Case A.6

The Baptist Foundation of Arizona

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.[513]

Background

The Baptist Foundation of Arizona (BFA) was an Arizona religious nonprofit 501(c)(3) organization that was incorporated in 1948 to provide financial support for Southern Baptist causes. It was formed under the direction of the Arizona Southern Baptist Convention, which required BFA to be a profitable, self-sustaining independent entity (i.e., it could not accept money from any other source). In BFA's early days, it focused its attention on funding church start-ups and providing aid for children and the elderly. In 1962, Pastor Glen Crotts became its first full-time president and was subsequently succeeded in 1984 by his son, William P. Crotts.

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. Soon after the decline in the Arizona real estate market in 1989, management decided to establish a number of related affiliates. These affiliates were controlled by individuals with close ties to BFA, such as former board members. In addition, BFA gained approval to operate a

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

trust department that would serve as a nonbank passive trustee for individual retirement accounts (IRAs). In order to do so, BFA had to meet certain regulatory requirements, which included minimum net worth guidelines.

Related Parties

Two of BFA's most significant affiliates were ALO and New Church Ventures. A former BFA director incorporated both of these nonprofit entities. 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.[514]

New Church Ventures

Although the stated purpose of New Church Ventures was to finance new Southern Baptist churches in Arizona, its major investment activities were similar to those of BFA. That is, New Church Ventures raised most of its funds through the sale of investment agreements and mortgage-backed securities, and then invested most of those funds in real estate loans to ALO. Thus, the majority of New Church Ventures's assets were receivables from ALO. New Church Ventures's two main sources of funding were BFA's marketing of its investment products to IRA investors and loans it received from BFA.[515]

ALO

Contrary to its intended purpose to invest and develop real estate, one of ALO's primary activities in the 1990s was to buy and hold BFA's nonproducing and over-valued investments in real estate, so BFA could avoid recording losses (write-downs) on its real estate. In fact, ALO was the owner of many of the real estate investments that were utilized as collateral for IRA investor loans. However, BFA's 1991 through 1997 financial statements did not include a set of summarized financial statements for ALO. ALO incurred operating losses each year since its inception in 1988. By the end of 1997, ALO's total liabilities of $275.6 million were over two times its assets,

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

[515] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 8–9.

leaving a negative net worth of $138.9 million. In total, ALO owed New Church Ventures $173.6 million and BFA $70.3 million, respectively.[516]

BFA'S Religious Exemptions

BFA operated in a manner similar to a bank in many respects. Its investment products were similar to those sold by financial institutions. Its trust department, which was fully authorized by the federal government to serve as a passive trustee of IRAs, was similar to a trust department at a bank. BFA also made real estate loans in a manner similar to a bank. Because of its bank-like operations and products, BFA faced several risk factors that affect banks and other savings institutions, such as interest-rate risk and liquidity risk.[517]

Yet, because of its status as a religious organization, BFA's product offerings were not subject to the same regulatory scrutiny as a bank's products.[518] That is, although BFA underwrote its own securities offerings and used its staff to sell the investment instruments (like a bank), it was able to claim a religious exemption from Arizona statutes that regulate such activities. BFA also claimed exemption from Arizona banking regulations on the basis that its investment products did not constitute deposits as defined by Arizona banking laws.[519]

Passive Trustee Operation

BFA gained approval to operate a trust department that would serve as a nonbank passive trustee for IRAs. To operate a trust department, BFA had to comply with certain regulatory requirements, such as maintaining an appropriate minimum net worth. In addition to the minimum net worth requirement, treasury regulations also required BFA to conduct its affairs as a fiduciary, that is, it could not manage or direct the investment of IRA funds. In addition, BFA had to subject itself to an audit that would detect any failures to meet these regulatory requirements. In cases where the minimum net worth was not achieved, treasury regulations prohibited a trustee

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[516] Ibid., 8–9.

[517] Ibid., 4–5.

[518] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 5.

