COSO at 30 Years

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Mark Beasley: Good afternoon and welcome to COSO at 30 Years, broadcast live on www.sechistorical.org. I am Mark Beasley, Deloitte Professor of Enterprise Risk Management, Professor of Accounting and ERM Initiative Director at North Carolina State University, and moderator for today's program.

Three decades ago, in 1985, five private-sector organizations, the American Accounting Association, the American Institute of CPAs, Financial Executives International, the Association of Accountants and Financial Professionals in Business, and the Institute of Internal Auditors formed a joint initiative to sponsor the National Commission of Fraudulent Financial Reporting, which is commonly known today as the Treadway Commission in recognition of its original chairman James C. Treadway, Jr., who was at that time the Executive Vice-President and General Counsel at Paine Webber, and a former SEC Commissioner.

The report of the National Commission of Fraudulent Financial Reporting was issued in 1987 and a copy of the report is available in the collection of the virtual museum and archive of the history of financial regulation at www.sechistorical.org. Since then, the Committee of Sponsoring Organizations of the Treadway Commission, widely known as COSO today, remains dedicated to providing thought leadership through the development of frameworks and guidance on enterprise management, internal control, and fraud deterrence.

Today's program will look at COSO's work and impact over the last 30 years. Joining with me today are David Landsittel, a COSO Chairman Emeritus. David began his career with Arthur Andersen & Co, and served as chairman of the AICPA auditing standards board. We also have Larry Rittenberg, who also is a COSO Chairman Emeritus, whose service preceded Dave's. Larry is Professor Emeritus of Accounting at the University of Wisconsin. We're also joined with Richard Steinberg, founder and Chief Executive Officer of Steinberg Governance Advisors, Inc. Rick led the development of two COSO landmark reports, the Internal Control Integrated Framework and then the Enterprise Risk Management Integrative Framework, both recognized as standards for effective internal control and risk management.

COSO has partnered with the SEC Historical Society and its virtual museum and archive of the history of financial regulation for this program, and to add to its materials to the museum's collection. The virtual museum and archive is the preeminent source for trusted and verified information and material on the regulation of the capital markets. The Society and the museum are independent of and separate from the U.S. Securities and Exchange Commission and receive no public funding. The museum is exhibited independent of any SEC oversight. The Society is grateful for the generous support of COSO in making today's broadcast possible, and thanks Robert Hirth, the current COSO Chairman, for all his efforts in helping to record and document the history of COSO.

Let's begin with the history of COSO. We naturally want to start with a little perspective of where COSO began. Dave, I'm going to turn to you and see if you can give us a quick thumbnail of what some of the events that were in place that triggered the need to bring these five organizations together back in 1985 and if you can give us a sense for what the vision was when it was created.

David Landsittel: Thanks Mark. Back then there was an emerging concern about an increase in the incidence of fraudulent financial reporting. I had recently completed a term as chair of the Auditing Standards Board, which had concerns that related to the impact of fraudulent financial fraud on auditing standards, but importantly there was a recognition that we needed a broader perspective of all the stakeholders that were involved and might be affected by fraudulent financial reporting. That triggered the idea of getting the five sponsoring organizations together to sponsor a private sector initiative with the Treadway Commission.

The vision of the Treadway Commission involved two related aspects: one, to identify the cause of factors that lead to fraudulent financial reporting, and secondly, to identify steps and provide recommendations to help reduce the incidence of fraudulent financial reporting.

Mark Beasley: And those recommendations were to a variety of bodies, right?

David Landsittel: That's correct. The final report had recommendations that dealt with the auditor, the preparer, the regulator, research and the educator, so it tried to recognize the importance of the involvement of all the stakeholders that might be impacted by fraudulent financial reporting.

Mark Beasley: Larry, can you give us your assessment of the Treadway Commission Report? What was your take in how it addressed those challenges that Dave mentioned in really deterring fraudulent reporting?

Larry Rittenberg: When I think about it, Mark, a couple of things hit my mind. First of all, when I was even younger, we talked about fraud, but it was always fraud within a company and as we learned at the period that David was talking about, companies could enrich themselves by reporting fraudulent financial information. First of all I think it clarifies the difference between fraudulent financial reporting and just other kinds of fraud. That led to a lot of academic research, it led to changes in practice, it led to changing how we educate future generations of auditors. I think the other thing that was instrumental is that they recognized that we needed a new approach to looking at internal controls. Fraud is a major risk, we have to address that risk, we need a more comprehensive view of internal control which led us to start thinking about better governance, things like the control environment, things like tone at the top. That led to the recommendation among many others, and I think we should recognize that the Treadway Commission's recommendations were broader than just the internal control framework. I'll talk a bit about that later, but it led to the work that Rick led us on in developing the comprehensive integrative framework for internal control overall.

