NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF CENTER VALLEY FEDERAL CREDIT UNION

Report #OIG-10-02
April 14, 2010

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EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a Material Loss Review of Center Valley Federal Credit Union (Center Valley). We reviewed Center Valley to (1) determine the cause(s) of the credit union's failure and the resulting loss to the National Credit Union Share Insurance Fund (NCUSIF); and (2) assess NCUA's supervision of the credit union. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence; interviewed management and staff from NCUA Region 2; and reviewed NCUA guidance, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPR).

We determined embezzlement was the direct cause of Center Valley's failure. As of December 31, 2008, the credit union had approximately $8.4 million in total assets. When NCUA conducted a surprise visit to review Center Valley's call reports and to obtain share and loan balance downloads, examiners found the chief executive officer (CEO) was keeping two sets of financial records and a $12.1 million discrepancy existed. Back dated transactions to member accounts were used to conceal the fraudulent activity. In addition, during routine examinations the CEO repeatedly blamed the unavailability or inaccurate data on computer problems. The CEO used credit union funds for the CEO's personal benefit and the benefit of the CEO's family members, including the construction of a restaurant and resort business. Furthermore, on August 3, 2009, a Federal Grand Jury indicted and charged the CEO with embezzling and misapplying $9 million from Center Valley and money laundering. Consequently, on January 4, 2010, the CEO pled guilty to the charges.

We also determined that credit union management failed to meet their required obligations to implement proper internal controls and oversight. Specifically, management did not ensure (1) member account verifications were properly conducted, (2) adequate internal controls were in place, and (3) controls were monitored for effectiveness. For example, although Center Valley's Supervisory Committee contracted with external auditors to complete their annual audit, we did not find any evidence of other work performed by the Supervisory Committee. In addition, neither the external auditor nor credit union management resolved a $252,000 bank reconciliation error. Furthermore, bank reconcilements were several months in arrears, file maintenance reports were not reviewed, and there was a lack of segregation of duties. Therefore, the CEO was able to conduct the embezzlement for approximately three or more years.

Finally, we determined NCUA examiners did not adequately evaluate the risks to Center Valley's operations. Specifically, examiners did not thoroughly evaluate the credit union's internal controls when assessing transaction risk and management component ratings. We found prior to the discovery of the embezzlement NCUA examiners were aware of some internal control weaknesses but did not rate transaction risk as high. For example, the CEO repeatedly cited computer problems or software issues as the causes of inaccurate data and delays in obtaining file downloads from 2004 through

2007. The external auditor reported the credit union was not following its written policies and control procedures, and found a $252,000 bank reconciliation error was not resolved. However, the examiners repeatedly noted during examinations that no reportable conditions or material weaknesses existed. Furthermore, it was not until the discovery of the fraud that NCUA identified serious internal control weaknesses. As a result, NCUA missed opportunities to expand examination procedures that may have detected the fraud sooner and mitigated the loss to the NCUSIF caused by Center Valley's failure.

In addition, we reviewed industry observations regarding occupational fraud. We believe the industry's observations apply directly to issues we observed during our review. We determined Center Valley's lax internal control environment created an environment susceptible to fraud. Our comparative analysis can be found in Section C of this report.

This report does not contain recommendations but provides observations and suggestions. As major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted.

We appreciate the courtesies and cooperation NCUA management and staff provided to us during this review.

BACKGROUND

Center Valley Federal Credit Union

Center Valley Federal Credit Union (Center Valley), located in Wheeling, West Virginia, was chartered as a Federal Credit Union in 1975. It was a low-income[1] credit union[2] with two branches, six fulltime employees, seven Board members and two Supervisory Committee members. The CEO, who worked for the credit union for over 14 years, was highly qualified, well known and trusted in the credit union community. As of December 31, 2008, the credit union had approximately $8.4 million in total assets and served 3,000 members. Center Valley was located in NCUA's Region II.

On February 13, 2009, the NCUA Board placed Center Valley into involuntarily liquidation pursuant to section 207(a)(1)(A) of the Federal Credit Union Act[3] (FCU Act) and appointed itself as liquidating agent. Center Valley's failure resulted in a loss to the NCUSIF of approximately $16.4 million.

NCUA Examination Process

Total Analysis Process

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[4] components, and reviewing qualitative and quantitative measures.

NCUA uses a CAMEL Rating System to provide an accurate and consistent assessment of a credit union's financial condition and operations. 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. During an examination, examiners assign a CAMEL rating, which completes the examination process.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,[5] trend analysis,[6] reasonableness analysis,[7] variable data

[1] A credit union can receive a low-income designation when a majority of members either earn less than 80 percent of the average of all wage earners, as established by the Bureau of Labor Statistics, or have an annual household income that falls at or below 80 percent of the median household income for the nation as established by the Census Bureau.
[2] Low-income credit unions can accept non-member deposits, participate in the Community Development Revolving Loan Program, offer secondary capital accounts and qualify for exception from the aggregate loan limit for member business loans.
[3] 12 U.S.C. §1787(a)(1)(A).
[4] The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset/Liability Management.
[5] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[6] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[7] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

analysis,[8] and qualitative data analysis.[9] Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a 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. NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, 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.