[519] Ibid., 4–5.

from accepting new IRA accounts and required the relinquishment of existing accounts.[520]

BFA's Independent Auditors

From 1984 to 1998, BFA engaged Arthur Andersen as its independent auditor. Arthur Andersen was also hired by BFA or BFA's attorneys to perform other accounting and auditing, management consulting, and tax services. From 1984 to 1997, Arthur Andersen issued unqualified audit opinions on BFA's combined financial statements.

From 1992 to 1998, Jay Steven Ozer was the Arthur Andersen engagement partner with the ultimate responsibility for the conduct of the BFA audits, including the review of all audit work performed, resolution of all accounting issues, evaluating the results of all audit procedures, and signing the final audit opinions. Ann McGrath was an auditor on the BFA engagement from 1988 to 1998. In 1991, she began her role as manager on the audit engagements. For audit years 1991 to 1998, McGrath had primary responsibility for all audit planning and field work, which included assessing areas of inherent and control risk, supervising the audit team, and reviewing all of the audit workpapers.[521]

Employees' Concerns over ALO's Deficit

In April 1996, several of BFA's accountants and one attorney were sufficiently concerned about ALO's deficit situation and related financial viability issues to confront BFA's senior management team. The response was perceived as inadequate by the employees. And, due to their concerns about the lack of response by the BFA senior management team, most of them resigned during 1996, citing their concerns in their letters of resignation. One of BFA's accountants who showed concern was Karen Paetz.

Karen Paetz's Concerns

Karen Paetz was familiar with the financial condition of ALO and the interrelationships among ALO, New Church Ventures, and BFA because one of her responsibilities had been to supervise the preparation of the financial statements of New Church Ventures and ALO. In 1994, at the request of BFA President Crotts, Paetz produced a detailed analysis of the fair market value of ALO's assets as compared to the cost basis of its assets. Her analysis

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[520] Ibid., 15–20.

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

revealed a $70.1 million negative net worth.[522] Paetz's misgivings about ALO, New Churches Ventures, and BFA prompted her to resign as a BFA accountant in July 1996.

During the seven years Paetz was employed by BFA, she interacted frequently with the Arthur Andersen auditors during each year's audit. In February 1997, during the field work for Arthur Andersen's 1996 audit of BFA, Paetz decided to contact Arthur Andersen auditor Ann McGrath and set up a lunch meeting with McGrath in order to voice her concerns. At the meeting, Paetz expressed her concern about ALO's deficit, which was in excess of $100 million and ALO's monthly losses, which were approximately $2.5 million. In addition, Paetz noted that the money from BFA and New Church Ventures was being used to service ALO's substantial debt to BFA. Paetz specifically advised McGrath to ask BFA, during the 1996 audit, for detailed financial statements. for both ALO and New Church Ventures.

Arthur Andersen's Response to Concerns

McGrath reported her meeting with Paetz to the engagement partner, Ozer. However, Arthur Andersen's audit workpapers, and its analysis of fraud risk, did not make reference to the Paetz meeting in February 1997 because McGrath and Ozer considered the meeting to be a "nonevent."[523]Arthur Andersen did, however, expand its audit procedures for the 1996 audit and requested from BFA the detailed financial statements of ALO and New Church Ventures. However, BFA refused to make the detailed financial statements for both ALO and New Church Ventures available to McGrath and Ozer.

McGrath and Ozer decided not to insist that ALO's financial statements be provided although the financial statements were necessary to properly assess ALO's ability to repay its loans back to BFA and affiliate New Church Ventures. Fortunately, the financial statements of ALO were a matter of public record and part of a four-page annual disclosure statement that ALO had filed with the Arizona Corporation Commission on March 19, 1997, during Arthur Andersen's field work for the 1996 audit. This four-page annual report showed a $116.5 million negative net

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[522] Ibid., 29–30.