Mark Beasley: Not just financial reporting, but all kinds of financial directives. So that had a major affect in 1987 by focusing the profession more on governance and controls, which ultimately led to 1992, when COSO released this internal control integrated framework that you refer to. That framework represented one of the first, if not the first, sort of principles-based frameworks for management and others to use when designing and implementing internal controls. Dave, can you give us a little more color on what motivated COSO to think—okay, we need a framework, we need to develop something like that.

David Landsittel: First of all, as Larry said, the group that spearheaded the development, and Rick obviously was chief among that group, recognized that there needed to be a base pronouncement that people could look to as to what constitutes effective internal control. For example, the Auditing Standards Board had pronouncements that dealt with internal control; the Institute of Internal Auditors had pronouncements that dealt with internal control; the FEI as well and there was academic research that related to internal control. However, there was no single source that somebody could go to as a benchmark as to what constitutes effective internal control. That was the heart of the Treadway recommendation to propose development of that single source that somebody could look to, and a broad source that was principles-based. The idea was once we have that source, it would help public companies judge the effectiveness of their internal control systems and hopefully make improvements to their system that would, among other things, lead to the reduction of the incidence of fraudulent financial reporting.

Mark Beasley: Rick, you were obviously playing a major role and we want to hear a little bit more about that, but could you give us a sense for some of the key players that were involved in this project, and in a lot of ways you were starting with a blank screen. Who was involved and what were some of the key challenges that you were having to deal with to get this concept to reality?

Richard Steinberg: That's right Mark, and I'll talk about the key players and I'd like to name names because they were so important to the success of this project. It starts with COSO board of course as it initiated and sanctioned the project. Those people were Bob May of the AICPA, Al Arens of the AAA, Bill Bishop of the IAA, Tom O'Toole of IMA, and Norm Roy of FEI. Then there was the advisory council which was very important to the project -- the senior executives of such companies as IBM, AT&T, Shell Oil, Household International, and a senior auditing firm partner. Those names just quickly: Gaylen Larson, Andy Bailey, Roger Carolus, Perry Caldwell, Bill Ihlanfeldt, Dave Landsittel, who of course is on this broadcast, John Stewart, and a consultant to the council, which was Howard Sears. It really provided very important insights, guidance, and oversight.

In terms of Coopers & Lybrand, there was the deputy chair Vin O'Reilly and Frank Tanki, the head of the technical services of the firm. They really oversaw the project, and as you mentioned I led the core project team which was designed to develop the framework and that was supported by a couple of partners, Mal Schwartz and Bob Spears, and really many other Coopers partners and managers who were involved in the project.

I think it's important to know that there were hundreds of others providing input to the project. We can talk about a cast of thousands, as there were over a thousand people involved in the form of interviews, responses to questionnaires, workshops, exposure field testing -- those were with CEOs and board members and legislators and regulators, all providing input. The core team also setup an advisory group to bounce ideas off of and we engaged several academicians. The point being there was broad involvement of a wide array of knowledgeable and experienced individuals in organizations.

Mark, you asked about some of the challenges and there were certainly many, and as you said we did basically start with a blank screen. Although we had good conceptual knowledge, the core team did, and some of the issuances that David just mentioned from the AICPA and SEC and Treadway itself, and so forth, but a good deal of thought and creativity had to be brought to this development effort. Then as significant as anything else there was a wide disparity among business executives and the various parties involved as to what internal control really was all about, and bringing those disparities together was a key to the project's success.

David Landsittel: Just a comment, Coopers & Lybrand spearheaded the authoring of this project. The advisory council did go through a formal RFP process, and in doing that, I remember that Coopers' presentation was so impressive and they were so committed to the dedication to resources to the project that it was so easy for the advisory council to conclude that Coopers was the one that we wanted to engage. They made a wonderful contribution to the project and it was clear from the beginning that we had the benefit of a talented group of people, including Rick, on the project.

Mark Beasley: They were obviously committed for the long haul. Rick, it was a multi-year kind of effort if I recall.

David Landsittel: It was a three-year project.

Richard Steinberg: We anticipated about a 12 months project, and it started in August of 1989 and ended in September of '92, so it stretched out a bit.