Center Valley received a composite CAMEL code 1 rating through September 2005. From March 2006 through March 2008, the credit union received a composite CAMEL code 2 rating. (See Appendix A Table A-1 for Center Valley's CAMEL ratings.)

Risk-Focused Examination Program

In May 2002, NCUA announced its new Risk-Focused Examination (RFE) Program, for implementation in the fall of 2002. Risk-focused supervision procedures often include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. 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 Report and FPR trends. The extent of supervision plans depends largely on the severity and direction of the risks detected in the credit union's operation and on 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 Call Reports;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union.

[8] 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.
[9] 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.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the 12-Month Program.[10] 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 12-Month Program will provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

Objective, Scope and Methodology

The FCU Act[11] requires the NCUA's OIG to conduct a material loss review when the NCUSIF incurs a material loss with respect to an insured credit union. The Act defines a material loss as (1) exceeding the sum of $10 million and (2) an amount equal to 10 percent of the credit union's total assets at the time at which the Board initiated assistance or was appointed liquidating agent. NCUA notified the OIG of an estimated loss reserve for Center Valley of $16.2 million. Consequently, in accordance with the FCU Act and Chapter 3 of the NCUA Special Assistance Manual, we initiated a material loss review.

The objectives of our review were to (1) determine the cause(s) of Center Valley's failure and the resulting loss to the NCUSIF, and to (2) assess NCUA's supervision of the credit union. To accomplish our objectives we conducted fieldwork at NCUA's headquarters and the regional office, both located in Alexandria, VA. Our review covered the period from September 2003 to February 2009, Center Valley's liquidation date.

To determine the cause of Center Valley's failure and assess the adequacy of NCUA's supervision we:

- Analyzed NCUA examination and supervision reports and related correspondence;
- Reviewed external auditor work papers;
- Interviewed NCUA staff; and
- Reviewed NCUA guidance, policies and procedures, Call Reports (5300 Reports), and FPRs.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software and Credit Union Online systems. We did not test the 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.

[10] The 12-month program requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling eligibility.
[11] The FCU Act §216(j), 12 U.S.C. § 1790d(j).

This report does not make recommendations but provides observations and suggestions. As major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted

We conducted this audit from June 2009 through April 2010 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 that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Management reviewed a discussion draft of this report. We incorporated their suggested changes where appropriate.

RESULTS IN DETAIL

We determined embezzlement of credit union funds was the cause of Center Valley's failure. We also determined that Center Valley's management inactions facilitated the embezzlement. In addition, we determined that had NCUA taken stronger supervisory actions regarding Center Valley's lack of internal controls, NCUA might have mitigated the loss to the NCUSIF.

A. Why Center Valley Federal Credit Union Failed

Embezzlement of Credit Union Funds

We determined a fraudulent act caused the credit union to fail. Specifically, the CEO embezzled funds from Center Valley and this resulted in an estimated loss of $16.4 million to the NCUSIF. In addition, on August 3, 2009, a Federal Grand Jury indicted the CEO for embezzling and misapplying $9 million in credit union funds, and money laundering. Furthermore, on January 4, 2010, the CEO pled guilty to the charges.

On January 2, 2009, a third party contacted NCUA because several certificates of deposit issued by Center Valley were not listed on Center Valley's call report. The following business day an NCUA examiner conducted a supervision contact to determine why the certificates of deposit were not reflected on the credit union's call report and as a first step requested the share and loan balance downloads. The CEO attempted to delay the examiner's review by citing computer problems and end of the year closing procedures; however, the examiner persisted. Although the CEO indicated computer problems prevented downloading of the files, the examiner watched as the manager re-ran the download and had the manager email them the file. Conversely, two hours later the CEO told the examiner the file previously provided was not correct because of the on-going computer problems and provided a supposedly accurate second version. The examiner determined the first file was more representative of what the members' share and loan balances should have been, while the second file balances were manipulated to match the general ledger balances and to cover the fraudulent activity. Consequently, the examiner found that the CEO was keeping two sets of financial records.

NCUA examiners compared the two sets of records and discovered the following discrepancies in member loan and share accounts. The first download showed $15.8 million in share account balances, while the second download showed $6.3 million, a $9.5 million discrepancy. For the loan balances, the first download totaled $5.2 million and the second download totaled $7.8 million, which resulted in a difference of $2.6 million. The two balances combined resulted in an aggregate loss discrepancy of $12.1 million.

Account Type	First Download	Second Download (Two hours later)	Difference
Shares	$15.8 million	$6.3 million	$9.5 million
Loans	$5.2 million	$7.8 million	$2.6 million
Total			$12.1 million

Examiners determined, back dated transactions in the credit union's data processing system were used to conceal the fraudulent activity in member accounts. Therefore, account statements received by members appeared to have the correct transaction activity and balances. However, a subsequent member account verification performed by NCUA revealed an additional $3.4 million in share account discrepancies. During the account verification, credit union members reported and NCUA examiners found the following types of concerns:

- Missing funds;
- Back dated transactions;
- Certificate of deposit balance discrepancies;
- Fraudulent (not member authorized) deposits and withdrawals; and
- Fraudulent loans.

