



**NCUA**  
National Credit Union Administration

**OFFICE OF INSPECTOR  
GENERAL**

**MATERIAL LOSS REVIEW OF  
C B S EMPLOYEES FEDERAL CREDIT UNION**

Report #OIG-20-01  
February 11, 2020





Office of Inspector General

**MEMORANDUM**

**TO:** Distribution List

**FROM:** Inspector General James W. Hagen

**SUBJ:** Material Loss Review of the C B S Employees Federal Credit Union

**DATE:** February 11, 2020

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of C B S Employees Federal Credit Union (“C B S” or “the Credit Union”) due to its failure and resulting estimated \$39.5 million loss to the National Credit Union Share Insurance Fund (Share Insurance Fund). We reviewed the Credit Union to: (1) determine the cause(s) of the failure; (2) assess NCUA’s supervision of the Credit Union; and (3) provide appropriate suggestions and/or recommendations to mitigate future losses.

We determined the Credit Union failed due to the former Chief Executive Officer’s fraudulent activities, primarily related to misappropriation of funds. We provide details on this finding in the report below. As a result of our review, we are making two recommendations to NCUA management to correct these findings. Management agreed with both of our recommendations and plans to take corrective action to address each one.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us during this audit.

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## TABLE OF CONTENTS

<u>Section</u>	<u>Page</u>
EXECUTIVE SUMMARY .....	1
BACKGROUND .....	4
RESULTS IN DETAIL.....	10
A. Why the Credit Union Failed.....	10
B. NCUA’s Supervision of the Credit Union.....	12
OBSERVATIONS AND RECOMMENDATIONS.....	16
APPENDICES:	
A. Objectives, Scope, and Methodology .....	18
B. NCUA Management Response.....	20
C. Acronyms and Abbreviations .....	21



## EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of C B S Employees Federal Credit Union (“C B S” or “the Credit Union”), a federally insured credit union. We reviewed the Credit Union to: (1) determine the cause(s) of the Credit Union’s failure and the resulting estimated \$39.5 million loss to the National Credit Union Share Insurance Fund (Share Insurance Fund); (2) assess the NCUA’s supervision of the Credit Union; and (3) provide appropriate suggestions and/or recommendations to prevent future losses.

To achieve these objectives, we analyzed the NCUA’s examination and supervision reports, as well as related correspondence, for the period March 31, 2016 through December 31, 2018. We interviewed NCUA officials and regional staff, and reviewed NCUA guidance, including regional policies and procedures and NCUA 5300 Call Reports (Call Reports).

We determined the Credit Union failed due to misappropriation of approximately \$42.2 million in cash, due to fraud. The Credit Union’s former Chief Executive Officer (CEO) concealed the missing cash by understating member share balances on the financial statements, primarily related to share certificates. Table 1 below presents the balances in the fraudulently reported financial statements compared to the actual corrected financial statement balances.

Table 1

As of February 28, 2019 (in thousands)			
Fraudulently Reported Financial Statements		Corrected Financial Statements	
		<b>Cash - Missing</b>	<b>\$ 42,157</b>
Cash	\$ 7,461	Cash	\$ 7,461
Other Assets	\$ 15,182	Other Assets	\$ 15,182
Total Assets	\$ 22,643	Total Assets	\$ 64,800
Share Certificates	\$ 4,900	Share Certificates	\$ 45,191
Other Shares	\$ 15,074	Other Shares	\$ 16,940
Other Liabilities	\$ 24	Other Liabilities	\$ 24
Equity	\$ 2,645	Equity	\$ 2,645
Total Liabilities & Equity	\$ 22,643	Total Liabilities & Equity	\$ 64,800

NCUA Western Region Officials determined the Credit Union to be insolvent and executed an *Order of Liquidation* for the Credit Union on March 29, 2019.



The following factors created an environment in which such misstatement could go undetected.

### **Questionable Management Integrity**

The former CEO displayed a lack of integrity and did not manage the Credit Union in the best interest of members. Examiners discovered approximately \$42.2 million in discrepancies between the general ledger and the member share sub-ledger as of February 28, 2019. The former CEO embezzled this amount from the Credit Union. Prior to its discovery, embezzlement by the former CEO had continued unabated for approximately 20 years. The former CEO was the only person at the Credit Union involved in the embezzlement scheme.

### **Lack of Segregation of Duties**

Lack of segregation of duties and dual controls allowed the former CEO to both perpetrate and conceal the fraud.<sup>1</sup> The former CEO possessed all of the following:

- Access to official Credit Union checks, which enabled him to alter the physical records of Credit Union checks;
- “Super-user” access to the Credit Union accounting system, which enabled him to alter both the check payee information (electronic records of Credit Union checks) and file maintenance reports, which concealed this action; and
- Sole responsibility for financial reporting, which gave him the ability to prepare fraudulent financial statements.

