Case 3.4

The Baptist Foundation of Arizona: A Focus on Company Level Controls

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.[152]

Background

Soon after the precipitous decline of Arizona's real estate market in 1989, BFA 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. 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 (deficiency in assets) of $83.2 million at year-end 1995, $102.3 million at year-end 1996, and $124.0 million at year-end 1997.[153]

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

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

It was later revealed that BFA had sold real estate to both ALO and New Church Ventures at book value (or at a profit), even though the fair market value of the assets was, in actuality, significantly lower than the amounts recorded on BFA's books. In addition, ALO had borrowed money from BFA and its related entities to provide the down-payment necessary to execute the purchase transactions with BFA. As a result, ALO's debt increased each year from 1989 to 1997, and its deficit from operations also increased each year.

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.[154]

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

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

detailed analysis of the fair market value of ALO's assets as compared to the cost basis of its assets. Her analysis revealed a $70.1 million negative net worth.[155] 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. 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."[156] 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 of 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

[155] Ibid., 29–30.

[156] 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.[157] 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.[158]

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. Of course, 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.[159]

Case Questions

1. 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?
2. 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?
3. 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?
4. 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

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

[158] Ibid., 30–32.

[159] Ibid., 31–32.

information from a whistleblower?

5. 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?