CPAs' MORAL REASONING AND SUPPORT FOR EXPANDING SARBANES-OXLEY TO NONPUBLIC ENTITES

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ABSTRACT

This paper views the Sarbanes-Oxley Act of 2002 (SOX) as governmental intervention intended to strengthen the corporate governance of publicly traded companies. As such, SOX is seen as an intrusive government attempt at assisting the CPA profession in fulfilling its moral responsibility to protect the public interest from unscrupulous financial reporting by corporate management. Since CPAs are instructed via their professional code of conduct(s) to act in the public interest, this paper examined whether CPAs' moral reasoning relates to support for expanding SOX to nonpublic entities. Using a well-established scale for measuring moral reasoning, the findings reveal that the moral reasoning of CPAs is negatively related (albeit marginally significant) to their support for expanding SOX to nonpublic entities. The findings suggest that, from a moral perspective, CPAs view an expansion of SOX to nonpublic entities as unnecessary to helping the profession meet its moral responsibility to serve the public interest.

Keywords: moral reasoning in accounting, certified public accountant (CPA), Sarbanes-Oxley Act, nonpublic entities, financial reporting

Introduction

Following the accounting/auditing debacles of companies like Enron and WorldCom, both of these occurring shortly after the turn of the century, Congress passed the Sarbanes-Oxley Act of 2002 (SOX) as an attempt to improve corporate governance. SOX was a form of governmental intrusion on the self-regulatory activity of the CPA profession and it must be complied with by those companies which trade their equity interests over a public stock exchange that is overseen by the Securities and Exchange Commission (SEC). CPAs have a moral obligation to serve the public interest, especially in their capacity as auditors. The afore-mentioned audit failures which preceded and prompted the creation of SOX resulted in harm to the investment community. Accordingly, SOX is viewed in this writing as the government's response to a perceived failure in the self-regulatory efforts of CPAs to fulfill their moral responsibility to protect the public interest from erroneous financial reporting by unscrupulous managers.

At the time of this writing, SOX only applies to those entities which are deemed "public" by virtue of their stock trading over a public stock exchange regulated by the SEC. SOX does not currently cover nonpublic entities and there has been much debate over whether the SEC should expand its SOX coverage to those entities (referred to as the cascading of SOX to nonpublic entities). A nonpublic entity refers to one that is not presently subject to securities law. Nonpublic entities would include privately owned entities, nonprofit entities, etc. The purpose of this paper is to investigate whether CPAs see the expansion of SOX to cover nonpublic entities as necessary to fulfilling the profession's moral responsibility to serve the public interest. CPAs are endowed by society with a moral responsibility for monitoring the fairness of financial reporting and this research seeks to determine whether CPAs "morally" view SOX application to nonpublic companies as important to the corporate governance of those entities.

Problem and Research Question

SOX represents an intrusion by the government into the corporate governance of publicly traded companies. The problem is that this intrusion implies that the self-regulation of CPAs is inadequate to effectively assure compliance with the profession's moral responsibility to serve the public interest. Through its many organizations like that of the American Institute of Certified Public Accountants (AICPA), State Boards of Public Accountancy, State Societies, etc., CPAs have traditionally established their own, self-imposed, regulations for maintaining ethical standards intended to help protect the public interest from abusive reporting by corporate agents. The research question in this study investigates whether CPAs' moral reasoning is related to their support for further government intrusion via expansion of SOX to nonpublic entities. Attempting to answer this question is very important to not only the accounting profession and regulatory authorities, but also the financial community at large. This is because the CPA profession, through its various codes of ethics (AICPA, State Boards, State Societies), has a stated "moral" obligation to protect and serve the public interest first and foremost. If CPAs morally reason that SOX should be expanded to nonpublic companies, then it can be said that CPAs view SOX coverage to those companies as helping the profession satisfy its moral obligation to protect the public from potentially unscrupulous accounting practices within those companies. Conversely, if CPAs do not morally reason that the expansion of SOX to nonpublic entities should be enacted, it can be said that CPAs do not see extending SOX to cover those types of entities as necessary to satisfy its moral obligation to protect the public interest. Assuming that SOX implies inadequate self-monitoring by CPAs, the specific research question addressed in this study is as follows:

From a moral reasoning perspective, do CPAs support the expansion of SOX to cover nonpublic entities?