Mark Beasley: I think for purposes of history I think it's helpful to remember that in the late 1980s, we were dealing with the savings & loan crisis, so you've got the Treadway Commission coming in '87 followed by the S&L issues, providing a backdrop to all this activity that I think is interesting. Dave, today we think of COSO as COSO, which represents the very long name the Committee of Sponsoring Organizations, but we refer to it by its acronym. Was this sort of the transition from referring to everything as the Treadway Commission to now referring to it as COSO beyond that?

David Landsittel: Yes there really were two separate bodies. The Treadway Commission had one mission and that was to provide the report that dealt with the concerns about the incidence of fraud and the recommendations. It wasn't thought as something that would be ongoing, but when the sponsoring organizations responded to the recommendation about internal control, that's when COSO became COSO rather than the Treadway Commission. There's a period of time here because the Treadway Commission is 1985 to '87 and then as you mentioned '89 through '92 was the first significant COSO project, and there was a thought at that point in time that there would be an ongoing oversight after the issuance of that report. The Treadway Commission was a onetime deal; the COSO initiative with the internal control was thought of as something that would require follow-on oversight after the issuance of the report.

Mark Beasley: It wasn't a project team, but was designed to be beyond that?

David Landsittel: Yes.

Richard Steinberg: Mark you asked about how COSO came about, in terms of the acronym. I've been asked many times how the acronym COSO came up and I guess I personally need to take either the credit or the blame, however you phrase it. I remember when the COSO Report was about to be printed, I was involved in drafting a cover letter for the COSO board. I was thinking about an acronym like COSOTC, for Committee of Sponsoring Organizations of the Treadway Commission. I thought that was too long, so I shortened it to COSO, that's how it came about.

Mark Beasley: Larry, can you give us a little perspective on the impact of that '92 framework in the 1990s. We're going to get to the Sarbanes-Oxley period later, but for now how would you describe that early period of time after '92 when the frameworks were released and the impact in the business community?

Larry Rittenberg: I think the impact was not as significant as we hoped it would have been. Part because as Rick pointed out, they did an amazing job starting with a fresh page. When we looked at internal control before that, we tended to look at transactions and segregation of duties and all of a sudden we see something that talks about the control of environment, talks about risk, talks about control activities, about monitoring, all of those factors relating to objectives of better financial reporting, all integrated into a framework. It took a while to get there, the importance of governance, a really effective and independent audit committee has to be there, commitment to good behavior. Things that auditors who were born accountants most of the time looking at debits and credits and like structure, this appeared to be a little bit more unstructured than I think they were used to. But, and this maybe goes back to my bias as spending many years as an educator, it was picked up by all of the major auditing textbooks and from that point on students who became the next generation of auditors were familiar with the COSO framework. The elements of the cube, there's a reason there's three dimensions there and understanding that if you have a weakness, which we found out in the savings & loan crisis, we found out in Equity Funding before then, that tone at the top issue becomes really more and more important. I found in discussions with audit partners at the time. They would say we spend a lot more time just thinking and interviewing top management to find out where they are and where they're from and what their values are. I think we developed the next generation but we still had some struggles learning how to integrate the framework. Rick and Dave, you may have some different views, you were in practice at that time, but that was my take of the '90s.

David Landsittel: Let me just go back to the time it was issued and my perspective as an advisory council member. First of all we were very proud of the product, as you would expect, and of course of Coopers & Lybrand's contribution as well. But I think we were worried that would this be something that people would initially embrace and then put on the shelf and people would not really look at it. I think the points that you raised are important, Larry, the concepts of framework became embedded in a lot of other literature, including academic textbooks and training, and the Auditing Standards Board embraced it, and accordingly, its ongoing impact became apparent.

Mark Beasley: But, as we saw it, embedded behind the scenes into some regulation. Rick, Dave mentioned the selection of Coopers to provide some of the heavy lifting. Could you give us a little bit more detail of what that looked like and Coopers' role in the process?

Richard Steinberg: The Coopers project team's role was really to design, develop and write the framework. Part of our role was to obtain information, input from many other participants, and in so doing, this is really an important part of it, to gain broad based acceptance of the ultimate framework. So the process that we went through was designed to gain that acceptance at the end of the day. As to why we decided to take on this assignment, I think you asked me that, didn't you?

Mark Beasley: Yes.