In addition, until approximately January 2019, when the Credit Union changed its Corporate Credit Union, the former CEO was the only person at the Credit Union who was able to access the Credit Union’s accounting system.<sup>2</sup> We concluded these factors created an environment in which the misappropriation of assets and the related understatement of members’ share accounts went undetected.

We also determined had the NCUA followed National Supervision policies and identified the Supervisory Committee audits and member account verification procedures as unacceptable, and appropriately addressed identified risks related to the lack of segregation of duties and dual

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<sup>1</sup> On May 20, 2019, pursuant to a plea agreement, the former CEO pled guilty to Count One of the First Superseding Indictment (Bank Fraud, in violation of 18 U.S.C. § 1344), in *United States v. Edward M. Rostohar*, 2:19-CR-0220-ODW, United States District Court in and for the Central District of California. On September 16, 2019, the court sentenced the former CEO to 169 months in prison and ordered him to pay \$40,541,130 in restitution to NCUA.

<sup>2</sup> On or about March 10, 2019, the Credit Union’s Office Manager accessed the Credit Union’s digital record system to stop payment (at a member’s request) on a member’s check, when the Office Manager by happenstance noticed that a large check immediately preceding the member’s check was made payable to then CEO Edward Rostohar. The Office Manager explored digital records and discovered numerous other checks made out to Mr. Rostohar and immediately notified the Chair of the Credit Union Board, which resulted in the Credit Union’s report of the apparent fraud to NCUA.



controls at the Credit Union, it may have identified the fraud sooner and may have mitigated the loss to the Share Insurance Fund.

As a result of our review, we are making two recommendations to NCUA management related to strengthening oversight, particularly for credit unions that lack segregation of certain key duties.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us during this review.



## BACKGROUND

The NCUA OIG contracted with Moss Adams to conduct an MLR for the Credit Union as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). The Credit Union was federally chartered and located in Studio City, California. The NCUA's Western Region provided supervision over the Credit Union.

### General History of the Credit Union

The NCUA chartered C B S Employees Federal Credit Union in 1961. The Credit Union primarily served employees of C B S, Inc., and its subsidiaries and divisions in the states of California, Oregon, Washington, Idaho, Utah, Nevada, Arizona, Alaska, and Hawaii. According to its final Call Report dated December 31, 2018, C B S reported total assets of \$21 million and membership of 2,798.

From March 2016 to December 2018, C B S generally received positive ratings, with a CAMEL<sup>3</sup> Composite rating of 2 for the 2016 and 2017 Examinations. Our review of examiner work papers provided by the NCUA's Western Region and additional files provided by the NCUA's Asset Management and Assistance Center (AMAC) showed an external party completed Supervisory Committee audits on behalf of the Supervisory Committee. This external party completed these audits for the periods from October 1, 2015 through September 30, 2016, October 1, 2016 through September 30, 2017, and October 1, 2017 through September 30, 2018. Our review of examination work papers determined examiners reviewed the Supervisory Committee audit report as of September 30, 2017.

During the examination effective March 31, 2016, the examiner in-charge (EIC) found errors in the Call Report and a lack of secondary review of items reported in the Call Report. Specifically, the finding noted in part that C B S needed to “[e]nsure someone other than the preparer performs a thorough second review of manual calculations and entries in the CU Online system.” During the next examination, which was effective December 31, 2017, this was not included as an examiner's finding.

### Supervisory Committee Audits

During our review, we noted a third party performed the Supervisory Committee audits on behalf of the C B S Supervisory Committee. Examiners did not review the Supervisory Committee audit work papers in the March 31, 2016 Examination because the third party is located in Paso Robles, California and would have charged \$300 to copy workpapers. However, examiners did review the Supervisory Committee audit work papers in the December 31, 2017 Examination, and concluded: “[t]he workpapers were reviewed and supported the report issued.”

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<sup>3</sup> The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.





As part of our review, we reviewed the Supervisory Committee audit reports and found they merely consisted of checklists completed by the third party. In addition, we compared these audit reports to the Supervisory Committee Manual and found some of the procedures did not appear to line up with the checklists. The steps the third party followed were outdated. Sections of procedures as outlined in the Supervisory Committee Guide – Minimum Procedures Appendix A were missing.

### **Identification of Fraud**

On March 11, 2019, the NCUA Western Region received a call from the Board of Directors of C B S reporting evidence of theft by the long-time CEO. The next day, the NCUA accompanied the Board Chair to the Credit Union to meet the CEO. The result of this meeting was the suspension of the CEO by the Credit Union Board and the start of NCUA’s investigation into the matter. The examiners determined the amount of cash missing as of February 28, 2019 was approximately \$42.2 million.