NCUA examiners determined the CEO used credit union funds for the CEO's personal benefit and the benefit of the CEO's family members. NCUA management then hired an independent certified public accounting firm to document the suspected fraud losses. This firm identified over $3 million in losses occurring from April 2006 through January 2009. These losses coincided with the construction of a restaurant and resort business owned by the CEO and the CEO's spouse. In addition, the firm reviewed records compiled by NCUA examiners and determined $1.9 million in credit union checks were disbursed for the benefit of this business venture. The primary methods used by the CEO to embezzle credit union funds included:

- Making unauthorized withdrawals from members' accounts by using official credit union checks to draw funds or loan proceeds from the accounts;
- Drafting unrecorded credit union checks and using the checks to pay creditors of the CEO, family members, and other related entities;
- Recording fictitious deposits into personal, family members' and related entities accounts; and
- Disbursing checks from the related party accounts that were funded with the fictitious deposits.

Limited Oversight by Management

We determined that credit union management which includes the Board of Directors and Supervisory Committee, failed to meet their required obligations to implement proper internal controls and oversight. Specifically, management did not ensure (1) member account verifications were properly conducted, (2) adequate internal controls were in place, and (3) controls were monitored for effectiveness. As a result, the CEO was able to conduct the embezzlement for approximately three or more years.

According to NCUA guidance, supervisory committees are responsible for ensuring that credit union Board of Directors and management establish practices and procedures that sufficiently safeguard member assets.[12] In addition, the supervisory committee must determine whether policies and control procedures are sufficient to safeguard against error, conflict of interest, self-dealing, and fraud.[13] Furthermore, federally insured credit unions are required to obtain a supervisory committee audit at least once every calendar year.[14] If an audit is performed or contracted out, a review of the structure of the credit union's internal controls and accuracy of the credit union's records must be performed.[15] Finally, the supervisory committee should perform a verification of members' accounts at least once every two years by comparing the accounts to the treasurer's records.[16]

Center Valley's Supervisory Committee contracted with external auditors to complete their annual Supervisory Committee audit. However, we did not find any evidence of other work performed by the Supervisory Committee, although annual audit internal control questionnaires indicated other audit work was performed. In addition, after the discovery of the fraud, NCUA examiners concluded and we agreed that the credit union's internal controls were non-existent. Some of the more serious internal control deficiencies were:

- Failure to properly conduct independent verification of members accounts;
- Untimely and suspect bank reconcilements;
- Failure to balance shares, loans, cash and settlement accounts daily;
- Issuing credit union checks using the same check number;
- Data processing system allowing back dated transactions:
- Failure to review file maintenance reports;

[12] NCUA Rules and Regulations Section 715.3(a)(2).
[13] NCUA Rules and Regulations Section 715.3(b)(4).
[14] NCUA Rules and Regulations Section 715.4, 715.5, 715.7.
[15] Supervisory Committee Guide 4.03.
[16] NCUA Rules and Regulations Section 7.15.8(a).

- Lack of segregation of duties:
  - Using the same data processing password for all employees;
  - Granting supervisory authority for all employees on the computer system;
  - Staff performing transactions on their own accounts; and
  - Same staff person underwriting, approving and disbursing loans.

Member Account Verifications Not Properly Performed

The Supervisory Committee Audit and Verification Review checklists for Center Valley, completed by NCUA examiners during the March 31, 2004 through March 31, 2008 examinations, indicated member account verifications were done. However, according to NCUA management, member account verifications were not properly conducted because the verifications were based on membership lists provided by the CEO. Furthermore, an independent certified public accounting firm hired by NCUA to document the suspected fraud losses could not find any evidence that member account verifications had been performed for the past several years. Finally, allowing the CEO to provide the membership lists, afforded the CEO an opportunity to conceal any improper member account activity.

Improper Bank Reconcilements

We found that the 2005 Supervisory Committee audit, issued July 14, 2005, noted an unresolved problem with the reconciling of $252,000 in cash. Two deposits appearing on an April 2005 statement were used to balance the March 31, 2005 statement. However, the monies were not posted to the credit union's general ledger until April 4 and 5, 2005, and should not have been used to balance the March accounts. The CEO indicated it was a software conversion error and after contacting the software provider would fax the documentation to the external auditor. We could not find any evidence that either the external auditor or the Supervisory Committee followed up on the supposed error or NCUA examiners questioned the un-reconciled cash.

Lack of Daily Account Balancing

NCUA examiners discovered that bank reconcilements were several months in arrears, there was no evidence that balances for shares, loans, cash, and settlement accounts were reconciled daily. In addition, the 2004 Supervisory Committee audit identified issues in loan underwriting, bank reconcilements, share accounts, internal control policy/procedure non-compliance and accounting system problems. We found no evidence of Supervisory Committee action to resolve any of the noted problems. An independent review of monthly bank reconcilements would have prevented this from occurring.

Improper Check Disbursements and Back Dated Entries

NCUA examiners discovered credit union checks disbursed using the same check number. This negates the control to properly control and monitor each specific disbursement. In addition, NCUA examiners discovered entries posted to member accounts using backdated transactions. An independent review of system transaction logs could have revealed both of these types of transactions.