Richard Steinberg: I thought so. Although we knew it would require a major financial investment, Coopers & Lybrand always considered itself a leader in the profession. We saw the opportunity to continue in that role, and we knew there was increasing interest as Dave pointed out, in the subject of internal control, and Larry did also, and we recognized that the resulting output would be widely viewed and might become a standard on the subject. That was how we entered this project. We saw our role as utilizing our existing experience on the subject. We knew from the outset what the categories of control objective would be. We had those in our proposal and we stayed with them: operations, financial reporting, and compliance. We certainly had other thoughts on how the framework might shape up, but virtually all the other concepts were developed during the course of the project. And I'd like to just say one more thing here, the Coopers project team also kept in mind that we had the role of being the framework's authors. That is, while the COSO board and advisory council provided invaluable guidance, the Coopers team really made the final decisions in what the framework said, subject of course to an ultimate decision by the COSO board on whether or not to accept the final report.

Mark Beasley: In that final report there was one visual that many people now know, if they're in a publically-traded company, as the COSO cube. Can you give us a little sense, Rick, on the cube diagram and the categories of objectives and how that came about?

Richard Steinberg: I have had dreams about that cube and sometimes nightmares. What happened really was that during a meeting of the advisory council and the C&L project team -- it was towards the end of the project -- an advisory council member - Andy Bailey - said that he understood the three categories of objectives, he understood the five components, and that internal control applies to any part of business. But how, he asked, do these three elements work together, how do they interrelate? Very frankly I had no clue at the time, but by the time I walked up to a flip chart in the corner of the room picked up a marker, it kind of magically came together. I was always interested in architecture—I'm not going down a sideline here -- and as a component in a course I had there was a mechanical drawing segment, so I knew how to draw a three-dimensional form. I drew a three-dimensional cube on the chart and I put at the top the three categories of objectives, down in the front the components, on the side the parts of the business. I said this is how the elements interrelate. David is smiling now because the advisory council huddled up at the end of the conference table for about a minute or two, and Chairman

Gaylen Larson then said, Rick, if you put that cube in the report, we will recommend to the COSO board that the report be accepted.

David Landsittel: One of the beauties that I think the cube illustrates is really the simplification of the organization of the framework that was provided by Coopers. It wasn't something that was so complex that you couldn't show that interrelationship -- there are three fundamental objectives, five components, segments of a business -- three dimensions and the ability to put those together in a cube is something that I think shows the power of the framework being effective, coordinated, but on the other hand not overly complex.

Mark Beasley: I can tell you from an academic perspective, it provides a great teaching tool to give that big picture, just as you're describing. We've talked about the launch of the framework in '92, and it's embraced through the '90s and then ten years goes by and we're in early 2002. The financial reporting community experienced the largest financial statement frauds in history with the unraveling of Enron and then WorldCom, Enron in 2001, WorldCom in June 2002. Congress quickly passed the Sarbanes-Oxley Act in July 2002 which contained a number of requirements included the Section 404 requirements for management assertion and then auditor attestation about internal controls over financial reporting. Larry, can you give us a sense for how the passage of the Sarbanes-Oxley Act, specifically, impacted the significance of COSO as a thought leader in internal control?

Larry Rittenberg: First, it helped to have the public reporting on internal control mandated, and the most comprehensive framework that existed was the COSO framework so there became a recognition that this must be pretty well-developed and thought out. Second, as we have gone over a period of time, the internal control in our organizations have become much better. There were many deficiencies if you look at the research reports that came out during 2004, 2005, a lot of companies who thought they had pretty good internal controls did not, and people kept saying we see the weaknesses now that we've never seen before, so I think that was a major part of it. I think the other part, maybe not everybody went back to the original Treadway Commission to look at their recommendations, but the recommendations that were made back in '87 pretty much paralleled what went into the Sarbanes-Oxley Act of 2002. The issues about public reporting on internal control over financial reporting, the issues related to the tone at the top, the ethical commitment, again stronger audit committees, all became entrenched. The idea that risk relates to objectives, and we're going to talk about this a little bit later, but COSO turned this around that it all started with objectives, and there are risks to achieving those objectives and controls to mitigate it. I think people recognized it and as we went into the revision in 2013, they saw that the framework of the outline of the body was still solid after 20 years even though technology and business had changed dramatically. I think through that combination of things COSO earned the respect it has in the marketplace.

Mark Beasley: Rick, you've had a lot of accomplishments over your career, but I would think looking at your work in '92 and then fast forward that work into the Sarbanes-Oxley Act, you have to be proud, when you think about that. Let's think about – what if the framework had not existed when SOX was issued, what would that look like?

