherwise. (Source: Compustat)

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Notes

1. This argument is in line with prior evidence that the geographical areas in which firms operate significantly influence their decision-making (Chourou et al., 2020; Hilary & Hui, 2009; Marquis et al., 2007). For example, employees, managers, and executives tend to live near their workplace (Christensen et al., 2018), socialize with their local community, and thus are influenced by the diversity of that community (Lozano & Escrich, 2017). Furthermore, communities expect firms to promote and incorporate their diversity using formal and informal mechanisms, including respect for ethical behaviors established by norms, practices, formal rules, and laws (Cole & Salimath, 2013).
2. For instance, Srinidhi et al. (2011) suggest that a diverse board of directors with more females can improve the quality of earnings.
3. The results of an untabulated Hausman test to our data indicate that a fixed effect model specification is more appropriate than a random-effect one.
4. In our interpolation, we assume a constant rate of change across the years 2001 to 2009. In the extrapolation process, we forecast missing values using the level of the change that we calculate for the previous years. Linear interpolation is a statistical method, by which related known values can be used to estimate an unknown value using the formula: $y = y_1 + (x - x_1/x - x) * (y_2 - y_1)$. For example, this study uses real 2000 and 2010 data from ARDA to linearly interpolate the missing values between these dates. We rely on linear forecasting to extrapolate missing data after 2010.

5. A high value of H indicates more diverse counties. A county with only one race/religion/age category would have an H value of 0, because P_i would be equal to 1 and multiplied by ln (P_i), which is equal to 0. If the race/religion/age categories are evenly distributed, the H value would be high.
6. To create our sample, following Hilary & Hui (2009), we locate firms within U.S. counties by matching their ZIP codes from Compustat, with county specific FIPS codes provided by ARDA.
7. We measure board diversity using gender (Arun et al., 2015; Bui et al., 2021; Harakeh et al., 2019) and capture it using the proportional method (Williams & Meân, 2004).
8. In untabulated results, instead of including *LOSS* and *NEG_GP* to account for firm motivations to engage in earnings management (Burgstahler & Dichev, 1997), we include *small profit* and *earnings decline*. The variable *small profit* is an indicator variable coded as one when the absolute value of net income is less than or equal to the first percentile of this variable, and zero otherwise. We find that the indicator for small profits/losses is negatively associated with *DCACC*, and that the results for the community diversity variables are consistent with those in Table 4. *Earnings decline* is an indicator variable, coded as one when previous year earnings are higher than current year earnings, and zero otherwise. These results indicate that *earnings decline* is negatively associated with earnings management across the twelve sets of results, and that the results for our variables of interest are consistent with those in Table 4, with the exception of the models where earnings management is assessed using DACC.
9. Gull et al. (2018) provide evidence that the relationship between female directors and earnings management becomes insignificant when accounting for the statutory and demographic attributes of the directors. This suggests that detecting and correcting earnings management requires specific competencies and skills, making the relationship non-generalizable across different samples.
10. We utilize data from the U.S. Census Bureau to construct the two instrumental variables. We measure population as the logarithm of the total county population and education is measured as the percentage of county residents holding a bachelor's degree. To ensure consistency over time, we apply linear interpolation and extrapolation techniques to these variables. In areas with larger populations, factors such as migration, economic opportunities, social structures, and multicultural influences contribute to increased diversity (Cardoso, 2023), attracting various demographic groups in terms of race, religion, age, and gender. Similarly, areas with higher levels of education tend to promote inclusivity and social mobility, resulting in greater diversity (Putnam, 2007). Essentially, a more educated workforce is generally more open to diverse hiring practices and tends to have higher rates of female participation in the labor force, thereby enhancing racial, religious, and gender diversity.
11. To ensure that our GMM estimation satisfies the necessary conditions, we conduct additional untabulated analyses. First, we incorporate the lagged dependent variable and employ robust standard errors. The results are consistent with those in Table 4, indicating that this adjustment does not alter our key findings. Second, we perform Arellano-Bond tests to assess the presence of first-order and second-order serial correlation. As expected, we find evidence of first-order autocorrelation but no evidence of second-order autocorrelation. Third, we conduct Hansen J tests, which largely validate the appropriateness of our instruments. The Hansen J test/tests, for the model involving religious diversity, presents/present better results when education level and population income are used as instrumental variables (rather than county population and education level). For the 2SLS estimation, the first-stage regression results indicate that most of the coefficients on the instruments are statistically significant, with the exception again being religious diversity. F-tests for excluded instruments further confirms that our instruments are relevant and valid in most models. Finally, the Cragg-Donald Wald F-statistic exceeds the Stock-Yogo threshold, indicating the strength of our instruments.
12. In *DIV_FACTOR*, the weights of the variables are 0.64, 0.03, 0.55, and 0.53, for *RACE_DIV, RELIG_DIV, AGE_DIV*, and *GEND_DIV,* respectively. The parallel weights of the variables for *RELIG_FACTOR* are 0.10, 0.99, 0.12, and 0.05, respectively.

13. We also estimate a robustness analysis examining the relation between the two factors measuring diversity and upwards and downwards earnings management (i.e., abnormal accruals that are positive and negative). Untabulated results show that *DIV_FACTOR* and *REL_FACTOR* are negatively associated with upwards earnings management. *DIV_FACTOR* is only marginally associated with downward earnings management, and *REL_FACTOR* is not significantly associated with downward earnings management.
14. Proximity to financial markets may be looked at as it could also be a factor in creating additional pressure for scrutiny. To address this concern, we have considered New York (NY) as the center of the financial market and run our models for the relationship community diversity and earnings management for a sample excluding firms located in NY. The untabulated results of the subsample analysis depict negative and significant results for our four measures of diversity. The results suggest that even if we exclude firms that are geographically closer to financial markets our results hold true.
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