On March 27, 2019, the Regional Director (RD) of the Western Region requested approval to place C B S into involuntary liquidation to facilitate the proposed purchase and assumption transaction, with a projected Share Insurance Fund loss of \$39.5 million. The RD signed the Order of Liquidation on March 29, 2019. Problem areas identified by the NCUA included insolvency and unsafe and unsound practices, specifically due to the misappropriation of assets and fraudulent financial reporting perpetrated by the former CEO.

### **Mechanism of Fraud**

The following describes the mechanism by which the former Credit Union CEO misappropriated funds from the Credit Union. The former CEO made false entries to the Credit Union’s general ledger and effectively created a second set of records to conceal the Credit Union’s financial condition. Importantly, he was able to falsify both the physical records and electronic records to conceal his activity.<sup>4</sup>

To withdraw funds, the former CEO would write an official Credit Union check on a share account to the payee of his choice. In addition to checks issued to himself and his companies, he also paid his personal American Express bills, other personal expenses, and vendors used while

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establishing and remodeling a side business he owned. Checks he issued were in his name or in the name of one of his companies, and he would deposit the altered check in an account that he controlled.



After the official Credit Union check was issued, the former CEO would go back into the data processing system and delete the payee information, which was intended to be an electronic record showing to whom the check was payable. Deletion of payee information from the data processing system is not possible without special administrative privileges to the Credit Union's data processing system. The former CEO had granted himself administrator privileges. As an administrator, the former CEO was able to refuse to adopt, over-ride, or disable standard control features. He used this level of system access to delete the electronic record of the check payee.

The former CEO used funds withdrawn from share account XXXXXXXX-S1 to issue official checks for his benefit. This share account belonged to the Credit Union and was used as a clearing account. Normally, when the credit union issued a check, funds would be transferred from a member account to share account XXXXXXXX-S1. These funds would then immediately be withdrawn through an official Credit Union check. We learned that share account XXXXXXXX-S1 should have never had a remaining balance after issuance of an official Credit Union check.

When removing funds by issuing official checks for his personal benefit, the former CEO did not follow this process. Instead of transferring funds into share account XXXXXXXX-S1 from a member account, he exploited a weakness in the data processing system and made a transfer from a general ledger account. The former CEO posted entries directly to general ledger account #XXXXXXX, Regular Shares. This account was intended to reflect the aggregate of all shares held in the individual member share accounts as listed on the sub-ledger, which summarized all the individual members' accounts. By transferring from a general ledger account, he was able to reduce the amount of reported liabilities (shares) and withdraw money from the Credit Union by

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<sup>5</sup> In the Credit Union's system, the former CEO would designate the payee of the check as "." After the check was printed, the former CEO would manually type in his name or the name of one of his companies as the payee on the check.



issuing an official check without affecting an individual member account. This action led to compromised financial statements, where lower share amounts were reported to the Board of Directors than owed to the members in aggregate.

In order to continue to access funds to perpetrate and conceal the fraud, the former CEO needed to attract and retain shares in the form of share certificates. To this end, the Credit Union offered above-market interest rates on share certificates. The former CEO determined the offered rates. For example, at the time of liquidation, the Credit Union was offering a rate of 3.1 percent for a one-year share certificate, which was significantly above the market rate of approximately 1.3 percent at the time.<sup>6</sup> The Credit Union reported approximately \$3.5 million in share certificates on the Call Report as of December 31, 2018, even when above-market rates were offered.

## **NCUA Examination Process**

### Total Analysis Process

The NCUA uses a total analysis process that includes collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL components, and reviewing qualitative and quantitative measures.

The NCUA uses the CAMEL Rating System for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the Share Insurance Fund, and for identifying those institutions requiring special supervisory attention or concern. The CAMEL rating includes consideration of key ratios, supporting ratios, and trends. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition. At the conclusion of an examination, examiners assign a CAMEL composite rating.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,<sup>7</sup> trend analysis,<sup>8</sup> reasonableness analysis,<sup>9</sup> variable data analysis,<sup>10</sup> and qualitative data analysis.<sup>11</sup> Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a

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<sup>6</sup> Source: [www.depositaccounts.com](http://www.depositaccounts.com)

<sup>7</sup> Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

<sup>8</sup> Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

<sup>9</sup> As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

<sup>10</sup> Examiners can often analyze an examination area in many different ways. NCUA's total analysis process enables examiners to look beyond the "static" balance sheet figures to assess the financial condition, quality of service, and risk potential.