Investigating this research question contributes empirical evidence that addresses whether CPAs view an expansion of government intervention to nonpublic companies as necessary to help satisfy the profession's moral responsibility to serve the public interest.

Literature Review

In this study, the functionalist model of ethics (rules) is assumed in order to help establish the basis for expecting a possible relationship between a CPA's moral reasoning and her/his support for the expansion of SOX to nonpublic entities. The model views professional codes of conduct as attempts by professionals to resolve ethical dilemmas; or said another way, the professional conduct code is a means of protecting the public interest from unethical members of the subject profession (Abbott, 1983). So, according to this model, the purpose of ethics-based regulation adopted by a profession is to help resolve ethical issues faced by its members. Accordingly, the regulation exists to aid the profession in satisfying its moral responsibility to serve the public interest. SOX fits this modeling profile, albeit it is not a specific component of the CPA's professional conduct code. In fact, SOX is outside of the self-imposed regulation of CPAs, but was created for the express purpose of improving corporate governance and thereby strengthening the audit function. SOX represents regulation which CPAs must adhere to as well as monitor compliance with, so that the public interest might be protected from the likes of what happened to them following all the miscues of a CPA powerhouse firm, namely Arthur Andersen.

There have been many studies performed which have reported on the relationship of CPAs' moral reasoning to various ethical issues. Some of the more salient ones relative to the current study are addressed first. Ponemon and Gabhart (1990), using an experimental study, found a systematic relationship between a CPA's moral reasoning and her/his ability to resolve an independence conflict dilemma requiring professional judgment. It was specifically determined that CPAs with lower moral reasoning tend to be more likely to violate independence rules than CPAs who possess higher moral reasoning. Ponemon (1993) found that auditors with higher moral reasoning were more sensitive in judging important signals related to client management's integrity, competence, and to the probability of discovering material financial errors.

Allen and Ng (2001) found that the moral reasoning of CPAs was not related to their support for relaxing ethics bans within the CPAs' professional conduct code. These bans had come under challenge by the Federal Trade Commission (FTC) as possible restraint of trade activity. This work involved a setting where existing ethical regulation was being undone rather than created. It was further determined that the moral reasoning of CPAs, relative to their support for relaxing these particular self-imposed ethical bans, was possibly being adversely affected by self-interest among the CPAs. Allen and Ennis (2007) extended this work, looking more closely at whether a CPA's financial stake in public practice was influencing her/his moral reasoning in that same setting involving the FTC's challenge that certain ethics rules within the CPA's code were there to restrain trade. They found support for the notion that self-interest was interfering with CPAs' moral reasoning relative to that particular setting.

In each of the studies mentioned above where the moral reasoning of CPAs was a measured variable, the Defining Issues Test (DIT) was employed to measure moral reasoning. The DIT is used in the current study to capture the CPA's moral reasoning and is discussed, at length, in the next ("METHOD") section, specifically under the "Data Collection" and "The DIT and How it Measures Moral Reasoning" subsections. The afore-mentioned studies, again, utilizing the DIT as a measure of moral reasoning, looked at issues similar to the present study in that respondents' moral reasoning was being studied in relationships involving an accountant's responsibility to protect the public interest from unscrupulous financial reporting by agents. In the current study, the moral reasoning of CPAs is being examined in relationship to their view as to whether SOX should be expanded to cover the corporate governance over financial accounting responsibility within nonpublic entities……just as it is already required within public companies.

Focusing more generally on the DIT, as a measure of moral reasoning, to gain an appreciation for its extensive use in accounting studies, virtually every accounting study which has used the DIT to measure the moral reasoning of accountants and auditors up to 1994 is discussed in Rest and Narvaez (1994). Since 1994 and in addition to the more recent Allen and Ng (2001) and Allen and Ennis (2007) studies already mentioned, some other accounting works using the DIT as a measure of moral reasoning include Louwers et al (1997), Thorne (2001), Thorne et al (2003), Bernardi and Arnold (2004), and Scofield et al (2004). Louwers et al (2001) and Thorne (2001) looked at certain demographic characteristics of accountants on their (DIT) moral reasoning scores while Thorne et al (2003), Bernardi and Arnold (2004) and Scofield (2004) studied the relationship of audit experience with DIT scores. Jennings (2004) concluded that a negative association between business education and DIT scores is likely due to how business education focuses on shareholders and maximizing shareholder value rather than focusing on the broader issues of how accounting decisions impact all stakeholders.

