

Missing Ingots

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Tensions ran high as financial constraints began to choke the life out of Precision Casting Pvt. Ltd. (PCPL). After enduring another horrendous fiscal year, banks had refused the company's founder any sort of financial support and the company's financial position hit rock bottom. Bankruptcy seemed like the inevitable fate of the corporation.

Rewind 12 years and we'll see how PCPL came into existence. Ronald Lee had just graduated with a metallurgic engineering degree from the National University of Singapore. He already had a degree in management, and with his newfound achievement, felt that he was ready to take on the world. He returned home to Malaysia and married the daughter of a high-flying local businessman. His union with Sheryl came with its own benefits. Being married into a family with a sound business background, Lee soon became acquainted with big business and high-ranking government officers. In just a few short months, Lee had received approvals to develop land for his operations and to bring foreign workers into the country from Bangladesh. By January of the following year, PCPL was established as a small corporation that produced high-pressure aluminum die-cast parts for automobile companies. The quality of his products was unmatched by any competitor in Asia and within two years, PCPL had become the leading Asian supplier. However, nothing lasts forever. Lee was unable to handle the quick success and had developed 'the habits of an arrogant socialite. His attention to his work dropped severely and, as a result, the quality of the products declined and the profit margin dwindled. One year later, PCPL had begun sustaining severe losses and Lee had to liquidate 20 percent of the company's assets.

A Beacon of Hope

Yet now, as Lee sat in his high-rise office overlooking the Kuala Lumpur skyline, a grin spread across his face. Out of the dark abyss that was about to

engulf PCPL came a beacon of hope that could save the company — Ahmad Siddiqui and Yeo Ah Fatt had agreed to invest in PCPL. Ahmad Siddiqui was a manpower supplier in Malaysia who had made millions over the course of ten years. He was also the sole supplier of staff to PCPL and had developed a close friendship with Lee. Yeo Ah Fatt was an automobile spare-parts dealer who placed frequent orders with PCPL and was also well acquainted with Lee. However, the two new investors did not conduct due diligence and review any of PCPL's financial records before deciding to invest.

As a soft-spoken but shrewd businessman, Lee understood very well that Siddiqui's eagerness to invest in PCPL came from a desire to elevate his image from that of a labor supplier to an established businessman. This suited Lee just as well; his own extravagant lifestyle and ambition to be recognized in the high society of nouveau-riche Malaysians had opened many social opportunities for him. He could relate to Siddiqui's reputational concerns, and Lee had no qualms exploiting those concerns in his hunt for someone to boost PCPL's dwindling capital and prop up the failing corporation. Siddiqui was impressed with Lee's supposed business acumen and trusted him as an expert in the industry. Lee's other close business associate, Ah Fatt, wanted to invest because he hoped to establish a supplier at minimum cost in order to beat his competitors. Ah Fatt owned more than a dozen retail outlets and was too busy managing them to directly take part in PCPL's operations, but he trusted Lee's ability as a quality manufacturer with sound experience in the aluminum die-cast industry.

Siddiqui invested \$4.5 million in PCPL and held 60 percent of the company's total capital in the name of his wife; they both became members of the board of directors of PCPL. Ah Fatt invested \$2.5 million and gained control of 30 percent of the capital. Lee controlled the remaining 10 percent. Neither of the investors conducted proper financial due diligence. They trusted Lee's forecasts of future profits and audited financial statements from the past three years, which reflected only nominal losses but piled up creditors. The unsuspecting investors were convinced that the "minor" financial setback could be overcome by purchasing new machines with their investment. They firmly believed that with Lee's expertise and their investment, PCPL would start generating profits quickly. Since both these new investors were busy with their existing businesses, they allowed Lee nearly complete freedom in running the show as he had been doing for the past decade. Siddiqui, as one of the signatories of all the bank accounts, hardly raised any questions about payments being made to the various suppliers.