Lack of Review of File Maintenance Reports

Although the Supervisory Committee's annual audit internal control questionnaires indicated other audit work such as review of file maintenance reports and bank reconcilements were performed, we did not discover evidence of any other work performed by the Supervisory Committee. Our review of Center Valley's annual Supervisory Committee audit reports and work papers showed that the auditors did not cite any material internal control issues regarding the file maintenance reports during the 2006 and 2007 audits. In addition, the only internal control work papers from these audits were internal control questionnaires completed by the Center Valley's CEO. Consequently, we cannot determine the extent of internal control testing performed by the external auditor. Furthermore, NCUA examiners determined that file maintenance reports were not reviewed. The non-review of data processing reports (file maintenance, transaction logs, exception etc.) by an independent party, such as a supervisory committee, may facilitate improper activity due to a lack of activity monitoring. This also highlights an audit weakness when audit questionnaire answers are not verified.

Lack of Segregation of Duties

Center Valley had a Board of Directors, a Supervisory Committee and six employees. Although it was a small institution, Center Valley had the capability to segregate some operational functions. In addition, when it was not possible to segregate duties the Supervisory Committee needed to become more active. Center Valley was lacking segregation of duties in the following areas:

- Disbursing funds and reconciling bank/corporate accounts;
- Using the same data processing password for all employees;
- Granting supervisory authority for all employees on the computer system;
- Credit union staff performing transactions on their own accounts; and
- Same staff person underwriting, approving and disbursing loans.

Information System Issues

The CEO blamed many of the issues or problems discovered by external auditors and NCUA examiners on computer problems. Specifically, the CEO cited computer problems as the cause of the bank reconcilement issues, loan and share account discrepancies and the inability to download share and loan files timely. We found NCUA examiners noted computer problems during examinations from 2004 through 2007. However, given the losses and closure of Center Valley the CEO most likely alleged the computer problems to conceal fraudulent activity.

B. NCUA Supervision of Center Valley Federal Credit Union

Credit Union Risks Not Adequately Evaluated

We determined NCUA examiners did not adequately evaluate the risks to Center Valley's operations. Specifically, examiners did not thoroughly evaluate the credit union's internal controls when assessing transaction risk and management CAMEL ratings. As a result, NCUA missed opportunities to expand examination procedures that may have detected the fraud sooner and mitigated the loss to the NCUSIF caused by Center Valley's failure.

NCUA's risk focused examination process should determine the adequacy of internal controls and the degree of reliance on the work efforts completed by competent, professional individuals and documented in reports and audits.[17] For example, evaluating internal controls involves:

- Identifying the internal control objectives relevant to the credit union;
- Reviewing pertinent policies, procedures, and documentation;
- Discussing controls with appropriate levels of personnel;
- Observing the control environment;
- Testing transactions as indicated by the level of risk;
- Sharing findings, concerns, and recommendations with the board of directors and senior management; and
- Determining that the credit union has promptly corrected noted deficiencies.[18]

In addition, NCUA guidance indicates examiners should base the scope, type, and depth of an internal control review on the credit union's size, complexity, scope of activities, and risk profile. An assessment of the credit union's audit function plays an important part in this determination. When management or examiners note internal

[17] NCUA Examiner's Guide, Chapter 1.
[18] NCUA Examiner's Guide, Chapter 4.

control weaknesses, the credit union should take immediate action to correct the deficiencies.

Furthermore, according to NCUA guidance, internal control is the process, developed by a credit union's board of directors, management, and other personnel, designed to provide reasonable assurance in the effectiveness and efficiency of its operations, the reliability of its financial reporting and the credit union's compliance with applicable laws and regulations.

NCUA internal control examination objectives help to:

- Determine whether the credit union has implemented efficient and effective operations and risk management systems;
- Determine whether the credit union accurately records transactions;
- Determine timeliness and reliability of financial reporting;
- Determine whether the credit union complies with regulations, internal policies, and internal procedures; and
- Assess whether the credit union has implemented adequate internal controls to safeguard assets.[19]

In our opinion, NCUA did not adequately achieve any of these objectives. Although the examiners, Supervisory Committee and external auditors may have performed their required minimum procedures, none of them properly assessed the adequacy of the credit union's internal control structure nor tested its operational effectiveness. We reviewed NCUA examinations[20] conducted prior to the discovery of the embezzlement and determined NCUA examiners were aware of some internal control weaknesses. For example, the CEO repeatedly cited computer problems or software issues as the causes of inaccurate data and delays in obtaining file downloads from 2004 through 2007. The external auditor noted during their January 2004 Supervisory Committee annual review that the credit union's written policies and control procedures were not being followed. We believe the examiners relied upon the Supervisory Committee and external auditors to assess internal controls and there was no evidence that examiners verified any of procedures performed by the Supervisory Committee or external auditors. Furthermore, it was not until the discovery of the fraud that NCUA identified serious internal control weaknesses.

