The CPA Journal

Current Issue • About the CPAJ • Search the Archives • NYSSCPA.org

AUDITING

July 2003

Lessons from the Baptist Foundation Fraud

By ***Lawrence C. Mohrweis***

Over a period of several years, the management of the Baptist Foundation of Arizona (BFA) engaged in one of the most audacious fraud schemes on record. BFA ultimately filed for bankruptcy, and thousands of elderly investors lost their life savings. How did such a massive fraud develop? What clues did the auditors overlook? BFA's failure and the subsequent penalties provide a sobering reminder to auditors that it is important to understand the causes of fraud and even more critical to engage in effective audit procedures to detect fraud. Improving and strengthening fraud detection is at the heart of the accounting profession's new antifraud initiatives, such as the recently issued SAS 99, *Consideration of Fraud in a Financial Statement Audit*.

Background

Founded in 1948, BFA was created as a nonprofit agency of the Arizona Southern Baptist Convention. Its initial mission was to raise donations and support for Southern Baptist causes. 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 the first full-time president and was subsequently succeeded in 1984 by his son, William P. Crotts. Under William Crotts' leadership, the foundation engaged in a major strategic shift in its business. BFA began to invest heavily in the Arizona real estate market, and at the same time, it accelerated its efforts to sell IRA-type retirement investment plans to church members. In one year, there was an amazing increase in the sale of these IRA-type investments, from $7.2 million in 1984 to $211 million in 1985, which highlights just how dramatically the foundation's mission changed under new management.

Arizona real estate prices were skyrocketing in the early 1980s. Like many investment cycles, however, the upward trend did not continue. In 1989, Arizona's real estate bubble burst and property values declined substantially. Nevertheless, BFA management was highly motivated not to show any losses and to report only positive results. First, it was critical for BFA to meet the Treasury regulations' fiduciary requirements governing nonbank passive trustees of IRAs. Second, financial assistance was not expected to come from any other source. The Baptist Convention required BFA to be a profitable, self-sustaining independent entity.

Management responded to the new environment by structuring accounting transactions to mitigate the real estate losses. Management set up "independent separate corporations," with individuals closely associated with BFA, such as former board members, controlling these new companies. Then, BFA sold property to these companies and received notes receivable that were recorded at the property's book value, not its diminished current value. Transactions between the foundation and these corporations were designed to achieve the accounting treatment desired by management. At the time of BFA's bankruptcy, a complex mesh of over 90 insider-controlled entities had been used to help disguise BFA's tenuous financial condition. The real estate market did bounce back, but by the mid-1990s the only phenomenon that kept BFA's operations from collapsing was a constant influx of new investor money that was used to pay interest on old money. In other words, it had become a classic Ponzi scheme.

ALO and New Church Ventures

Two of the most significant entities set up to hide BFA's nonperforming real estate properties were ALO and New Church Ventures. A former BFA director incorporated both 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.

ALO's stated purpose was to develop real estate. New Church Ventures' purpose was to finance new Southern Baptist churches in Arizona. However, the substance of ALO's actions was to buy and hold BFA's overvalued real estate in exchange for notes receivable valued in the millions of dollars. By 1997, ALO had a negative net worth of $138.9 and owed BFA $70.3 million and New Church Ventures $173.6 million. The majority of New Church Ventures' assets were receivables from the insolvent ALO. Both ALO and New Church Ventures owed BFA significant amounts of notes receivables.

As a nonprofit company, ALO filed its financial statements each year with the Arizona Corporation Commission as required by state law. The 1996 information, available for public inspection from the Arizona Corporation Commission, showed that ALO had a negative net worth of $116 million and had been losing more than $20 million per year for several years. Payments were being made on the receivables only because of funds being obtained from either New Church Ventures, or, indirectly, from BFA itself. The audit team requested the financial statements for ALO and New Church Ventures, but management refused to release the statements. If the audit team had obtained copies of ALO's detailed financial statements, the auditors would have discovered that ALO was insolvent.