Since neither of PCPL's new majority owners participated in the company's day-to-day operational activities, they did not doubt the authenticity of the first few quarterly financial reports they were given — things seemed to be going smoothly. PCPL showed a net profit of \$380,000, which was quite encouraging for new investors/owners.

Siddiqui was satisfied because his company was fulfilling all of PCPL's labor needs, and Ah Fatt was enjoying supplies at very competitive rates. What they did not realize was that there was something cooking right under their noses and it would completely destroy PCPL.

Declining Performance

During the second half of the following year, Lee called a board meeting to discuss certain issues pertaining to increased competition and a dwindling gross margin due to a variety of factors — all of which he convincingly explained. Both of his investors considered the problem genuine and vowed to provide full support to Lee. Siddiqui even agreed to extend a credit term of six months for payment of workers' wages and Ah Fatt agreed to a cash term for supplies made by PCPL.

Despite the support of the investors, PCPL's situation did not improve and a few months later Lee requested that Siddiqui and Ah Fatt lend him some money on his personal guarantee because the bank had already refused to increase his loans. Reluctantly they both approved his proposal, which opened a floodgate of borrowing. In less than eight months Lee had borrowed approximately \$1.6 million to meet various liabilities at an interest rate of 24 percent. The financial results at the end of the year worried both investors but they were reassured by Lee that some big orders from two well-known customers would pull the company back to profit.

The next year produced a loss of \$2.4 million with huge amounts owed to creditors and other mounting liabilities. This was the last straw for the investors. Ah Fatt met Siddiqui at his office to discuss the problem privately, and they decided to get to the bottom of PCPL's issues without letting Lee know about their concerns. They noticed that despite a 10 percent increase in sales, PCPL's consumption of raw material had increased by 26 percent — an alarming situation. The duo decided to recruit my fraud examination firm to investigate.

The Cost Analysts

With Lee in control of the entire operation and their investment at stake, Siddiqui and Ah Fatt did not want to scare Lee. So they introduced me to him as a cost analyst they hired to determine if any of PCPL's costs could be reduced. Since both of his major shareholders were firm about the decision, Lee had no choice but to allow our engagement.

My team and I had very little knowledge about the aluminum die-cast business when we accepted the assignment, so before we began the investigation, I spent about a week studying the industry and Lee's operation to get a fuller picture. I hired Alexander Tan to be our team's subject matter expert and had quite a few questions for him, such as:

- What is the average waste of aluminum when it is melted and used for die cast (known as *dross*)?
- What is the accepted level of impurity in standard aluminum ingot in terms of percentage?
- What is the productivity rate for a 200, 400, 600 and 1,000 tons PSI (pressure per square inch) machine?
- How and where is impure aluminum scrap disposed of and what is the current prevailing price for it?
- What is the normal rate of defect with die-cast products and what is the process for recovering aluminum from defective products?

The price of aluminum ingots is governed by the London Metal Exchange (LME) with a certain amount of premium, so I also visited the LME and other websites to obtain technical data and price movements of aluminum in the past 36 months. We gathered further information about other major players in the industry in Malaysia and prevailing market practices to know how the cost was derived, when a new die cast was needed and the mechanism of transferring the cost of the die to the customer for whom it was cast. This information-gathering exercise helped me to appreciate the genuine difficulties Lee would have maintaining records with complete accuracy.

After a week of research, armed with all the relevant information, I was ready to bring my investigation into a case that had been baffling the investors for more than two years. Since the issue concerned an excess consumption of the basic raw material compared to product output, my first objective was to confirm whether excess consumption actually existed.

The figure that reflected the purchase of raw aluminum ingots came from the general ledger and then we segregated all the purchase invoices because they would provide quantitative details for us later. Due to the fact that all the products were sold based on weight, we had some extra work on our plate to convert our figures. With the help of the marketing department's database and based on the standard weight for each and every product sold, all the sales quantities were converted into kilograms. We also determined the quantitative details of raw materials purchased, works in progress and finished goods. The results were both appalling and baffling — they suggested that an excess of 110 tons of aluminum had been purchased in one year alone. This, of course, profoundly affected the purchase cycle, production cycle and revenue cycle.