<sup>11</sup> Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the Credit Union's current condition, and its future. Qualitative data analysis may include assessing lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, and economic conditions.



group because some individual ratios may not provide an accurate picture without a review of the related trends.

Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. The NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, the NCUA requires examiners to determine whether material negative trends exist, ascertain the action needed to reverse unfavorable trends, and formulate, with credit union management, recommendations, and plans to ensure implementation of these actions.

### Risk-Focused Examination Program

In 2002, the NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports as well as on-site work. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation.*

Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up; and (b) analyzing Call Reports as well as the risks detected in the credit union's operations and in management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

- Review of quarterly Financial Performance, Risk, and Call Reports;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the Annual Examination Scheduling Program (AEP).<sup>12</sup> The NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the Annual Program would provide more timely, relevant, qualitative, and quantitative data to recognize any sudden turn in a credit union's performance.

In 2016, the NCUA revised its examination policy<sup>13</sup> that resulted in additional minimum required examination procedures based on a national review of risk. The policy directed a

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<sup>12</sup> The AEP requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling availability.

<sup>13</sup> In December 2016, the NCUA released the Risk-Based Examination Scheduling Policy in Letter to Credit Unions 16-CU-12.



periodic national review of risk issues and adjustment to the minimum review procedures. The NCUA indicated the intent of the policy was to shape its examination and supervision program to consistently identify and mitigate emerging risks in response to changing environmental factors within the credit union industry. As a result of this policy, E&I, with input from the regions, now updates the minimum scope procedures, as necessary, by focusing on emerging risks, risk monitoring observations, results of quality control reviews, regulatory changes, and lessons learned from NCUA OIG Material Loss Reviews. The NCUA reviews and updates the minimum examination scoping steps on an annual basis.

### Small Credit Union Examination Program

In 2011, NCUA's Region I (now a part of the NCUA Eastern Region) piloted the Small Credit Union Examination Program (SCUEP) to determine whether examination resources could be better aligned with industry risks. Essentially, the SCUEP expanded the minimum required examination scope for nationally identified areas of elevated risk and reduced the minimum required examination scope in CAMEL 1, 2, or 3 federal credit unions with less than \$10 million in total assets.

Based on the success of the pilot, NCUA established the SCUEP on a national basis in January 2012. NCUA officials indicated that the new scope requirements supplement existing RFE practices and do not replace the examiner's judgment and responsibility to refine and adjust their scope, noting that examiners should continue to follow the concepts of the RFE process outlined in the Examiner's Guide for areas of elevated risk.

In 2015, the NCUA issued instructions that established requirements for defined-scope examination with tiered procedures for SCUEP-eligible federal credit unions. Effective in 2015,<sup>14</sup> SCUEP exams were required to focus resources on the areas that presented the greatest potential risk to the Share Insurance Fund in those institutions: internal controls, recordkeeping, and lending. In the examinations for C B S, examiners applied SCUEP procedures to the credit union but the procedures failed to detect the issue.

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<sup>14</sup> NCUA required field staff to complete the small credit union examination training before they could perform a SCUEP defined-scope examination.





## RESULTS IN DETAIL

We determined that the Credit Union failed due to the fraudulent activities of the former CEO involving the embezzlement of approximately \$42.2 million in Credit Union assets, primarily through misappropriation of funds through fraudulent use of official Credit Union checks. After the Credit Union alerted the NCUA examiners of the fraudulent activities, the NCUA determined the Credit Union to be insolvent and liquidated it within three weeks of uncovering the fraud. The NCUA Board designated AMAC as liquidating agent per the *Order of Liquidation*.

Contributing factors included issues with management integrity, lack of segregation of duties, lack of dual controls, and failure of the Supervisory Committee to perform its duties related to the general direction and control of the affairs of the Credit Union.

### A. Why the Credit Union Failed

#### The Former CEO's Actions Caused the Credit Union to Fail

We determined that the former CEO's fraudulent activities, primarily related to misappropriation of funds, caused the Credit Union to fail. Below are the specific factors that we believe allowed this fraud to remain undetected for an extended period of time.

#### Management Integrity and Lack of Segregation of Duties

We determined the Credit Union's management, specifically the former CEO, did not conduct the business of the Credit Union in the best interest of its members. Specifically, examiners discovered share liabilities understated by approximately \$42.2 million, due to the misappropriation of funds through fraudulent use of official Credit Union checks.

After Credit Union staff alerted the NCUA to the former CEO's embezzlement, examiners in the NCUA's Western Region discovered that the former CEO had embezzled approximately \$42.2 million of assets from the Credit Union, which as previously described, he concealed through fraudulent financial reporting. Once examiners corrected the fraudulent journal entries, they determined the Credit Union had significant negative members' equity and was insolvent.