Richard Steinberg: That's a great question and of course we can't be sure. I'd say we'll never know, but one might think that Section 404 might never had been included in the Sarbanes-Oxley Act. I say that because the SEC had proposed management reporting on internal control effectiveness a couple of times before, in 1979, again in 1988, but never issued final rules in part because the comments that came back referred to not only the cost but also that there was no clear roadmap of what constituted "effective" internal control. That is, it was argued that without a basis for measuring a company's system of internal control against an accepted standard or baseline it would not have been possible really to reasonably report on internal control effectiveness. Now the COSO board, the advisory council, and Coopers & Lybrand certainly knew this history when embarking on the project, and as mentioned earlier the primary purpose of this was to provide a framework that would help organizations enhance their internal control systems and gain the associated benefits, and there are many. But we frankly had in the back of our minds the need to provide a basis for reporting in the event that the SEC or Congress decided down the road on such requirement.

Mark Beasley: Interesting.

David Landsittel: One of the things that's interesting is that the SOX 404 provision doesn't specifically allude to COSO as being the baseline to measure internal control effectiveness. It just says there needs to be a baseline that meets certain criteria, and it's to COSO's credit and the credit of the framework that approximately 99% of registrants use the COSO framework as their baseline for measurement of the effectiveness of controls. Even though it wasn't explicitly mentioned in the SEC regulation supporting SOX 404, people look to the COSO framework as the baseline to measure effectiveness.

Mark Beasley: The vision that you had in '92 to be preparing for that future event, now coming to reality, was tremendous when you think about that.

Larry Rittenberg: I was just going to say I think Rick was going back to a lot of the comment letters that the SEC received where there was a perception, not only of the cost but that it would not add much value, and certainly over the past decade we have seen the cost can be managed effectively, it's good business, and most of the firms with internal control have done very well in the marketplace, whereas those with poor controls have not.

Richard Steinberg: As most of us know, the registrants, the CFOs, and the external auditors were frankly also concerned about potential liability related to making a statement of internal control effectiveness without any standard to measure it against.

Mark Beasley: Obviously the framework was tremendous foundation to be able to comply with 404, but that didn't mean it was easy as most public companies will tell us, and their auditors, but when you think about the early years of implementation, Larry I think you were chairing the board about this point, where the implementation of 404 was occurring, there were some challenges particularly being voiced from the smaller business community about the application of the framework to a small business context. Then there was also some confusion over the monitoring component, that specific element of the five components that people were maybe misinterpreting, and applying. Can you give a sense for some of those issues and then how COSO tried to address that?

Larry Rittenberg: You're right, I was chair at the time and we had some discussions, even at the SEC about small businesses, and a question—can we develop a COSO "lite," and as we thought through that process I certainly came to the conclusion and the board did at that time that there wasn't a COSO "lite." There is effective internal controls and there's not effective internal controls, but when we looked at the overall COSO internal control framework we found, as you stated earlier, basic principles in the framework. We found that small businesses could meet those principles. There might be some differences in how they document it, there might be some differences in how they implement a particular control or they may have a different control than you'd find in a large business, but it mitigated the effective risk. We went through that process and I remember sitting down with the PwC project team.

Richard Steinberg: With Miles Everson heading that.

Larry Rittenberg: With Miles Everson and Frank Martens was a major player in that, sitting in Chicago, if you remember, we had this one conference and people talked about small business and I stayed the next day to work with the team. They were discussing things and it just wasn't jelling and it was either Frank or I or together said why don't we take a look at this, just lay out the principles. We started a principles approach which you see now in the COSO 2013, we had a few more than they have now but we worked that down and then we said, if we understand the principles let's understand what are the key elements, like attributes, so we had a principle on ethics, and we said what are the key attributes. Well, you've got to codify your ethical culture. You've got to communicate it, you've got to determine if there's a way to determine there's lack of adherence and you've got to address those. That may take place differently in a small organization than a big organization, and it might focus a lot more on the work of the small business owner. But we laid out those principles and they work, they work very well, the feedback that we got was that they work very well.

Richard Steinberg: Thanks Larry, that was very, very important on a number of levels. Essentially the principles and attributes approach served as the foundation for the 2013 update to the internal control framework, so that was a starting point. I guess like a bad penny my name keeps turning up. I was asked by the PwC team doing this small business guidance to help them, and I think they did a great job in making sure all of the principles in the '92 framework were in fact included in that small business guidance.