Working Hypotheses

After carefully studying PCPL's internal control infrastructure, I developed a few theories to account for the missing 110 tons of aluminum, taking into account the internal control weaknesses I had observed.

- The excess raw materials that Lee purchased never reached the factory but were debited to the purchases anyway.
- The raw materials had been received, and semifinished goods had been produced and sent to a third party for final processing, but they had not been returned to PCPL or been accounted for properly.
- Raw materials had been rejected and sent to outside parties for remelting but had not been returned.
- More semifinished goods were sent out for further processing than the records showed, because Lee did not maintain quantitative records of defective and unfinished goods.
- Stated dross (waste) was higher than the actual quantity, and/or while disposing of the dross, quality aluminum had also been snuck out of PCPL's inventory.
- Finished goods had been shipped out to local customers and paid for with cash, hence no sale was recorded.

We tested these hypotheses one by one, and an examination of the purchase invoices confirmed that:

- Five different invoices that had been issued on different dates for the purchase of aluminum ingot could not be matched against entries in the inventory logs. If the materials had been delivered, they had not been entered into inventory.
- The supplier on these five invoices was the same — Ganesh Metal Industries — but it was not a regular industry supplier of ingot.
- The name of the truck driver on all five invoices was the same and the signatures were similar, but not exact matches. This suggested that it was not the same person signing each time.
- The five questionable invoices did not include a delivery time, but all of PCPL's other invoices did.
- There were no entries in the PCPL's guard book (maintained by security at the main gate) to confirm the vehicle numbers of delivery trucks for these five invoices.

The total weight of the aluminum on these five suspicious invoices equaled 66 tons, but we were looking for 110 tons of missing aluminum. This indicated that Lee, the one in charge of PCPL's books, had used more than one method to record higher consumptions and falsify the company's financial results. To confirm that the material had not been received but payments had been made nonetheless, I moved to the second stage of the investigation and guided my team to test the validity of our other hypotheses.

To gather evidence related to the five suspicious invoices, we thoroughly scrutinized journals and ledgers for any entries related to the purchase of raw material. For three of the five payments, the bank statement

revealed payment was made with a check made out to cash, as opposed to a typical check with the supplier as the payee. Although PCPL's controller, Tina Khoo, insisted that cash checks had been issued to Ganesh Metal Industries upon its request, it was a highly unusual practice; we could find no other cash payments to suppliers at any point throughout the year.

After obtaining authorization from Siddiqui, I made photocopies of all the checks that had been used to pay suspicious suppliers and was able to confirm that the checks had been cashed by Lee — his name, signature and identification card number appeared on the back of the checks. In addition, we discovered three payments to a second company by the name of Multiple Construction, but the bank payment voucher and check stub reflected it was paid to Ganesh Metal Industries, which had supplied the aluminum associated with the five suspicious invoices.

Suspicious Vendors

We conducted background checks into Multiple Construction and Ganesh Metal Industries and discovered that Ganesh was a subsidiary of Multiple Construction, which had three directors, one of whom was named William Lee. Since the last name Lee is common and I didn't want to jump to conclusions, I approached the bank where the cash checks had been presented and was able to confirm that, although Ronald Lee was not a director at Multiple Construction, he was the sole signatory on the bank account. So Lee had, in essence, written a check to himself. We were still looking into the connection between William and Ronald Lee, but had not found anything conclusive yet.

Further investigations confirmed that Ronald Lee had used different methods to inflate the cost of production through bogus purchases, padded expense claims and payment of commissions to secure orders. He was the initiator of the scheme but had help from his trusty lieutenant, PCPL's controller, Tina Khoo, who was exceptionally skilled in her understanding of audit procedures and financial statements. She helped Lee keep the fraud concealed for almost three years. It seemed that Lee's manipulative objective behind the entire fiasco was to siphon off profits from PCPL for personal use to fund his lavish lifestyle.