In general, there is widespread support of the functionalist model which, again, promotes the idea that it is for moral reasons that a profession imposes ethical regulation upon itself. That is, the ethical regulation exists to help the profession satisfy its moral responsibility to serve the public interest. In the current study, the DIT enables the measurement of a respondent's moral reasoning score which, in turn, allows the research question in this study to be investigated, namely to determine whether the respondents, from a moral reasoning perspective, support the expansion of SOX to nonpublic entities.

Method

Given the functionalist model's "moral" explanation for the imposition of ethical regulation toward a profession's membership, it is intuitively appealing to conjecture that the moral reasoning of CPAs may be related to their support for expanding SOX to nonpublic entities. That is, statistically speaking, CPAs will either morally reason that expansion of SOX will not help, it will help, or that there is just no moral connection there (i.e insignificance), but it is intuitively appealing to surmise that since SOX represents a change in the ethical regulation landscape of the CPA, it would follow that CPAs would hold some kind of moral view toward expanding SOX to nonpublic companies. The current study investigates whether CPAs view an expansion of SOX to nonpublic entities as "morally" necessary to help the profession satisfy its moral obligation to serve the public interest. In order to accomplish this research, the relationship between a CPA's moral reasoning and her/his support for expanding SOX to nonpublic entities is examined.

Hypothesis

On the one hand, the expansion of SOX to nonpublic entities might be "reasoned" by CPAs as a morally necessary action to take. That is, if CPAs view SOX as making the self-regulatory activity of the profession more complete, it is reasonable to expect that they would morally support expanding its provisions to nonpublic entities. On the other hand, if CPAs do not see the expansion of SOX as necessary to better enable the profession in fulfilling its moral responsibility to protect the public interest, they would not be expected to morally support its expansion. Thus, while it can be argued that the moral reasoning of CPAs should be related to their support for expanding SOX to nonpublic entities, it is not clear whether a positive or negative relationship is more likely. It is fitting, then, that this study establishes the following non-directional hypothesis, which is stated in the alternative form:

> H_1: The moral reasoning of CPAs is related to their support for expanding SOX to nonpublic entities.

Data Collection

This study collected data via a mail survey performed during late 2004 and early 2005. The data was collected on CPAs from a random sample of AICPA members. Out of 941 CPAs solicited, 292 usable responses were attained, resulting in a 31 percent response rate. One follow-up mailing was performed and late respondents were compared to early respondents. Nonresponse bias was not evidenced. The survey instrument included a brief questionnaire and a widely-used measure of moral reasoning, the DIT. The questionnaire was extensively pretested before being sent out to CPA respondents. In addition to collecting demographic information from the CPA respondents, the questionnaire elicited whether a CPA supported the expansion of SOX to nonpublic entities. The DIT was used to capture a CPA's level of moral reasoning.

The DIT and How it Measures Moral Reasoning

Rest (1979) discusses the development of his DIT as a measure of the respondent's moral reasoning. In that 1979 work, he addresses the extensive evaluation of the measurement device to assure the reliability and validity of the DIT. In their book, Rest and Narvaez (1994) discuss the numerous documented studies among various professions (including a chapter designated exclusively to discussing studies performed with regard to the accounting profession) which have employed the DIT as a measure of a respondent's moral reasoning. The DIT profiles individuals as employing certain types of moral reasoning in the resolution of a moral dilemma. Further, the test characterizes these different types of moral reasoning as different developmental stages of moral reasoning. The developmental stages included in the DIT are consistent with Kohlberg's six-stage set (Kholberg, 1976). A person with stage 1 moral reasoning tends to resolve an ethical dilemma by attempting to avoid punishment. The stage 2 type seeks an outcome that is favorable to self. At stage 3, the party tries to measure up to the expectations of the group in order to gain acceptance. The stage 4 individual resorts to assuring compliance with traditional norms, namely laws and rules. A stage 5 person follows her/his own opinions along with following democratically established rules and laws. Finally, the stage 6 party adheres to more abstract, self-chosen ethical principles, even when the principles are at odds with democratically established mandates.