Larry Rittenberg: It was, and then as we went from there, you asked the question about monitoring. One of the questions that came up with small businesses is can I sit here as the CEO of this small business and read a report and say I've effectively monitored my internal controls? We thought it wasn't quite that easy, even with very knowledgeable CEOs. As an aside we also addressed the issue of how much you'd have to document, that small businesses can document things slightly differently but they need to show that the principles are there and working. The other thing we know about monitoring, and this is sort of one my pet areas, is that we want to make internal controls more cost effective for every organization and we're now going into this era of more digital everything. We need more monitoring, and so we needed to take that component of the internal control framework and dive deeper into it. In this case, Trent Gazzaway of Grant Thornton, led that project and again very conceptually oriented, but then once we did that we understood how they all fit together and what constitutes effective monitoring. Still today a lot of organizations that are working on monitoring, the other thing we did that is not in the 2013 updated framework, but to explain things in the small business and in the monitoring we had kind of a flow diagram to understand how things fit together. They start with objectives, there's risk to those objectives, there are control activities to mitigate the risk, there's effective communication going back and forth, all of that needs to be monitored so they're all simultaneously working. You change internal control from sort of a once a year thing you do for SOX to an ongoing process, and that's what companies, all organizations need, that was the intent of the monitoring document.

Mark Beasley: I think it's important for us to clarify that these were more how-to guidance. The '92 framework was still in play, it wasn't a new framework kind of thing.

Larry Rittenberg: We did not change any of those elements, it really was kind of diving one level deeper to lay out the principles and then the attributes which personally I really liked, it just flows very well.

David Landsittel: It is interesting to note that there was early on a COSO framework recognition of the importance of monitoring that has evolved today in the business community with the focus on analytics and "big data." The opportunities have exploded but here you have a baseline that COSO developed in the monitoring guidance that's very helpful in applying, what today is advanced technology that allows you to be more robust in the area.

Mark Beasley: Yes, that's a very good point. Sometimes we've referred to the 2013 revision, so Dave, you were chairing at this point so can you give us a little perspective. I know we don't have time, we could do a whole hour on that I'm sure, but a little perspective of what led to the revision which was the 20th anniversary of the '92 framework, what was the main driver of that?

David Landsittel: First of all, our COSO board spent a number of hours talking about a strategy for the revision and whether there needed to be a revision because most of the COSO board members thought the '92 framework continued to be an effective framework. Because it is principles-based with concepts that really are timeless, there wasn't a concern that you would be revising something that was defective. It was a concern about is there an opportunity to further enhance something that's already effective. So the board concluded that, 20 years later, it's time to update the framework. We had three goals from the start, and again with the help of PwC, the successor firm of Coopers, those goals were well accomplished.

The first goal was to update the context of the document. If you think back in 1992, we didn't have email or a usable internet; business was not as complex in a number of areas – for example, there wasn't nearly as much outsourcing which affects internal control and how you look at internal control. Governance had further developed, as Rick would know, including the increasing importance of the board and the importance of audit committees. There were a number of developments that we wanted to weave into the updated document to make, in effect, a 2013 as opposed to a 1992 context. Second, we wanted to make the principles, which were implicit in the 1992 framework, more explicit. Supporting the five components in the update framework are 17 principles and a number of what we now call "points of focus" that support the principles. We thought that would add significantly to the understandability of the framework. I think history already has shown that was a wise move and again we had comfort because it already was something that was founded in the COSO small business document.

Finally, as our third goal, we wanted to broaden the emphasis in the discussion of the objectives. Rick mentioned the three objectives being compliance, operations and financial reporting. We wanted first to add a little more emphasis on the opportunity to look at internal controls through all three of those objectives and not just financial reporting – and let me back up a minute. SOX was very helpful in providing visibility to the framework, but it did so in terms of effectiveness related to the objective of financial reporting, whereas we thought the real opportunities of the framework go much more broad than that and deal with compliance and operations as well.

So in summary, there were three goals that we focused on in developing the updated framework, the first being updating the context; second, making the principles explicit; and third, broadening the emphasis on the objectives.

Mark Beasley: So far we've started with a focus on fraudulent financial reporting with the Treadway Commission and that led us to the conversation of the focus on internal control. We want to move to that third leg of COSO's area and that focus is enterprise risk management, and in 2004 COSO issued its Enterprise Risk Management Integrated Framework so now we're almost 11 years beyond that. Larry, can you give us a little more color on why COSO decided to go down the path of developing a framework on enterprise risk management in addition to the framework already existing on internal control?