Since my team was simultaneously testing the validity of other hypotheses, we were able to confirm that the goods that had been sent for re-smelting were properly recorded and the recorded waste was not higher than actual. Cross-verification and recording of transaction did not provide any indication that these records had been manipulated. Interestingly, the company to which material was sent to be re-smelted was Multiple Construction. In addition, PCPL's records regarding the aluminum sent to them were not satisfactory — the goods sent out did not reconcile with the total, re-smelted quantity that PCPL received back, after deducting the units that had been damaged during processing and those still being processed. The

gap was substantial and a number of the relevant documents we needed to confirm the figures were missing.

My team and I turned our attention to the documents that indicated how much raw material was with Multiple Construction and compared the numbers with the invoices from the processor. It appeared that the amount of aluminum on the processor's invoices was more than PCPL received. The invoices did not include any supporting documents, but, despite such obvious red flags, Lee approved the invoices for the payment himself.

A visit to the factory with Siddiqui revealed that some processed material was packed in different packaging without labels and shipped directly to car-part traders. We could not locate records of sales to any of these traders.

We collected the daily production records generated during each shift for each of the nine die-cast machines Lee owned and compared them to those maintained by the production department. The machine records showed much higher production levels than the department reports. Our detailed analysis allowed us to clearly show that machines were in operation, raw material was consumed and goods were produced, but not all of the final material was moved into production. We discovered that those missing quantities were shipped to Multiple Construction and then on to dealers and customers, as per Lee's instructions. The sales were deposited in the designated account held by Lee and not recorded on PCPL's sales accounts — although the expenses of the transactions were well documented. William Lee at Multiple Construction received 10 percent of the sales for his help in the scheme.

To bring the case to a conclusive end we interviewed Ronald Lee and presented him with all the evidence. He readily admitted his fraudulent scheme to divert sales from PCPL and keep the profits to himself. He told us that William Lee was his cousin and that he had agreed to help with the scam for a percentage of the profits.

Currently both Siddiqui and Ah Fatt are negotiating a settlement with Lee to get their money back with interest, but they have both said if the negotiations fail, they will take legal action against Lee. To date they have not filed a complaint with the police because they are afraid that Lee, with his friends in high places, could make their report ineffectual and then they could lose the chance of recovery through negotiation.

Lessons Learned

- Siddiqui and Ah Fatt both learned not to trust people with their money without conducting proper financial due diligence. They trusted Lee as a business associate and friend, and let their

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personal relationship cloud their professional skepticism. They also said if they could do it again, they would also have consulted with industry experts to look for any operational red flags already present in PCPL.

- Too much trust without proper control and supervision provided ample opportunity for Lee to show losses and divert profits from the business, which led his investors to believe that the die-cast business was not profitable.
- Ah Fatt and Siddiqui have also acknowledged the importance of accounting professionals and their role in providing invaluable services — especially when new investment is required. However, it was an expensive and painful lesson for them both to learn.

Recommendations to Prevent Future Occurrences

- Conduct proper due diligence before investing to check the financial history of the company and to see if it is operating with the normal range of the industry. Look for conflicts of interest among principals of the investment company and its vendors or customers.
- Professional skepticism is not just for auditors. Employees in a business should watch for red flags and report them to their supervisor or an anonymous hotline.
- Be active in your investments. If you hand over control with your money, you have no way of knowing what is happening to it.

About the Author

Prabhat Kumar, CFE, FCA and qualified forensic accountant, is Director and Senior Consultant with Alliance IFA (M) Sdn. Bhd, a company providing forensic accounting services in Kuala Lumpur, Malaysia. He has more than 18 years of experience in audit, accounting and financial expertise. For the past six years, he has focused his practice in financial information analysis and forensic accounting for the purpose of detection of fraud and to provide litigation support services. He has been instrumental in instituting a sound and effective internal financial control system for various entities, including multinational corporations.