Franklin Co. – Buried Problems

Franklin Co. was a wholly owned subsidiary of very large US company, which was an SEC registrant, but required a separate audit opinion because of a loan agreement. The Canadian subsidiary was frequently assigned responsibility to run contracts in foreign countries, especially in countries where French was a working language. French was frequently used within Franklin because it was based in Montréal.

The audit was almost over, but on reviewing the working papers prepared by her staff, the manager noted an open item. - “Read the Iran contract”. The Iran contract was with the government to build a floating pulp and paper mill that was to be anchored at one of Iran’s ports. Total value was over $300 million. She surmised that the staff considered this to be a very boring and somewhat time-consuming task and had hoped she wouldn’t notice.

The manager was under pressure to sign off on the audit to meet the parent company’s deadline, so she made two staff come in to work over the weekend to review the document, which was several hundred pages. “Skim through the non-financial stuff as well” suggested the manager, who was concerned that they did not know enough about this huge contract.

On Sunday afternoon, the manager got a phone call. A staff member had found a clause buried in the detail that provided a payment of about a $20 million fee to a French consulting firm. The manager then brought the partner into the picture and they were both suspicious of this payment. Why so large? Why had nobody informed them about it? Why was it buried in an obscure part of the contract?

The partner pursued it and ordered further investigation. It was discovered that payment under this clause was made to the consultant’s bank in the British Virgin Islands and the auditors thought it was probably a bribe. So even though the sign-off was due the next day, they refused to do so, much to the ire of their US affiliate that audited the parent company.

Weeks of intense enquiry did not reveal what the money was actually used for, but it was discovered that the principal behind the French company was a very wealthy Middle Eastern man with a rather unsavoury reputation. The directors of the Canadian company pressured the auditors to sign off, saying that it was a necessary contract cost so nothing more needed to be done. The audit partner was aware that if this was a bribe it would be an illegal act and be required to be at least disclosed separately, and the SEC was involved as well. He was asked to attend a directors’ meeting to explain his approach. He told the directors that this payment could not be supported by any available evidence and that meant that, for all they knew, the funds could actually have been pocketed by the CEO himself (who was sitting at the table!). The directors did see the light at that point. The auditors never did sign an audit opinion and, since the Canadian subsidiary went into bankruptcy soon afterwards, no further audits were performed.

Questions:

1. Why did the note: “Read the Iran contract” trigger the manager’s professional skepticism?
2. How important is it that all working papers be reviewed, and why?
3. Is having to work on a weekend part of life for an auditor? Why?
4. If this bribe had not been discovered and a clean opinion given, would the financial statements have been incorrect?
5. What are an auditor’s responsibilities if they suspect a bribe has been paid?
6. What risks flow from tight time deadlines and fee budgets?
7. Why is it important to review significant contracts and agreements?

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.