Larry Rittenberg: I think there are a couple of major reasons, Mark. One, is risk is a part of the internal control framework that we began with, but at that point in time with all of the context that you've helped give us earlier today there's a lot of risk in business. There's a lot of literature about risk and risk management, but there was no common literature, there was no integration of that literature and everything that existed in that literature started with risk, it did not start with objectives and that's one of the major things that Rick, Miles Everson and Frank Martens helped us understand is that it always starts with objectives and there's a need to get out of these so called silos or little independent parts of the organization to look at enterprise risk management throughout the organization. We also tried to force managers to make some decisions about how much risk and what type of risk are they willing to take. We introduced new terms that people have had trouble dealing with, but conceptually if you think about it risk appetite, how much risk are you willing to take. Risk tolerances, what's the variation are you willing to deal with around your risk appetite. Concepts that organizations need to start talking about or needed to start talking about if they're going to mitigate the risk and keeping in mind where that project came about with. It's not about the risks primarily, it's about achieving your objectives and understanding there are risks that are going to be there between you and your objectives and you've got to figure out how to deal with it, how to manage them or move on with them. That was the reason.

Mark Beasley: Rick I know you get this question probably a lot, I know I have, you've got the COSO Internal Control framework, you've got the COSO ERM framework, so I think one of the things we want to make sure our listeners hear is they are two frameworks but they are very related. Can you help us sort of see that relationship between the two?

Richard Steinberg: Mark, you're right on, on both counts, and I do get this question very often and the answer very simply is that the ERM framework is broader than internal control, period, end of sentence.

I'll add to that a little bit. Internal control of course is an integral part of enterprise risk management and is encompassed within it. Now as we go down a little deeper, the internal control framework has three categories of objectives, ERM has four. Internal control has five components, ERM has nine. As Larry said to have effective ERM, a company needs to set risk tolerances and has to align them with an overall risk appetite. It also needs to take a portfolio view, that is to consider risk from an overall broad-based perspective. And there's a much fuller consideration of risk in ERM. As we developed the ERM framework, it was really deemed important though to retain the internal control framework for its continued use in reporting especially under SOX 404. Overall while there's great overlap between the two, ERM has a much more robust focus on risk.

David Landsittel: Let me just add to your point about ERM being broader, which I totally agree with. One of the ways I think of it and this is somewhat pragmatically speaking, but I think of controls as being one sided, always reducing the risk, whereas ERM recognizes that there are alternatives in dealing with the risk that provide opportunities to the company on an upside as opposed to the controlled downside managing of the risk.

Larry Rittenberg: Good point, David, a really good point and the framework talks about the relationship of going back into strategy. There may be risks you want to take and need to take.

Mark Beasley: The framework was out in 2004, but COSO was pretty active after that issuing other guidance related to ERM. Do you want to touch on that?

David Landsittel: Since that time we've issued 12 thought papers that deal with the challenges of implementing ERM and let me just say that we recognized in some surveys, including surveys that Mark, you spearheaded for us, that there's uneven application and implementation of ERM in the business community. Some people might say they have a risk management ERM program, often they are not very robust and so we were anxious to help companies move up the maturity curve, so to speak, in terms of their effectiveness in implementing ERM. We would engage authors help us issue thought papers that dealt with difficult ERM implementation subjects. For example, Larry spearheaded as a lead author of a thought paper that dealt with risk appetite, which concept is a difficult issue to implement. And you, Mark, were very effective in terms of your thought papers that dealt with a relationship of ERM to the board and how the board deals with ERM in their oversight. These are issues that we thought were important in our goal of helping companies become more robust in their implementation of ERM.

Richard Steinberg: If I might just add to that, I think these thought papers have done a great job in another way as well and that is to help to reinforce the idea that not every risk management function in a company or not every risk management process rises to the level of enterprise risk management. I think a lot of observers out there still equate the two almost synonymously and certainly these papers helped to get the point across that they're not.

Mark Beasley: I think it's important for us to point out right now, COSO is in the process of looking at revision of that framework, updating I guess, similar to the 2013 internal control so that's ongoing today. We also started with the topic of fraudulent financial reporting in the context of the Treadway Commission Report and I think it's important for us to at least make sure we don't overlook the work that COSO did in the area of research on the topic of fraudulent financial reporting.

David Landsittel: This is one where Mark, you should take your moderator hat off. We recognize that you were the key author of two research papers important to COSO that dealt with research in fraudulent financial reporting, so give us a thumbnail sketch of those two papers.