To profile a respondent, the DIT presents the respondent with several hypothetical narratives representing ethical dilemmas. This study used the most widely used DIT version, the three narrative (ethical dilemma) version. The respondent, after reading an ethical dilemma, ranks 12 items in order of the relative importance each contributes toward resolution of the dilemma. The DIT developmental stage scores are measured based on the 4 highest ranked items following each narrative. The P-score, or Principled score, is the most commonly used DIT measure in studies which employ the DIT. The P-score represents an index or proxy of principled moral reasoning (Rest, 1986). It denotes the relative importance a respondent assigns to stage 5 and stage 6 items. Thus, a respondent who chooses stage 5 and stage 6 items as more important in the resolution of the DIT narrative ethical dilemmas is said to be more principled in her/his moral reasoning compared to a respondent who ranks stage 5 and stage 6 items as less important.

Data Coding

To test the hypothesis in this study, two variables were measured with regard to the CPA respondents, namely, their moral reasoning and their support for expanding SOX to nonpublic entities. To proxy for moral reasoning, the DIT P-score was captured for each respondent. So, a CPA with higher moral reasoning is one who reflects a higher principled moral reasoning score from the DIT, and vice-versa. Rest (1990) describes the process involved in tabulating a respondent's P-score. The score can range from 0 to 90, inclusive, where a higher score denotes a higher level of principled moral reasoning.

CPAs' support for expanding SOX to nonpublic entities was captured by simply asking the respondent to indicate support by selecting "yes" (coded 1) and indicating opposition, or a lack of support, by selecting "no" (coded 0). This resulted in two groups for hypothesis testing.

Statistical Analysis Technique for Hypothesis Testing

Spearman Rank Correlation was used to test the hypothesis. The moral reasoning scores of the two groups, those in support of expanding SOX to nonpublic entities and those not in support of expanding SOX, were compared to ascertain the nature of any potential relationship.

Analysis of Data and Results

Table 1 shows a detailed profile of the CPA respondents in this study. The 292 CPA respondents are profiled based on age, education, sex, years of experience in public accounting, employment type, primary work-related duties, political affiliation, position in the practice of public accounting and, finally, specific job code for those CPA respondents which indicated that they were "not' in public accounting." As can be seen in the table, the sample of CPAs in this study represents a diversified group of respondents.

Table 1. Profile of CPA Respondents

CPA Characteristics	N	*Percentage
Age		
20-29	42	14.4
30-39	103	35.3
40-49	92	31.5
50-59	50	17.1
60 and above	5	1.7
Education		
College degree	137	46.9
Some graduate School	23	7.9
Graduate degree	132	45.2
Sex		
Female	80	27.4
Male	212	72.6
Years of Public Accounting Experience		
None	14	4.8
Less than 5 years	63	21.6
5 to 10 years	65	22.3
11 to 15 years	59	20.2
16 to 20 years	30	10.3
Over 20 years	61	20.9

*Percentages may not sum to 100.0 due to rounding.

Table 1. Profile of CPA Respondents (Continued)

CPA Characteristics	N	*Percentage
Type of Employment		
Work for public company	45	15.4
Work for nonpublic company	247	84.6
Primary Duties		
Financial accounting	36	12.3
Audit/Attest	107	36.6
Taxation	89	30.5
Managerial accounting	9	3.1
Education	4	1.4
Consulting	22	7.5
Government	5	1.7
Other	20	6.8
Political Affiliation		
Conservative	148	50.7
Moderate	100	34.2
Liberal	44	15.1
Position		
Not in Public Accounting (NIPA)	94	32.2
Staff in Public Accounting	33	11.3
Manager in Public Accounting	89	30.5
Partner in Public Accounting	76	26
****Job Code (NIPA = 94)**		
Consulting/Partner/Owner	3	3.2***
Consulting/Staff member	3	3.2
President/CEO/COO	4	4.3
CFO/Officer/Financial Accounting	8	8.5
Officer/Nonfinancial/Nonaccounting	2	2.1
Financial Accounting/Management	35	37.3
Financial Accounting/Staff	12	12.8
Internal Auditor	9	9.6
Staff/Nonfinancial/Nonaccounting	7	7.5
Education Administration/Staff	2	2.1
Education Professor/Teacher	4	4.3
Government/Federal	3	3.2
Government/State	1	1.1
Government/Local	1	1.1

*Percentages may not sum to 100.0 due to rounding. ** Job Code for NIPA group only with missing values. ***Percentages based on NIPA= 94.