Following the removal of the former CEO by the Credit Union Board, the remaining Credit Union employees struggled to produce basic reports such as General Ledger reports and Trial Balances because the former CEO had never allowed them access to these functions within the accounting system. Several examiners informed us that the former CEO of the Credit Union performed almost all recordkeeping functions, including posting of journal entries.<sup>15</sup>

<sup>15</sup> When interviewed by OGC and E&I staff, the former CEO confirmed this fact.



Examiners noted the Credit Union did not have segregation of duties in place. The former CEO possessed all of the following:

- Access to official Credit Union checks which enabled him to alter the physical records of Credit Union checks;
- “Super-user” access to the Credit Union accounting system which enabled him both to alter the check payee information (electronic records of Credit Union checks), and to alter file maintenance reports which concealed this action; and
- Sole responsibility for financial reporting which gave him the ability to prepare fraudulent financial statements.

We believe if these responsibilities had been separated, it would have been more difficult for the former CEO to perform the fraudulent activities. For example, if a credit union had an internal control in place which required a separate individual with appropriate skills, authority, and access to the accounting system to review and approve documentation prepared by a different person, this type of fraud would be much more difficult to conceal. Examiners should have performed this separate review for the reconciliation between the share subsidiary ledger and the general ledger, file maintenance reports, which track changes made to the accounting records, and the supporting documentation used in financial statement preparation. However, the lack of segregation of duties at C B S allowed the former CEO to both perpetrate and conceal the fraud.

Similarly, if dual controls had been in place, Credit Union staff could have discovered the former CEO’s embezzlement long before they eventually discovered it.

#### Lack of Supervisory Committee Oversight

Part 715.4 of the NCUA Rules and Regulations require a federally insured credit union to obtain an annual Supervisory Committee audit. For credit unions with asset size of \$500 million or less, the requirement may be fulfilled by a financial statement audit performed in accordance with Generally Accepted Auditing Standards by an independent person who is licensed to do so, or by a Supervisory Committee audit completed by Supervisory Committee members or by another individual outside of the Supervisory Committee. Part 715.8 of the NCUA Rules and Regulations require a verification of member accounts at least once every two years.

Examiners indicated there had been issues with the quality of Supervisory Committee audits and member account verifications. Although the Supervisory Committee performed or obtained member account verification procedures as required under Part 715 of the NCUA Rules and Regulations for the years within the scope of our review; it failed to ensure the procedures completed were appropriate and sufficient.

Specifically, based upon our review of the Examination reports and Supervisory Committee audit reports, it appears the Supervisory Committee performed the member verifications required





by Part 715.8 of the NCUA Rules and Regulations. In addition, based on our review of the Examination reports and through interviews with examiners, it appears Credit Union members had received their account statements, which included the member verification language. However, there was no evidence to indicate the Supervisory Committee and/or the independent CPA that performed the procedures had performed a fundamental procedure to reconcile the share subsidiary to the statements printed by the print processor as part of the member verification process.

Reconciliation of share subsidiary to the statements printed by the print processor is a critical part of the member verification process because it ensures that statements sent to members match a credit union's records. Without performing such a reconciliation, there is no way to ensure the list of verified accounts represents an accurate and complete listing of a credit union's member accounts.

Chapter 24 of the NCUA Supervisory Committee Guide provides guidance for the procedures Supervisory Committees must follow when performing member account verifications. The Supervisory Committee Guide includes instructions in chapter 24.07 to: “[e]nsure that member’s statements are printed from the same data base used to generate the individual ledger totals – it is possible to have a system generate different listings from the same computer.” We were unable to obtain any evidence that the Supervisory Committee followed this procedure. Chapter 24.09 instructs Supervisory Committees to “[r]etain a copy of the member share and loan trial balance, and the sample (if used), to document the accounts verified.” This documentation does not appear to have been retained, but there were no examiner’s findings or any other documentation related to this in the Examination Reports.

We believe that had the Credit Union’s Supervisory Committee (or its designee) performed a reconciliation between the statements printed by the print processor and/or had obtained and retained a copy of the member share and loan trial balance to document the accounts verified, it is possible the discrepancy between members’ share accounts and the amount reported in the financial statements would have been discovered much sooner. The Supervisory Committee failed in its requirement to perform appropriate procedures related to verification of member accounts, as required by Part 715.8 of the NCUA Rules and Regulations.