[523] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 50–51.

worth as of year-end 1996, and a $22 million net loss for the year.[524] New Church Ventures' unaudited detailed financial statements were available for years 1995, 1996, and 1997. These financial statements revealed that substantially all of New Church Ventures's notes receivable were from ALO.[525]

Disclosure of ALO and New Church Ventures in 1996 Financial Statements

Footnote 3 to BFA's combined financial statements as of December 31, 1996, included an unaudited condensed balance sheet for New Church Ventures (identified only as "a company associated with Southern Baptist causes") as of year end 1996, which reported net assets of $2.5 million and total assets of $192.5 million. The footnote did not disclose ALO's financial position or that approximately 8l percent of New Church Ventures' assets were notes receivable from ALO. To the extent New Church Ventures receivables from ALO were uncollectible due to ALO's negative net worth, New Church Ventures would not be able to meet its liabilities, which included liabilities to IRA holders by year-end 1996 that totaled $74.7 million.[526]

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.[527]

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

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[524] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 30–31.

[525] Ibid., 30–32.

[526] Ibid., 31–32.

[527] Ibid., 19–20.

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."[528] 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 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

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

$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[529]

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 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 had 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.

Related Parties Disclosure

1991–1994

In addition to its affiliates, BFA's related parties included its subsidiaries, BFA senior management and their

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

immediate families, as well as any former or current members of the Board of Directors. Yet, except for information provided about New Church Ventures in its 1994 financial statements, the transactions and balances due from the following individuals and companies were *not* disclosed as related parties in the financial statements for the years 1991 through 1994:

- Dwain Hoover, BFA Board member;
- Harold Friend, former BFA Board member;
- Jalma Hunsinger, owner of ALO, former BFA Board member, and New Church Ventures Board member;
- ALO and its subsidiaries and affiliates; and
- New Church Ventures and its subsidiaries and affiliates.[530]

1995

In the footnotes to BFA's 1995 financial statements, rather than using their names, BFA described its related parties according to their titles or roles in the business. This practice made it far more difficult and time-consuming for users to identify the true identity of the related parties. For example,BFA disclosed its related parties as follows: "Director A [Dwain Hoover] and his companies"; "Benefactor A [Harold Friend] and his companies"; and "Benefactor B [Jalma Hunsinger] and his companies." ALO was a Benefactor B company and New Church Ventures was "a company associated with Southern Baptist causes."[531]

Related Party Pseudonyms

- Director A = Dwain Hoover;
- Benefactor A = Harold Friend;
- Benefactor B = Jalma Hunsinger;
- ALO = a Benefactor B company; and
- New Church Ventures = a company associated with Southern Baptist causes.

BFA disclosed in Footnote 13 of its 1995 financial statements, entitled "Related Parties," that "a substantial portion

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[530] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, pp. 16–17.

[531] Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 21.

of BFA's transactions involve individuals or companies associated with Southern Baptist causes."[532] In Footnote 13, it described "some of the more significant transactions involving related parties," including notes receivable from "Director A, Benefactor A, and Benefactor B or their companies" totaling $8,825,063, $2,400,000, and $53,797,827 (notes owed from ALO). Footnote 13 did not include an additional $37,400,000 in notes receivable owed to BFA from New Church Ventures, which was discussed in Footnote 3 entitled "Notes Receivable."[533]

The footnotes to the 1995 financial statements did not disclose the material nature of the total notes receivable owed to BFA from related parties ALO and New Church Ventures that accounted for 63 percent of BFA's total notes receivable—or 30 percent of BFA's total assets and more than ten times as much as BFA's total net assets. This substantial concentration of credit given to ALO and New Church Ventures was also not disclosed in Footnote 2 in a subsection entitled: "Concentration of Credit Risk," which stated: "Concentration of credit risk with respect to notes receivable are limited due to the fact that BFA requires notes receivable to be adequately collateralized."[534]

1996–1997[535]

In connection with its 1996 audit of BFA, Arthur Andersen commented in a "Memorandum on Internal Control Structure" on BFA's lack of review, analysis, and proper documentation of related party transactions.

Andersen also criticized the fact that the collateral on related party notes receivable was not adequately monitored. It noted that "certain of the notes receivable from individuals and companies affiliated with Southern Baptist causes had outstanding balances in excess of the current value of the underlying collateral." Yet, Arthur Andersen did not require BFA to take a reserve or write-down on its notes receivable. Rather, in BFA's 1996 financial statements, a footnote merely stated that "certain of the notes have outstanding balances that may be in

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532 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 21.

533 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 20–22.

534 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, 22–23.