Mark Beasley: I'll give a quick thumbnail sketch and we want to make sure we save a little time for some future thoughts, but a high level view, in '99 we were asked by COSO to look at the enforcement actions issued by the SEC alleging fraudulent financial reporting over an 11-year period. We looked through the enforcement actions to try to understand techniques to engage in fraud, and to try to get a sense for the context surrounding the cases investigated by the SEC. We issued the monograph in '99 to really provide a more, it wasn't the full population but a large number, sample size of those cases, to better understand when you look at it at an aggregate level, what's going on here, what's the nature of the fraud. Then that was updated again with a more extensive study in 2010 to catch us up for that next 10 years. What was interesting I think between the two was just seeing the improvements in board structure, a lot had happened in the governance space such that we really didn't see much difference between some of the governance issues between fraud and no firms that we might have seen in the early '90s.

To move onto our last topic, I do want to make sure with the three of you in this room to touch on this for a minute. We've talked about the history of COSO but it would be not wise on our part to not get your thoughts on the future of COSO and you've all played major roles in this. We've looked at the last 30 years, but let's spend just a second and look at the next 30 years. If you think about looking ahead, how would you envision the role of COSO over the next 30 years, and Rick I'll get you to provide your thoughts on that.

Richard Steinberg: Sure, I'll start us off. As we take a look at COSO's mission, we see its goal -- and it's almost a quote -- to provide thought leadership on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud. Now that's quite broad, and I expect COSO to continue to be in the forefront of those areas maintaining the frameworks and providing more guidance to business, including senior management and boards of directors. We've seen a great deal of focus recently, especially on boards of directors in the financial media and it certainly would not surprise me if the COSO board decided to move forward on the topic of corporate governance, focusing on such things as the responsibilities of boards of directors and how they can best carry those out and enhance their performance. I understand the COSO board -- I hope I'm not talking out of school here -- has had some discussions on this topic and I would think personally that a natural outgrowth consistent with its mission would be to move forward with a framework on the subject of corporate governance effectiveness.

David Landsittel: I agree with all of what Rick said. First of all, I personally I want to say I'm biased, but I love our mission. I love our mission because it deals with controls, risk and fraud, subjects that are so important to the success of organizations. I think governance is very consistent with that and having a framework on governance would certainly be something that the board would consider in the future.

Larry Rittenberg: If I might add just a couple of things here, Mark. I'm not sure that we're in the best position to do a framework on governance, but I think one of the things that COSO is going to have to think about over the next 30 years is whether to expand and diversify its membership. For example if we bring in the National Association of Corporate Directors as one of our representatives, so that we're more than five organizations that are primarily viewed as accounting organizations then we're in a better position to do that. I think that as we go forward where David has led us with more implementation guidance is a big thing. I think the board will eventually have to make a decision of whether or not it has any paid staff to do all of this. We've done a wonderful job as volunteers and I think it's important to recognize the commitment that organizations have made to support it, but I think the issue of diversifying and bringing in more membership may lead us to a better position to become the thought leader on those areas as well.

Mark Beasley: Dave, what are your thoughts? Do you see a more formalized structure at some point?

David Landsittel: Well I don't like the word "formalized" in the sense that I don't want to suggest that we become a standards setter. I like the idea of being a thought leader. I think when you're a thought leader you're not as constrained in terms of looking provocatively at leading edge kinds of things that might be helpful, whereas if you're a standards setter there is that constraint. So I like the idea that COSO continues to not be so formal and can throw out ideas in a thought leader fashion. I will say by the way that Bob Hirth, our current Chair, is doing a wonderful job with the board in looking to the future and moving COSO to the next level. He is very effective in moving us forward in ways that are important. Certainly globally, he's been all over the world, he's thinking about training, certification issues that deal with implementation. I'm very comfortable with his leadership.

Mark Beasley: 30 seconds here Larry, COSO is pretty much a U.S. based representative, do you see a more global footprint at some point?

Larry Rittenberg: I do, the question is how to get there and still have it COSO. I've worked with China, I've worked with Japan. There's a thirst for COSO; we just need to steer our way there. I hope I made the 30 seconds.

David Landsittel: It is surprising globally today what a footprint we have. I mean the COSO frameworks are already translated into 8 or 9 languages, and used in several countries.

Mark Beasley: Gentlemen we are approaching the end of our broadcast. Dave, Larry and Rick, it has been a real pleasure for me being with you again first, but I just appreciate the time you've taken to provide this excellent discussion today.

Today's broadcast will be available in audio mp3 format in the virtual museum and archive at www.sechistorical.org and an edited transcript will be added later.

On behalf of the SEC Historical Society, I would like to thank again COSO, the American Accounting Association, the American Institute of CPAs, Financial Executives International, the Association of Accountants and Financial Professionals in Business, and the Institute of Internal Auditors, and particularly Bob Hirth, for their generous commitment and assistance in making today's program possible. Thank you for joining with us today, and good afternoon.