Following the discovery of the embezzlement, NCUA examiners determined the non-existence of internal controls allowed the CEO to perpetrate the fraud. However, the risk focused examination procedures used prior to the fraud detection were not

[19] NCUA Examiner's Guide, Chapter 4.
[20] We reviewed NCUA examinations from September 30, 2003 through December 31, 2008. The September 30, 2008 and December 31, 2008, examinations were conducted following the discovery of the embezzlement.

sufficient in assessing the transaction risks. Specifically, NCUA examiners did not rate transaction risk high until after the embezzlement was uncovered. Appendix B contains the nine factors comprising the transaction risk indicators.

Transaction Risk Not Rated High

Examiners did not consider the following issues serious enough to rate transaction risk high at Center Valley:

- Weak internal controls;
- History of transaction processing failures;
- Serious weaknesses exist in operating and information system internal controls;
- Exposure to processing risk due to poor conversion management; and
- Failure of management to make required corrections to improve transaction processing risk controls.

We found the examiner rated transaction risk as low during the September 30, 2003, examination because "no serious record keeping concerns were noted" during past exams. In addition, during the March 31, 2004, examination the examiner indicated that transaction risk was low because of the controls in place and that the external auditor performed an acceptable audit. However, we reviewed the external audit report and identified control issues that the examiner should have noted. Specifically, the external auditor found and documented in the report that:

- The credit union had accounting system problems;
- The credit union had written internal controls policies and procedures, but did not comply with them;
- Each of the 71 loans reviewed contained at least one exception;
- Bank reconcilement forms which provide a proper paper trail were not used at the credit union; and
- The share totals balanced with general ledger totals; however, individual share ledgers were out of balance with their respective general ledger accounts. The difference was in the Share Certificate CDs and the external auditor attributed the cause to a subsequent transaction or an accounting system error.

In addition, the examiner noted on the Supervisory Committee Audit and Verification Review questionnaire that the Supervisory Committee followed up on recommendations and that no reportable conditions or material weaknesses existed. Furthermore, the examination document of resolution (DOR) did not mention any computer problems or any other internal control issues. However, we believe the issues noted in the external audit report were reportable conditions that created a high risk and that the examiner should have performed additional procedures.

According to the examiner, transaction risk was moderate for the March 31, 2006, examination because the credit union went through an accounting system conversion and the credit union provided appropriate reports and reconcilements. The examiner also indicated that the Supervisory Committee reviewed file maintenance reports and the credit union manager answered all areas of concerns. Additionally, the examiner stated that an external auditor performed the Supervisory Committee's annual audit.[21] We reviewed the external auditor's report and found a $252,000 bank reconciliation error was not resolved. Two transactions used to balance the credit union's cash account were not recorded in the general ledger. These transactions did not appear on the bank statements until April 4 and 5, 2005, and should not have been used to balance the March 2005 statement. The CEO cited computer problems and was to follow-up with the software provider. However, the CEO was not able to obtain a written response from the software provider and requested the auditor to issue the report with the exception for the $252,000. We did not find any evidence of the external auditor or the credit union resolving this issue.

In addition, the examiner noted on the NCUA Supervisory Committee Audit and Verification Review checklist that there were no reportable conditions or material weaknesses found during a review of the credit union's audit report. Furthermore, the examination DOR did not mention any bank reconciliation issues, computer problems or internal control issues. However, we believe the examiner should have followed-up on the $252,000 reconciliation error with the Supervisory Committee.

During the September 30, 2007, supervisory contact, the examiner rated transaction risk as moderate because the credit union had recently upgraded its computer operating system. According to the examiner, the CEO stated problems with the credit union's computer operating system prevented the downloading of files the examiner requested in advance. Consequently, the examiner could not perform the planned detailed review of internal control areas because the CEO could not provide the requested files. In addition, the examination DOR did not mention any computer problems or internal control issues.

During the March 31, 2008, examination, the examiner rated transaction risk as moderate because the credit union had inherent transaction risk due to the small staff. The examiner stated they reviewed the Supervisory Committee annual audit report and did not note any concerns. Our review of the December 31, 2007, Supervisory Committee annual report found the Supervisory Committee did not properly document

[21] This Supervisory Committee audit covered the period of February 1, 2004 to March 31, 2005 and the report was issued July 14, 2005. The next audit report covering the period of Aril 1, 2005 to November 30, 2006 was issued on March 31, 2007.

bank reconcilement reviews. However, the examiner noted there were no reportable conditions or material weaknesses.

(See Appendix A, Table A-2 for risk ratings and Appendix C for DORs)

CAMEL Management Component Not Adequately Assessed

Examiners regularly rated the management component of CAMEL as a one or two prior to the discovery of the embezzlement at Center Valley and after the discovery rated it a five. Examiners noted good overall management stating management was proactive and was able to cite reasons for uncontrolled growth. However, examiners did not view ongoing problems such as the repeated computer issues or the lack of internal controls as unacceptable risk warranting a DOR.

According to NCUA guidance,[22] the CAMEL management component provides examiners with objective, and not purely subjective, indicators and impacts all seven risks found in credit union operations.[23] In addition, the guidance states seven aspects of internal controls under the management component deserve special attention.[24] Of the seven aspects, we believe examiners should have been aware of weaknesses in four of the internal control areas. We also believe examiners should not have rated the management component as a one or two because adequate internal controls play a crucial role in controlling the risks to a credit union. We found:

- Information systems should have effective controls in place to ensure the integrity, security, and privacy of information contained on the credit union's computer systems.
    - From 2004 through 2007, the CEO cited computer problems or issues with the computer operating systems as causes of inaccurate data.

