Case 2.6

The Baptist Foundation of Arizona: A Focus on Fraud and Inherent Risk Assessment

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.[123]

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. Although Arizona real estate prices skyrocketed in

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

the early 1980s, the upward trend did not continue, and property values declined substantially in 1989. Soon after the decline, 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 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.[124]

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.[125]

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

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

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

inception in 1988. By the end of 1997, ALO's total liabilities of $275.6 million were over two times its assets, 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.[126]

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.[127]

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.[128] 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.[129]

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 from accepting new IRA accounts and required the relinquishment of existing accounts.[130]

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[126] Ibid., 8–9.

[127] Ibid., 4–5.

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

[129] Ibid., 4–5.

[130] Ibid., 15–20Ibid., 15–20

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?