535 Notice of Public Hearing and Complaint No. 98.230-ACY, Before the Arizona State Board of Accountancy, pp. 40–41.

excess of underlying collateral."

Again, for year-end 1997, Arthur Andersen assessed BFA's internal controls and criticized BFA for lack of review, analysis, and proper documentation of related party transactions and for failing to adequately monitor collateral on related party notes receivable. The criticisms stated in the 1997 Internal Control Memorandum were practically identical to those made by Arthur Andersen in 1996. In fact, in the 1997 memorandum, Arthur Andersen noted that its 1996 audit recommendations regarding related parties had not been fully implemented and encouraged management to do so.

The 1997 memorandum repeated, almost verbatim, Arthur Andersen's observation "that certain of the notes receivable from individuals and companies affiliated with Southern Baptist causes had outstanding balances, which appeared to be in excess of the current value of the underlying collateral."

Like its opinion in 1996, Arthur Andersen issued an unqualified opinion on BFA's 1997 financial statements, without requiring adequate disclosures regarding the concentration of credit risk with related parties and the nature of the relationships with ALO and New Church Ventures. The footnote disclosures regarding the amounts due from related parties also appeared to be inadequate and misleading to financial statement users.

Comprehensive List of Case Questions

1. Based on your understanding of inherent risk assessment, please identify three specific factors about BFA that might cause you to elevate inherent risk. Briefly provide your rationale for each factor that you identify.
2. Please comment on why the existence of related parties (such as ALO and New Church Ventures) present additional risks to an auditor. Do you believe that related party transactions deserve special attention from auditors? Why or why not?
3. Assume you are an investor in BFA. As an investor, what type of information would you be interested in reviewing before making an investment in BFA? Do you believe that BFA should have been exempt from Arizona banking laws? Why or why not?
4. Please consider the planning phase for the audit of BFA's trust department operations. As an auditor, what type of evidence would you want to collect and examine in order to determine whether BFA was meeting the U.S. Treasury regulations for nonbank passive trustees of IRA accounts?
5. Please consult Paragraphs #49 and 114 of PCAOB Auditing Standard No. 2. Define what is meant by control environment. Based on the information provided in the case, why does the control environment have a

"pervasive" effect on the reliability of financial reporting at an audit client like BFA?

6. Consult Paragraphs #55–59 of PCAOB Auditing Standard No. 2 and Section 301 of SOX. What is the role of the audit committee in the financial reporting process? Can you provide an example of how the Audit Committee may have been helpful in the BFA situation?
7. What is meant by the term "whistleblower" within the context of the financial reporting process? Do you think that all whisteblower complaints should go directly to the Audit Committee? Why? Do you think that a whistleblower program would have been helpful at BFA? Why?
8. Do you believe the Arthur Andersen auditors responded appropriately to the information received from BFA's former accountant, Karen Paetz? Do you believe any circumstances exist where an auditor should ignore information from a whistleblower?
9. Please consult Section 401 of SOX. How would Section 401 apply on the BFA audit? Do you believe that Section 401 should apply to an organization like BFA? That is, do you think the section would have improved the presentation of BFA's financial statements?
10. Please consider the sale of the Santa Fe Trails Ranch II stock by Foundation Investments to Mr. 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.
11. 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?
12. 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.
13. 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?
14. Since there is inherently greater risk that related party transactions occur on a basis other than "arm's length," what steps must a company take to properly disclose its related parties?
15. Please define what is meant by "arm's length" basis. Next, explain why gains recorded on transactions with related parties would have greater inherent risk of being overstated.

16. Please consult Paragraphs #49 and 114 of the PCAOB Auditing Standard No. 2. Define what is meant by control environment. Next, comment about the impact that BFA's related party disclosure practices would have on an auditor's assessment of BFA's control environment.
17. Consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about the related party transaction activity at BFA? Why?
18. Please consult Paragraph #84 of PCAOB Auditing Standard No. 2. The paragraph states that "the auditor should clearly link individual controls with the significant accounts and assertions to which they relate." For the assertion identified in Question #4, identify a specific internal control activity that would help to prevent or detect a misstatement or lack of proper disclosure for BFA.