## B. NCUA’s Supervision of the Credit Union

### Examination Oversight Needs Strengthening

We determined that examiners failed to identify that member account verification procedures were unacceptable. There was no evidence to indicate the Supervisory Committee and/or the independent CPA who performed the procedures had performed procedures to reconcile the share subsidiary to the statements printed by the print processor as part of the member verification process. Because of this, there was no way to ensure the list of verified accounts represented an accurate and complete list of Credit Union member accounts. Further, examiners noted the lack of segregation of duties but did not alter



planned examination procedures as a result of this assessment. Management was able to manipulate the financial statements. As a result, the fraud went undetected for an extended period of time and the Share Insurance Fund incurred a loss of approximately \$39.5 million.

Supervisory Background

The Credit Union received CAMEL Composite ratings of 2 for most of the period of our review, until the December 31, 2018 examination, which was conducted after the fraud was uncovered, and for which the Credit Union received a CAMEL Composite rating of 5.

The NCUA Western Region executed a *Notice of Involuntary Liquidation and Revocation of Charter* effective March 29, 2019. Table 2 below provides Composite and component CAMEL ratings for the applicable examinations during the scope period of our review.

Table 2

NCUA Examination Results for C B S**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
December 2018	22	5	5	5	5	5	5
December 2017	10	2	1	1	2	2	2
March 2016	10	2	1	1	2	2	2

\*\*Examination information provided by NCUA’s Western Region.

Failure to Identify Supervisory Committee Audits and Member Account Verifications as Unacceptable

Based on our review of examination working papers and the Supervisory Committee audits and member account verifications provided by AMAC, we determined examiners failed to identify the Supervisory Committee audits and member account verifications as unacceptable.

The NCUA Supervision Manual, chapter 2 section 3, states in part:

Examiners will consider an audit or verification unacceptable and develop plans of action when they determine: material parts of the audit or verification were not done, material parts of the audit or verification are not supported by work papers, material areas of credit union operations were not audited and the auditor lacks independence from the credit union.

The manual also lists the steps the examiner should take if they deem a Supervisory Committee audit unacceptable. It includes denoting it as a major area of concern in the Examination Overview and preparing a Document of Resolution (DOR), which provides a reasonable time for the Supervisory Committee to correct the deficiencies, among other steps.



The Supervisory Committee audit reports we reviewed consisted of checklists completed in pen by the independent CPA. In addition, some of the procedures did not appear to line up with the Supervisory Committee Manual and the steps followed appeared to be outdated. For example, one of the steps asks: *“Is the written security program, per section 748.4 of the Rules and Regulations, being followed?”* Per the Electronic Code of Federal Regulations, section 748.4 no longer exists.

Further, sections of procedures as outlined in the Supervisory Committee Guide – Minimum Procedures Appendix A are missing. For example, the prepared report includes some discussion of delinquencies, but a specific required section is to compare two months of delinquency reports and for all loans not included in the later report to document the reason they were removed. We did not find evidence to suggest that the third party performed this procedure. Based on the date on the template that the third party used, the procedures they performed appear to have been last updated in 1976.

Documentation of the processes surrounding Supervisory Committee audits and member account verifications appear to have been weak in general. In an examiner’s finding from the December 31, 2017 Examination, examiners noted the minutes of the Supervisory Committee meetings did not include many recommended items. Specifically, examiners stated:

“Some of the items that were completed and not recorded in minutes are:

- Account Verification,
- Meetings, meeting date and meeting attendance,
- Tracking audit and exam finding corrections,
- Performing cash counts of vault and teller drawers,
- Providing loan review, and [sic]
- File maintenance review.”

We believe that if examiners had identified the Supervisory Committee Audits and member account verifications as unacceptable and followed the protocol in the NCUA’s National Supervision Policy Manual, they could have discovered the fraudulent activity sooner. We also believe that the Supervisory Committee Guide lacks sufficient specific requirement for reconciliation of share subsidiary to the statements printed by the print processor.

#### Failure to Appropriately Respond to Heightened Risk Caused by Lack of Segregation of Duties

Based on our review of examination working papers, we determined examiners failed to respond appropriately to the heightened risk, which was caused by lack of segregation of duties and lack of dual controls at the Credit Union. Examiners noted the lack of segregation of duties and



documented this within their Risk Assessments. The Final Risk Assessment from the December 31, 2017 Examination noted “Limited dual controls due to the personnel available at a small credit union.” During the examination effective March 31, 2016, the EIC issued an examiner’s finding for errors in the Call Report, and lack of secondary review of items reported in the Call Report. Specifically, the finding noted that C B S needed to “[e]nsure someone other than the preparer performs a thorough second review of manual calculations and entries in the CU Online system.” The former CEO had access to both the physical and electronic accounting records, the ability to alter both types of records, and sole responsibility for financial reporting. None of the other Credit Union employees were permitted to access the accounting system.