Accounting Deficiencies

Arthur Andersen provided unqualified "clean" audit opinions on BFA's financial statements from 1984 to 1997. However, the State Board of Accountancy alleged that because of the very material departures from GAAP regarding the disclosure of related parties and the recognition of losses, the firm should have issued either a qualified or an adverse opinion on the 1991 to 1994 statements and an adverse opinion on the 1995 to 1997 financial statements. The following were among the major GAAP violations alleged by the State Board of Accountancy:

- Inadequate disclosure regarding ALO and New Church Ventures' relationships, transactions, and balances (SFAS 57, *Related Party Disclosures*).
- Inadequate disclosure of losses on notes receivables due from ALO and New Church Ventures (SFAS 5, *Accounting for Contingencies*).

Arthur Andersen, without admitting or denying any fault, settled an investors' lawsuit for $217 million. This settlement takes on a sad historical significance in that it represents the largest cash settlement for a nonprofit case and helped to further accelerate the demise of a once prestigious and great firm. Also, as a condition to the court-approved arrangement, the partner and the manager on the BFA audit lost their CPA licenses to practice and a third CPA was placed on probation, requiring that his work be monitored for two years by the Arizona State Board of Accountancy.

Red Flags

Unfortunately, the issuing of unqualified opinions, even after receiving some red flag warnings that fraud was occurring, led to the Andersen settlement. The following were some of the key warnings:

- ***High turnover of key staff.*** Between April and November 1996, three high-level BFA staffers—a lawyer and two accountants—resigned in protest. They each wrote letters noting their concerns about continued deception of investors and board members and specific allegations of fraud.
- ***Major tips uninvestigated.*** Shortly before the completion of the 1996 audit in February 1997, a former BFA accountant met with Andersen's BFA audit manager for lunch. The BFA accountant had formerly

prepared the financial statements of ALO and New Church Ventures. She warned the audit manager that entities owing BFA material amounts of notes receivables were insolvent and incapable of paying the receivables.

- ***Nonprofit status in peril.*** Andersen's tax practice informed the audit team in January 1998 that unrelated business income could jeopardize the foundation's tax-exempt status.
- ***Newspaper articles suggesting irregularities.*** The Phoenix New Times published articles on April 16 and 23, 1998, "The Money Changers," that contained extensive allegations of fraud and insider dealings at BFA. The audit team responded by reviewing each allocation and asking management if the allegations were true. Management assured the auditors that the allegations were not. On April 27, 1998, Andersen signed off on its unqualified opinion for the 1997 financial statements.

Revitalizing the Profession

Cases like the Baptist Foundation, along with other corporate frauds, have renewed efforts to prevent such accounting failings in the future. SAS 99 is the cornerstone of a multifaceted effort by the accounting profession to help restore investor confidence and supersedes the Auditing Standards Board's earlier fraud standard, SAS 82. SAS 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002, and earlier implementation is being urged.

An unambiguous lesson from the BFA case is that the audit team cannot rely too heavily upon management assurances. One of the key provisions of SAS 99 is an increased emphasis on professional skepticism. The audit team must put aside any prior beliefs as to management's honesty. Auditors must exchange ideas on how fraud could occur and adjust the audit program plan so that tests can are designed to be unpredictable and unexpected.

Another important provision of SAS 99 is that auditors should talk to employees, both in and outside of management. Information received from independent sources outside an entity that suggests the possibility that management fraud may be taking place requires a higher degree of due diligence by auditors. When credible tips or complaints are received about management fraud, auditors have a responsibility to expand their work to obtain independent corroborating evidence.

While the recently enacted Sarbanes-Oxley Act may only directly impact auditors that audit public companies, in today's environment it is more important than ever for auditors to employ sound fraud-detection audit procedures in all audit engagements. Auditors must broaden the range of information that they use. In applying SAS 99, auditors should plan and execute every audit with a questioning mind, recognizing the possibility that fraud may be present, regardless of past experience with the entity or prior beliefs about management's honesty and integrity. An increased focus on professional skepticism in gathering and evaluating audit evidence should lead to a revitalized accounting culture.

***Lawrence C. Mohrweis, PhD, CPA**, is a professor of accounting in the college of business administration at Northern Arizona University, Flagstaff, Ariz.*

Editor:
Robert H. Colson, PhD, CPA
The CPA Journal