- Segregation of duties at the credit union should be adequate, but may be limited by the number of employees in smaller credit unions.
    - Center Valley was a small credit union.

- Audit program effectiveness includes follow-up of any unresolved issues, which should be covered in subsequent reports.
    - We found no evidence that the Supervisory Committee resolved any of the problems the external auditor indentified during its 2004 audit.
    - The $252,000 reconciling error found during the 2005 Supervisory Committee audit was never resolved.

[22] NCUA Letter to Credit Unions, No. 03-CU-04 titled CAMEL Rating System.
[23] The seven risks are credit, interest rate, liquidity, transaction, compliance, strategic, and reputation.
[24] The seven aspects are information systems, segregation of duties, audit program, record keeping, protection of physical assets, education of staff and succession planning.

- Record keeping in accordance with well-established accounting principles reflects the actual financial condition and accurate results of operations. Subsidiary records should be kept in balance with general ledger control figures.
  - There was no evidence that balances for shares, loans, cash, and settlement accounts were reconciled daily.
  - The 2004 Supervisory Committee audit identified issues in loan underwriting, bank reconcilements, share accounts, internal control policy/procedure non-compliance and accounting system problems.

In addition, NCUA guidance[25] indicates examiners should be aware of any red flags, which may indicate that the examiner needs to expand analysis and review of the applicable operations. We found the following red flags existed at Center Valley:

- Limited personnel not conducive to segregation of duties or lack of segregation of duties when staff is adequate:
  - This is an inherent risk with small credit unions;

- Failure to provide or delays in providing standard reports or records:
  - The CEO repeatedly blamed computer problems for inaccurate data and delays in downloading files;

- Inactive Supervisory Committee:
  - Outside of contracting with an external auditor to perform its annual audit, the Supervisory Committee was not fully active;

- Non-independent member account verification:
  - The CEO provided the member lists;

- Inadequate internal controls:
  - Issues existed with loan underwriting, bank reconcilements, share accounts, internal control policy/procedure non-compliance and accounting system problems;

- Extravagant management or employee lifestyle relative to salary:
  - The CEO constructed a restaurant and resort business.

Accordingly, examiners should have expanded examination procedures. As a result, NCUA missed opportunities to mitigate the loss to the NCUSIF caused by Center Valley's failure.

[25] NCUA Examiner's Guide, chapter 7.

C. Observations

This section addresses observations regarding credit union operations and management actions.

Credit Union Operations and Managements Actions

We reviewed industry observations regarding occupational fraud.[26] We believe the industry's observations apply to issues we observed during our review of Center Valley's failure. For example, the Association of Certified Fraud Examiners (ACFE) reported in their 2008 report to the nation[27] the implementation of anti-fraud controls has a measurable impact on an organization's exposure to fraud. ACFE examined 15 specific anti-fraud controls and measured the median loss in fraud cases depending on whether organizations did or did not have a given control in place at the time of the fraud. In every comparison, the ACFE found significantly lower losses when controls had been implemented. We determined Center Valley's lax internal control environment created an environment susceptible to fraud.

The following table lists other industry observations regarding fraud and how they compare to our observations about Center Valley's failure:

Industry Observations of Fraudulent Activity	NCUA OIG Observations of Center Valley's Failure
Lack of adequate internal controls is the most common factor that allows fraud to occur.	Lack of segregation of duties. Backdated transactions allowed. Same data processing password used by all employees. Staff could perform transactions on own accounts.
Small businesses[28] have been determined to be most susceptible to occupational fraud.	Lack of segregation of duties due to low number of employees (six employees for two offices). $8 million in assets.

[26] The Association of Certified Fraud Examiners (ACFE) defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."
[27] Association of Certified Fraud Examiners, 2008 Report to the Nation on Occupational Fraud and Abuse.
[28] ACFE defines small businesses as organizations with fewer than 100 employees. This category suffered the highest median loss.

Lack of management review allows fraud to occur.	Supervisory Committee not fully active. Independent member account verification not properly conducted. Large cash discrepancy reported by external auditor not reconciled.
Behavioral red flags when perpetrators are living beyond their apparent means.	CEO constructing a major business venture (tavern, restaurant and resort).

Although, we determined that more diligent and aggressive supervision on the part of NCUA may have mitigated the loss, we believe the cause of Center Valley's failure was directly attributable to the fraud committed against its members through the actions of one individual.

Observations from our review include:

Examiners did not consider the lack of adequate internal controls serious enough to rate transaction risk high at Center Valley even though this issue is an inherent problem in smaller credit unions. We believe the lack of internal controls and the repeated computer issues indicated material weaknesses may have existed, warranting expanded examination procedures. Opportunities exist for management to reinforce the need for additional procedures. We suggest NCUA management:

- Emphasize the importance of additional procedures, such as the Red Flag review,[29] and expanding procedures when red flags are detected. This could be accomplished through training modules at the Recordkeeping and Internal Control Subject Matter Examiner training conferences, at regional conferences and at regularly held examiner training; and

- Have the Office of Small Credit Union Initiatives provide training on the importance of internal controls and the responsibilities of the Supervisory Committee during their credit union workshops and through issued guidance.