Although examiners appropriately performed procedures required by SCUEP and recognized the risk posed by lack of segregation of duties, the prescribed examination procedures did not detect the fraudulent activity. Further, the lack of segregation of duties did not result in a DOR, or any other formal or informal enforcement action. There were no such enforcement actions taken during the scope of our review.

In order to maintain a reliable source of funds to perpetrate the fraud, the former CEO needed to attract and retain share certificates. The former CEO was authorized to select the interest rates offered by the Credit Union for share certificates, and used this ability to set the rates at a high enough level to attract shares. The Credit Union was offering a rate of 3.1 percent for a one-year share certificate as of December 31, 2018, which was significantly above the market rate of approximately 1.3 percent at the time.<sup>16</sup> The Credit Union reported approximately \$3.5 million in share certificates on the Call Report as of December 31, 2018, even when above-market rates were offered. We found no documentation in the Examination Reports that examiners questioned these above-market rates.

One reason the former CEO was able to successfully hide the fraud from examiners is that he knew what to expect from the examination, because examination procedures and timing tended to be predictable from year to year. Even so, the former CEO appears to have spent considerable time and effort concealing his fraudulent activities and creating fraudulent financial statements that were in balance as of the dates requested, most commonly as of quarter end. Even when examiners physically observed the former CEO generate the reports, the reports were as of the Examination date, the former CEO knew the “as-of” date for the reports he would be expected to produce, and the accounting system had already been altered to conceal the fraudulent activity.

If examination procedures had required examiners to request share subsidiaries or AIREs reports as of a random date in situations when a lack of segregation of duties is present, it would have been difficult for the former CEO to produce the reports in a timely fashion, and the fraud could have been detected earlier. We believe that if examination procedures required examiners to perform additional procedures for credit unions that lack segregation of duties, and to incorporate an element of unpredictability into examination procedures, the likelihood of detecting fraud could increase.

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<sup>16</sup> Source: [www.depositaccounts.com](http://www.depositaccounts.com)



## OBSERVATIONS AND RECOMMENDATIONS

### A. Observations

Important observations from our review of the Credit Union include:

- Lack of segregation of duties and lack of dual controls are two of the most significant indicators of potential fraud risk. If a credit union lacks segregation of duties, a member of management is in a position to embezzle assets and conceal his or her fraud through fraudulent financial reporting.
- Performing a statement verification through reconciliation from the print processor to the share and loan subsidiaries is one of the most important procedures related to member account verification. Without this, there is no way to be sure the list of verified accounts represents an accurate and complete list of credit union member accounts. This reconciliation should be performed and documented for all member verifications.

### B. Recommendations

Based on our review, we are making the following two recommendations.

1. We recommend NCUA management revise examination procedures to prioritize assessing and developing a risk response for credit unions that do not segregate certain key duties and that require dual controls. These revisions should include a framework that examiners can complete an assessment of those characteristics that indicate lack of segregation of duties at a credit union and additional procedures that examiners should perform when a lack of segregation of duties is apparent.

### Management Response

Management agreed with the recommendation and indicated they have established a working group to start evaluating the Small Credit Union Examination Program including evaluating current scope steps, requirements, polices, and fraud detection techniques. Management plans to incorporate any working group recommendations into relevant policies, Examiner's Guide, training, and the Modern Examination and Risk Identification Tool by December 31, 2021.

### OIG Response

We concur with management's actions taken and planned.

2. We recommend NCUA management amend guidance related to member account verifications. Specifically, the amended guidance should require reconciliation from the print processor to the share and loan subsidiaries when a statement verification is performed.



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**Management Response**

Management agreed with the recommendation and indicated that by December 31, 2021, they will amend examiner guidance related to account verifications to include a reconciliation and any other fraud techniques.

**OIG Response**

We concur with management's planned actions.





## Appendix A

**OBJECTIVE, SCOPE, AND METHODOLOGY**

We performed this material loss review to satisfy the requirements of Section 216(j) of the FCU Act, 12 U.S.C. §1790d(j), which requires the OIG to conduct a material loss review when the Share Insurance Fund has incurred a material loss, or when unusual circumstances exist that warrant an in-depth review of the loss.<sup>17</sup> In this instance, the loss was over the \$25 million statutory threshold and therefore material.

The objectives of the MLR were to:

1. Determine the cause(s) of the Credit Union's failure and the resulting loss to the Share Insurance Fund;
2. Assess the NCUA's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) requirements of Section 208 of the FCU Act; and
3. Make appropriate observations and/or recommendations to prevent future losses.

To accomplish our review, we performed fieldwork at the NCUA's Western Region office in Tempe, Arizona. The scope of this review covered the period from March 2016 through liquidation in March 2019.

