Automated Testing of Controls

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Financial and Operational Internal Controls – A background

What are internal controls?

Financial and operational Internal Controls form the backbone of all businesses. They ensure that daily operational procedures are followed exactly as intended to achieve required internal and regulatory compliance. A control in any process has two aspects:

- The right outcome it intends to achieve
- The wrong outcome it intends to prevent

An example of an operational control can be - authentication to access software systems running business processes, where authorized users are allowed access, while unauthorized users are denied access. Similarly, financial controls can relate to the capture, classification and presentation of financial accounting transactions, requiring appropriate authorization, and oversight from top management.

Internal Controls can be preventative (don't allow errors to occur), detective (spot errors that have occurred), and/or corrective (fix errors) – depending on the purpose they serve.

Process Digitization and Automation of Controls

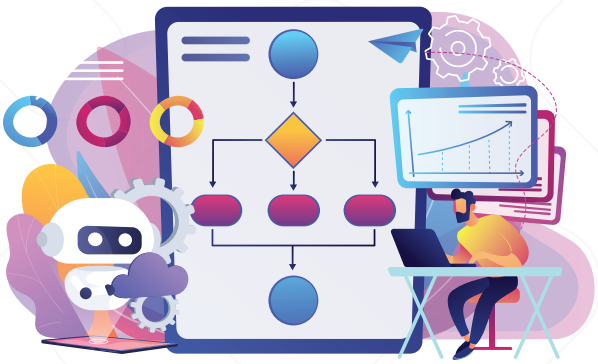
Manual controls create more operational risk as they can be executed by unauthorized personnel or, in some cases, authorized personnel in erroneous or fraudulent ways. With most businesses digitizing their processes, a significant proportion of controls are embedded in software, and their execution is automated with an audit trail generated. At the step where this process has a hand-off to/from a manual process, consequently increasing risks can be mitigated with appropriate checks and balances, such as by reconciling manual pieces of the process with the digitized process in cases where automation of a manual process or controls therein is not feasible.

Testing of Controls and the case for automation

Testing of Controls is a critical activity undertaken at regular intervals or when there are significant changes to business procedures. It is a time-consuming activity and a tremendous drain on the resources of an organization. Outdated documentation of internal controls creates risks to business itself, and compliance audits may be impeded – resulting in internal or regulatory non-compliance risks.

Therefore, a strategic approach to automated controls testing can go a long way in reducing risk.

Business operations form the First Line of Defence for any organization. The Second Line of Defence or Internal Compliance function validates and maintains the rigour around all internal controls for business processes. The Third Line of Defence or the Internal Audit function has the responsibility to periodically verify that business procedures were adhered to (in the audit period under scrutiny). Together, these functions roll up to the Head of Risk in an organization. Hence, an overarching strategy that involves stakeholders within all lines of defence is likely to be more effective than one driven by the Compliance function alone.



The Three Lines of Defense in Enterprise Risk

CFO **CEO** **Board**

Risk Appetite Framework (RAF) based comprehensive & dynamic oversight

Chief Risk Officer (CRO)

Executive level sponsorship for risk

First Line of Defense (Business Units)

Conduct day-to-day business with agreed risk rigour & a conducive control environment

- Risk ownership and complying to
  - Procedural steps
  - Approval levels
  - Key risk indicators (KRIs), inc. limits & thresholds
- Strategy guidance for internal controls formulation
- Own & drive RCSA (business self-assessment)

Second Line of Defense (Internal Compliance)

Independently assess and challenge risk contribution by Business and escalate to Board level

- Institute risk management practices with operational standards, taxonomy, risk frameworks, methodologies & models
- New risk identification for business environment & regulation changes
- Risk monitoring, aggregation & reporting (internal/regulatory)
- Advising and training Business