[29] NCUA Instruction 5000.20 and corresponding memo entitled Risk-Focused Examinations and Supervision – Updated Minimum Scope Requirements, requires examiners to complete the Red Flag Questionnaire at all examinations of credit unions with less than $20 million in assets. The requirements in this instruction and memo became effective for all examinations conducted after March 31, 2009.

Appendix A: Examination History

The following provides a summary of NCUA's supervision of Center Valley, which includes examinations and onsite supervision contacts from September 2003 through the December 2008 examination during which NCUA placed Center Valley under conservatorship.

Table A-1

Center Valley's Assets and CAMEL Ratings – 2003 to 2008

Examination or Contact Date	Assets	Composite	C	A	M	E	L
12/31/2008	$8,379,924	5	5	5	5	5	5
9/30/2008	$7,710,352	5	5	5	5	5	5
3/31/2008	$6,535,974	2	1	1	2	3	2
9/30/2007	$7,597,479	2	1	1	2	2	2
9/30/2006	$8,431,323	2	1	1	2	2	2
3/31/2006	$7,704,668	2	1	1	2	2	2
9/30/2005	$7,161,950	1	1	1	1	2	2
3/31/2004	$6,431,761	1	1	2	1	1	2
12/1/2003	$7,625,842	1	2	1	1	1	3
9/30/2003	$7,625,842	1	2	1	1	1	3

C=Capital; A=Asset Quality; M=Management; E=Earnings; L=Liquidity

Table A-2

Center Valley's Risk Ratings – 2003 to 2008

Examination or Contact Date	SR	TR	CMR	CRR	IR	LR	RR
12/31/2008	High	High	High	High	High	High	High
9/30/2008	High	High	High	High	High	High	High
3/31/2008	Med.	Med.	Low	Low	Low	High	Low
9/30/2007	Med.	Med.	Low	Low	Med.	Med.	Low
9/30/2006	N/A	N/A	N/A	N/A	N/A	N/A	N/A
3/31/2006	Med.	Med.	Low	Low	Med.	Med.	Low
9/30/2005	N/A	N/A	N/A	N/A	N/A	N/A	N/A
3/31/2004	Med.	Low	Low	Low	Low	Med.	Low
12/1/2003	N/A	N/A	N/A	N/A	N/A	N/A	N/A
9/30/2003	Med.	Low	Low	Low	Low	Med.	Low

SR=Strategic Risk; TR=Transaction Risk; CMR=Compliance Risk;
CRR=Credit Risk; IR=Interest Rate Risk; LR=Liquidity Risk; RR=Reputation Risk

Table A-3

Center Valley's Financial Trends – 2003 to 2008

Examination or Contact Date	Assets	Loans	Shares	Loans/Assets Ratio
12/31/2008	$8,379,924	$7,778,286	$6,307,232	92.8%
9/30/2008	$7,710,352	$7,403,177	$6,177,989	96.0%
3/31/2008	$6,535,974	$6,161,383	$5,159,949	94.3%
9/30/2007	$7,597,479	$7,020,722	$6,728,110	92.4%
9/30/2006	$8,431,323	$8,186,132	$6,692,490	97.1%
3/31/2006	$7,704,668	$7,283,084	$6,879,001	94.5%
9/30/2005	$7,161,950	$6,935,406	$5,806,142	97.0%
3/31/2004	$6,431,761	$5,248,298	$5,763,101	81.6%
12/1/2003	$7,625,842	$5,888,637	$7,005,179	77.2%
9/30/2003	$7,625,842	$5,888,637	$7,005,179	77.2%

Appendix B: Transaction Risk Indicators

The following summarizes NCUA Examiner's Guide, Chapter 2, Attachment 2.1, which provides examiners with guidance in the assignment of risk level.

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of transaction risk.	Reasonably understands key aspects of transaction risk.	Does not understand, or chooses to ignore key aspects of transaction risk.
Responsiveness to Market and Technological Conditions	Anticipates and responds well to changes.	Adequately responds to changes.	Does not anticipate or take timely or appropriate actions in response to changes.
Risk Exposure	Only a slight probability of damage to reputation, capital, or earnings.	Possible loss to reputation, earnings or capital exists but is mitigated by adequate internal controls.	Weak internal controls expose the credit union to significant damage to reputation, or loss of earnings or capital.
Transaction Processing Controls	History or sound operations. Likelihood of transaction processing failures is minimal due to strong internal controls.	History of adequate operations. Likelihood of transaction processing failures is minimized by generally effective internal controls.	History of transaction processing failures. Likelihood of future failures is high due to absence of effective internal controls.
Systems and Controls	Strong control culture that results in systems, internal controls, audit, and contingency and business recovery plans that are sound.	Adequate operating and information processing systems, internal controls, audit coverage, and contingency and business recovery plans are evident.	Serious weaknesses exist in operating and information systems, internal controls, audit coverage, or contingency and business recovery plans.
MIS	Satisfactory	Minor deficiencies may exist that relate to transaction and information processing activities.	Significant weaknesses in transaction and information processing activities.
New Products or Services	Favorable performance in expansions and introductions of new products and services.	Planning and due diligence prior to introduction of new services are performed although minor weaknesses exist.	Inadequate. CU is exposed to risk from the introduction or expansion of new products and services.
Conversion Management	Conversion plans are clear, comprehensive, and followed.	Conversion plans are evident, although not always comprehensive.	CU may be exposed to processing risks due to poor conversion management, either from the integration of new acquisitions with existing systems, or from converting one system to another.
Problem Identification and Corrective Action	Management identifies weaknesses quickly and takes appropriate action.	Management recognizes weaknesses and generally takes appropriate action	Management has not demonstrated a commitment to make the corrections required to improve transaction processing risk controls.