Table 2 shows the frequency of CPA responses for the two groups involved relative to the issue of support for expanding SOX to nonpublic entities. Of the 292 respondents, 211 CPAs were not in support of expanding SOX to nonpublic entities while 81 were in support of expanding SOX.

Table 2. Frequency of CPA responses toward support of expanding SOX

CPAs against expanding SOX	CPAs for expanding SOX
211	81

Table 3 reflects the results of hypothesis testing. The Spearman correlation coefficient was -.099 and it was significant at the .10 level. As can be seen in Table 3, the significance of the coefficient is precisely .092, using a 2-tailed test. Although the level of significance does not strongly support the acceptance of the hypothesis, it is nonetheless significant using the .10 level of significance. So, it does appear that the moral reasoning of CPAs may be related to their support for expanding SOX to nonpublic entities. Of particular interest is the finding of a negative relationship. As the moral reasoning of CPAs increases (recall that higher "principled" moral reasoning per the DIT denotes higher moral reasoning), the support for expanding SOX to nonpublic entities is diminished.

Table 3. Spearman Correlation results of hypothesis testing

	CPA Support for Expanding SOX to Nonpublic Companies
Principled moral reasoning	-.099 (0.092)

Conclusions and Contribution of Study and Suggested Future Research

Today, publicly traded companies must comply with SOX, but, as a general rule, nonpublic entities are excluded from SOX compliance. There has been significant debate as to whether SOX's coverage should be extended to nonpublic companies. Based on this study, collectively speaking, CPAs do not support expanding SOX to nonpublic entities. Additionally, from a moral perspective, CPAs do not appear to support expanding SOX to nonpublic companies. That is, the negative correlation found between CPAs' moral reasoning and their support for expanding SOX to nonpublic entities suggests that CPAs do not feel that expanding SOX will help them fulfill a moral obligation, as stated in their professional ethics code(s), to serve the public interest. In fact, even had this study resulted in a hypothesis finding of insignificance between CPAs' moral reasoning and their support for expanding SOX, the implication would be that CPAs do not see the expansion of SOX as necessary for them to fulfill their moral duty. A positive relationship would be the only result that could suggest that CPAs morally reason that SOX expansion to nonpublic entities is important to the protection of the public interest. Thus, the "negative" correlation found in this study showing that as moral reasoning of CPAs increases, support for expanding SOX decreases is a fairly strong statement that CPAs do not believe expanding SOX to nonpublic entities is necessary to protect the CPAs' public from unscrupulous financial reporting by the agents of those companies. This result is viewed as very important to regulators like the SEC. The opinion of CPAs should go a long way with regard to the government's decision over whether to ever expand SOX provisions to nonpublic entities.

On a very broad level, the conclusions of this study are arguably important, especially given the great uncertainty of the global economic climate today. As perhaps still the most significant player in the economic global landscape, America has long conducted its economic business following a free market philosophy. The self-regulation of professions in the U.S. has been an inherent part of that free market philosophy where the private sector deals with its own numerous and varied responsibilities and is rewarded, or punished, by its stakeholders accordingly. However, SOX represents governmental intrusion into that free market discipline. Today, government is intruding at almost every level of market-based activity as it seeks to help our economy recover.

CPAs are granted the authority in American society to conduct audits as a means of ascertaining the fairness of financial reporting. In recognition of this huge responsibility to serve the public interest, CPAs have adopted numerous regulations to self-monitor in order to control against misconduct in the profession. Therefore, having determined whether CPAs support further intrusion of government, via SOX, into the corporate governance of nonpublic companies offers vital information to the profession, regulators, etc., with regard to whether CPAs believe their self-regulation activity continues to be adequate to protect the public interest. Given the findings in this study, CPAs, from a moral perspective, do not appear to believe that an expansion of SOX is needed in order for the profession to meet its moral obligation to serve the public interest. Further research that studies the relationship of a profession's support for governmental intrusion into that profession's self-regulatory space is viewed as timely and necessary to help follow the progression of thinking as our society lives through these unusual times.

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