To determine the cause(s) of the Credit Union's failure and assess the adequacy of NCUA's supervision, we:

- Completed a risk assessment, which included a review of the Examination Reports as well as other risk considerations, including consideration of minimum scope requirements for examiners.
- Prepared a chronology and summary table of examinations, which include examination date, regulator, CAMEL rating, supervisory actions, and significant examiner comments.
- Reviewed examination files, including examination reports, risk assessments, examination findings, confidential sections, examination spreadsheet files, correspondence, analysis, and other documentation.
- Reviewed summaries of the Credit Union's Board of Directors minutes and Board packets, as well as summaries of Supervisory Committee minutes provided.

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<sup>17</sup> The FCU Act deems a loss "material" if the loss exceeds the sum of \$25 million or an amount equal to 10 percent of the total assets of the credit union at the time in which the NCUA Board initiated assistance under Section 208 or was appointed liquidating agent.



- Reviewed the external reports on Supervisory Committee audits, agreed-upon procedures and member account verification, including results, findings, and responses, as provided.
- Conducted interviews with Western Region management and staff involved with the examination, supervision, and liquidation of the Credit Union.
- Downloaded Call Reports for the scope period and performed analysis of a number of financial indicators, including capital adequacy ratios, return on average assets and equity, and asset quality ratios, and other elements of the balance sheet and income statement.
- Considered allegations of fraud, including means of misappropriation and potential warning signs.
- Developed a timeline and summary of enforcement actions taken by the NCUA from 2016 through liquidation.
- Assessed NCUA supervision and evaluated the timeliness of supervisory actions.
- Assessed the effectiveness of the Credit Union's management, and oversight by the Supervisory Committees and Board of Directors.

We relied upon materials provided by NCUA Western Region and AMAC officials, including information and other data collected during interviews.

We used computer-processed data from NCUA's AIREs and NCUA online systems. We did not test controls over these systems; however, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems to support our audit conclusions.

We conducted this review from May 2019 through January 2020, in accordance with Generally Accepted Government Auditing Standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



## NCUA MANAGEMENT RESPONSE



National Credit Union Administration  
Office of the Executive Director

SENT BY EMAIL

**TO:** Inspector General James Hagen

**FROM:** Executive Director Mark Treichel

**SUBJ:** Management Response – Material Loss Review of CBS Employees Federal Credit Union

**DATE:** February 4, 2020

The following is our response to the recommendations set forth in the Office of Inspector General's draft report titled, "*Material Loss Review of CBS Employees Federal Credit Union.*" We agree with the recommendations.

**OIG Report Recommendation:** We recommend NCUA management revise examination procedures to prioritize assessing and developing a risk response for credit unions that do not segregate certain key duties and that require dual controls. These revisions should include a framework that examiners can complete an assessment of those characteristics that indicate lack of segregation of duties at a credit union and additional procedures that examiners should perform when a lack of segregation of duties is apparent.

**Management Response:** We established a working group in September 2019 consisting of field examiners, regional analysts, fraud, Bank Secrecy Act, and accounting specialists, and the Chief Accountant. The group held its first meeting in December 2019 to start evaluating the Small Credit Union Examination Program including evaluating current scope steps, requirements, polices, and fraud detection techniques. We will incorporate this and any other working group recommendations into relevant policies, Examiner's Guide, training, and MERIT by December 31, 2021.

**OIG Report Recommendation:** We recommend NCUA management amend guidance related to member account verifications. Specifically, the amended guidance should require reconciliation from the print processor to the share and loan subsidiaries when a statement verification is performed.

**Management Response:** By December 31, 2021, we will amend examiner guidance related to account verifications to include the reconciliation and any other fraud techniques recommended by the working group.

Thank you for the opportunity to review and comment on the report.

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1775 Duke Street – Alexandria, VA 22314-3428 – 703-518-6320



**ACRONYMS AND ABBREVIATIONS**

<b>Acronym</b>	<b>Term</b>
AEP	Annual Examination Scheduling Program
AIRES	Automated Integrated Regulatory Examination System
AMAC	Asset Management Assistance Center
Call Reports	NCUA 5300 Call Reports
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management
C B S	C B S Employees Federal Credit Union
CDs	Certificates of Deposit
CPA	Certified Public Accountant
The Credit Union	C B S Employees Federal Credit Union
DOR	Document of Resolution
EIC	Examiner In-Charge
E&I	Office of Examination and Insurance
FCU Act	Federal Credit Union Act
FPR	Financial Performance Report
MLR	Material Loss Review
NCUA	National Credit Union Administration
OIG	Office of Inspector General
RD	Regional Director
RFE	Risk-Focused Examination
SCUEP	Small Credit Union Examination Program
SE	Supervisory Examiner
Share Insurance Fund	National Credit Union Share Insurance Fund