Appendix C: Documents of Resolution

The following tables provide a summary of repetitive recommendations/DORs to correct problems identified by examiners from March 31, 2004 through March 31, 2008. The DORs are categorized by issue.

Table C-1

Liquidity Risk

Examination or Contact Date	DOR Items
3/31/2004	Develop a cash flow budget for liquidity considering new services
9/30/2005	Continue with plan to reduce loan/asset ratio to 80 percent
	Continue with plans to repay outstanding LOC by 1/31/2006
	Invest surplus funds in day in day out instruments until liquidity goals met
3/31/2006	Develop cash flow budget
	Adjust budget to consider cost of borrowed funds
	Establish plan and time estimates for borrowed funds limits and repayment
9/30/2007	Continue to review and adjust loan a share rates for sufficient earnings and adequate liquidity
	Review financial plans compared to actual operations
	Continue to update and adjust budget based on actual operations and trends
3/31/2008	Tighten up lending standards to reduce loan demand
	Promote savings to increase shares
	Pay down outstanding borrowed funds
	Assure all surplus funds are invested in liquid accounts
	Monitor liquidity position on regular basis

Table C-2

Credit Risk

Examination or Contact Date	DOR Items
3/31/2004	Formalize Allowance for Loan Losses Methodology
	Indicate loan loss ratio used
	Consider using a charge-off policy
	Consider developing a delinquent borrower watch list
3/31/2006	Update Allowance for loans losses account to consider risk based lending program

Table C-3

Strategic Risk

Examination or Contact Date	DOR Items
3/31/2004	Complete and submit an updated Strategic Plan
3/31/2006	Test contingency plan
	Update business and marketing plans considering goals, cash flow etc.
9/30/2008	Place manager on administrative leave
	Permit NCUA to perform 100% positive member account verification
	Hire a temporary manager

Table C-4

Compliance Risk

Examination or Contact Date	DOR Items
3/31/2008	Assure Bank Secrecy Act Compliance assessment is completed annually
	Reduce threshold for daily cash aggregation report to $7,000

Appendix D: NCUA Management Comments

National Credit Union Administration

VIA E-Mail

TO: William DeSarno, Inspector General
Office of Inspector General (OIG)

FROM: Executive Director David M. Marquis
Office of Executive Director

SUBJ: Material Loss Review of Center Valley Federal Credit Union #21983

DATE: April 9, 2010

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review of Center Valley Federal Credit Union (MLR).*

Center Valley Federal Credit Union (CVFCU) failed due to the chief executive officer's (CEO's) embezzlement of credit union funds through unauthorized withdrawals, fraudulent loans, unrecorded credit union checks, and fictitious deposits and subsequent disbursements from personal and family members' accounts. Credit union management's failure to implement proper internal controls and oversight allowed the CEO to maintain two sets of financial records and conceal the fraudulent activity for three or more years. Specifically, there was no segregation of duties, the data processing system allowed back-dated transactions, all employees used the same data processing password, staff performed transactions on their own accounts, bank reconcilements were several months in arrears, file maintenance reports were not reviewed, member account verifications were not properly conducted, and the supervisory committee failed to resolve a $252,000 bank reconciliation error noted by the external auditors in 2005. The CEO repeatedly blamed computer problems for bank reconciliation issues, loan and share account discrepancies, and the inability to provide share and loan downloads timely for the examiners.

The MLR found that the external auditors failed to follow-up on material reportable conditions from the 2004 and 2005 audits, even though the same firm conducted subsequent annual audits. Furthermore, the work papers for the 2006 and 2007 audits did not clearly document the extent of internal control testing performed by the external auditors. The MLR also found that NCUA examiners did not sufficiently expand examination procedures to adequately review internal controls and follow-up on internal control issues noted in the 2004 and 2005 external audit reports. Examiners did not fully consider internal control weaknesses when assessing the level of transaction risk at CVFCU and assigning the management component of the CAMEL Rating. Examiners also did not address any computer problems or internal control weaknesses in examination Documents of Resolution.

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Though examination procedures are not designed or intended to detect fraud, we acknowledge the MLR's findings that inadequate assessment of the the level of transaction risk to CVFCU's operations may have resulted in missed opportunities to expand examination procedures that may have detected the fraud sooner and mitigated the loss to the NCUSIF. Updated guidance requiring examiners to complete the Red Flag Questionnaire at all examinations of credit unions with less than $20 million in assets has been issued. NCUA also requires completion of a fraud detection class as part of the core training for new examiners.

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