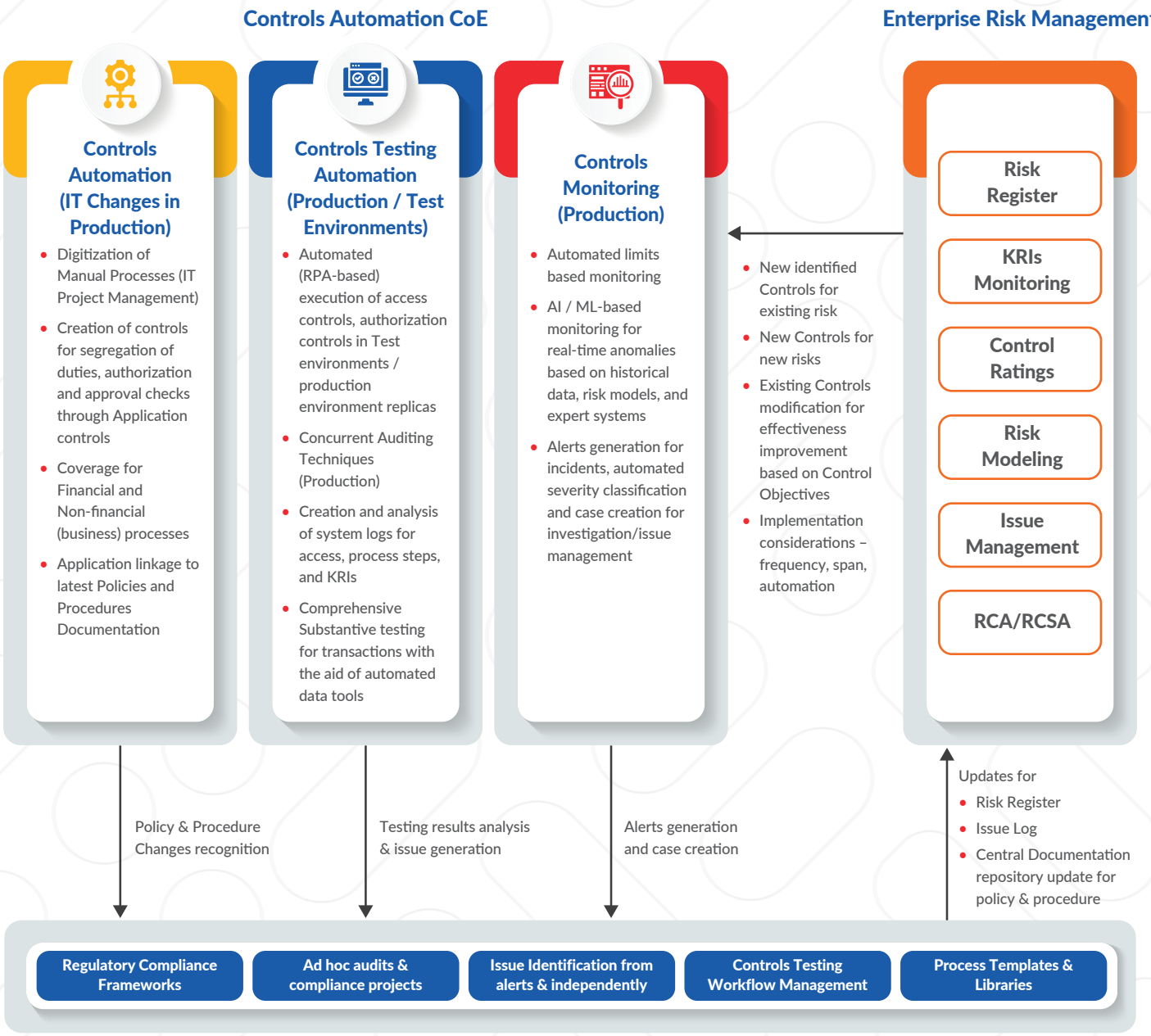
Third Line of Defense (Internal Audit & Assurance)

Independently review and challenge levels of efficacy & adherence of processes & controls

- Periodic verification & validation of control objectives, controls & execution
- Objective guidance for first two lines to rationalize and optimize controls
- Independent reporting to board to support internal control framework
- Key risk detection through audit activities & enhancing enterprise efficiency

Hexaware's PoV – Testing of Controls Automation

A CoE-driven approach specifically targeted at testing of controls can improve risk management and achieve reduced TCO over the long term by developing a platform that integrates seamlessly with business and risk functions.



Once uniquely identified, all risks and corresponding compliance requirements can be mapped to individual controls – in a clear and unambiguous one-to-many mapping format (where the same control meets different compliance requirements, at times).

Specific and up-to-date documentation mapped to risk identifiers (and controls) helps ensure accurate measurement of the efficacy of controls – this, in turn helps manage and keep pace with ever-changing, ever-evolving business, operational and regulatory changes.

Through a centralized platform and with a three-pronged approach – Controls Automation, Controls Testing Automation, and Controls Monitoring – organizations can negotiate emerging risks by managing all compliance requirements, controls, documentation, and issues detected.

Automation of controls can be achieved through three broad mechanisms (or a mix thereof, depending on specific compliance requirements)

- The 'Continuous Audit' approach where transactions in business applications are examined in real-time to check for fraud or operational errors. This would be particularly useful for large value transactions that must be prevented if executed against the intent of the procedure. This can also include dummy transactions to check the entire lifecycle of the transaction but without financial impact.
- Post-facto testing, where transactions are checked after execution or completion.
- Testing controls in production environment replicas, with exact images of production environment (application code and data), such that there is no risk to production environments, but the test results would be equally effective in identifying issues.

An integrated approach such as this, will ensure plenty of benefits:

A Single view of all organizational internal controls, with mechanisms to ensure that procedures followed are current, and risk is quantified at appropriate levels before being accepted at the designated risk appetite.

Highest levels of transparency – internally and for external stakeholders (customers, investors, and regulators).

Up-to-date risk register as well as effective RCAs (Risk & Control Assessments) and RCSAs (Risk & Control Self-Assessments).

Reduced internal and external audit completion time.

Repeatable results in case of framework-based compliance exercises such as SOX, PCI-DSS, and the like.

Conclusion

Testing of control automation can transform risk and compliance functions to improve cost efficiencies, resilience, and performance. It is the need of the hour, taking into consideration evolving business models and the advent of new technologies and the need to reduce risks and optimize cost. With Hexaware's deep-rooted automation-first approach hinged on our Automate Everything™ strategy, banking and financial services companies can leverage our integrated, end-to-end testing of controls solutions to disrupt risk and compliance management, and gain business advantage.

For more insights, do get in touch with our automation experts to reimagine risk and compliance management. Email: marketing@hexaware.com

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