Case 4.13

The Baptist Foundation of Arizona: A Focus on Evidence—Significant Transactions

Synopsis

The Baptist Foundation of Arizona (BFA), was organized as an Arizona non-profit organization primarily to help provide financial support for various Southern Baptist causes. Under William Crotts's leadership, the foundation engaged in a major strategic shift in its operations. BFA began to invest heavily in the Arizona real estate market, and also accelerated its efforts to sell investment agreements and mortgage-backed securities to church members.

Two of BFA's most significant affiliates were ALO and New Church Ventures. It was later revealed that BFA had set up these affiliates to facilitate the "sale" of its real estate investments at prices significantly above fair market value. In so doing, BFA's management perpetrated a fraudulent scheme that cost at least 13,000 investors more than $590 million. In fact, Arizona Attorney General Janet Napolitano called the BFA collapse the largest bankruptcy of a religious nonprofit in the history of the United States.[297]

Background

A former BFA director incorporated both ALO and New Church Ventures. The entities had no employees of their own, and both organizations paid BFA substantial management fees to provide accounting, marketing, and administrative services. As a result, both ALO and New Church Ventures owed BFA significant amounts by the end of 1995. On an overall basis, BFA, New Church Ventures, and ALO had a combined negative net worth of $83.2 million at year-end 1995, $102.3 million at year-end 1996, and $124.0 million at year-end 1997.[298]

From 1984 to 1997, BFA's independent auditor, Arthur Andersen, issued unqualified audit opinions on BFA's combined financial statements. However, it was later revealed that BFA had sold real estate to ALO and New Church

[297] Terry Greene Sterling, "Arthur Andersen and the Baptists," Salon.com Technology, February 7, 2002.

[298] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 3–4.

Ventures and other related entities at its cost (or at a profit), even though the fair market value of the assets was significantly lower than the amounts recorded on BFA's books.

Year-End Transactions

In December of each year, BFA engaged in significant year-end transactions with its related parties, ALO and New Church Ventures. These related party transactions primarily included real estate sales, gifts, pledges, and charitable contributions. Without these year-end transactions, BFA, on a stand-alone basis, would have been forced to report a significant decrease in net assets in each year, from 1991 to 1994. Yet, BFA did not disclose any information about these material related party transactions in its financial statements for the years 1991 to 1994.[299]

As an example, the significant real estate transactions that occurred in December 1995 with Harold Friend, Dwain Hoover, and subsidiaries of ALO enabled BFA to report an increase in net assets of $1.6 million for the year ended December 31, 1995, as opposed to a decrease in net assets that would have been reported. Importantly, for BFA to recognize a gain on these transactions in accordance with GAAP, the down payment for the buyer's initial investment could not be "funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller, or loans guaranteed or collateralized by the seller for the buyer."[300] However, in reality, the cash for the initial down payment on many of these real estate sales can be traced back to BFA via transactions with affiliates of ALO and New Church Ventures.

Foundation Investments, Inc.'s Sale of Santa Fe Trails Ranch II, Inc. Stock

Santa Fe Trails Ranch II, Inc. was a subsidiary of Select Trading Group, Inc., which was a subsidiary of ALO. The only significant asset owned by Santa Fe Trails Ranch II was 1,357 acres of undeveloped land in San Miguel County, New Mexico.

On December 26, 1995, 100 percent of the issued and outstanding common stock of Santa Fe Trails Ranch II was transferred from Select Trading Group to ALO. ALO then sold the stock to New Church Ventures in exchange for a $1.6 million reduction in ALO's credit line that was already owed to New Church Ventures. On the same day, New Church Ventures sold the Santa Fe Trails Ranch II stock to Foundation Investments, Inc., a BFA subsidiary, in

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[299] Ibid., 19–20.

[300] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 25.

exchange for a $1.6 million reduction in the New Church Ventures's credit line that was already owed to Foundation Investments. Also on the same day, Foundation Investments sold the Santa Fe Trails Ranch II stock to Harold Friend for $3.2 million, resulting in Foundation Investments recognizing a gain of $1.6 million in its financial statements.

The terms of the sale of the Santa Fe Trails Ranch II stock by Foundation Investments to Mr. Friend for $3.2 million was a 25 percent cash down payment ($800,000) with the balance of $2.4 million in a carry-back note receivable to Foundation Investments. To audit the transaction, Arthur Andersen's senior auditor John Bauerle vouched the payment received from Friend via wire transfer back to the December 31, 1995 bank statement. However, he did not complete any additional work to determine the source of the cash down payment.

To assess the true nature and purpose of this series of transactions, Arthur Andersen reviewed a feasibility study and 1993 cash flow analysis for the proposed development of Cedar Hills. An independent appraisal was not obtained. Arthur Andersen prepared a net present value calculation using the 1993 cash flow analysis to support the $3.2 million value that Friend paid to Foundation Investments on December 26, 1995. Arthur Andersen accepted the $3.2 million value without questioning why that same property was valued at only $1.6 million when New Church Ventures sold it to Foundation Investments on the same day.

TFCI's Sale to Hoover[301]

In December 1995, The Foundation Companies, Inc., a for-profit BFA subsidiary, sold certain joint venture interests in real estate developments to Dwain Hoover and recognized a gain on the transaction of approximately $4.4 million. In this particular transaction, the cash down payment from Hoover to The Foundation Companies of approximately $2.9 million was funded by a loan to Hoover from FMC Holdings, Inc., a subsidiary of ALO. Importantly, FMC received its own funding from BFA and New Church Ventures.

The details of this transaction were documented in Arthur Andersen's workpapers, primarily through a memorandum prepared by Arthur Andersen senior auditor John Bauerle on April 13, 1996. According to his memo, Bauerle concluded that the transaction did meet the criteria for gain recognition pursuant to SFAS No. 66. However, Bauerle's memorandum did not include any documentation to support how Arthur Andersen tested the source of the

[301] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 27–28.

cash down payment to help assure that the down payment was not directly or indirectly provided by BFA.

In early 1996, Arthur Andersen was auditing The Foundation Companies and prepared their annual management representation letter to be signed by the Foundation Company's Chief Financial Officer, Ron Estes. However, because of the previously described Hoover transaction, Estes refused to sign the management representation letter. CFO Estes protested against the Hoover transaction and ultimately resigned in June 1996. Arthur Andersen's audit workpapers related to the Foundation Companies 1995 audit did not address the absence of Estes's signature on the final management representation letter or indicate if it made any inquiries of Estes as to why he refused to sign the letter.

Case Questions

1. Please consider the sale of the Santa Fe Trails Ranch II stock by Foundation Investments to Friend. Do you believe that the auditor should have completed any additional testing beyond vouching the payment received from Friend? Provide the rationale for your decision.
2. Assuming that you would complete additional testing on the transaction described in Question 1, what is the most relevant financial statement assertion related to the transaction? Which audit procedures would you recommend to test the assertion? Why?
3. Please consult the key provisions of SFAS #66. Why did The Foundation Company's sale of the joint venture interests in real estate developments to Dwain Hoover fail to meet the provisions of SFAS #66? In your answer, make certain to note the impact of related party activity on your conclusion.
4. If you were the lead engagement partner at BFA, how would you have responded to the refusal of CFO Estes to sign the management representation letter? Why?