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Germany's Wirecard Scandal

The largest accounting fraud in the country's postwar history.

By Klaus C. Engelen

While all of Europe is still in the grip of the worst pandemic in a century, Germany's political and financial establishments are also haunted by the Wirecard AG scandal. It is turning out to be the largest case of accounting fraud in the country's post-war history. The sad story is that most of the political and financial establishments at all levels aided and abetted the mega-fraud.

On June 25, 2020, Wirecard, a darling of investors for years, filed for insolvency after revelations that €1.9 billion ($2.14 billion) was "missing" from its balance sheet, supposedly deposited in escrow accounts at two reputable Philippine banks.

The Wirecard scandal marks the first time that a member of the DAX, the blue-chip index of now forty major German companies trading on the Frankfurt stock exchange, has gone broke. When Wirecard took the place of Commerzbank AG in the DAX in September 2018, the fintech's shares were worth about €20 billion.

Its Austrian CEO Markus Braun, who owned 7 percent of Wirecard, was a billionaire. Now Braun (51) is in detention awaiting trial with two other company executives. His second-in-command Jan Marsalek (40), also Austrian, who was in charge of the company's Asian business, has vanished, and is pictured on a Europe-wide police search list.

GERMAN FINTECH DREAM SHATTERED

Wirecard, based in Aschheim near Munich, is now an insolvent global payments company that operated largely behind the scenes of online commerce. Founded in 1999, the company started by processing payments for gambling and pornography, before offering its customers in many regions of the world electronic payment transaction services as well as the issuing of physical cards. According to its promotion material, Wirecard authorized and processed payments for about 280,000 merchants, issued credit and prepaid cards, and provided technology for contactless smartphone payments. Clients included German discounters Aldi and Lidl as well as nearly one hundred airlines. Since January 2006, the group included a bank with a full German banking license. At its peak, Wirecard had 5,300 employees.

"Over the past decade Wirecard has fueled its expansion by buying smaller payment processing businesses and groups of customers around the world, including a 2017 move to take on 20,000 merchant clients of Citibank, spread over eleven Asia-Pacific countries," reported the

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Financial Times. "The deal was intended to make the company a household name across the region."

Financial Times kept digging

After the *Financial Times* began raising grave questions about Wirecard's accounting practices, the company cast such criticism of its global business model as the work of market manipulators and their journalistic helpers. When Dan McCrum, who led the *Financial Times* investigation on Wirecard along with his colleague Stefania Palma, published his story "Wirecard's suspect accounting practices revealed" on October 15, 2019, the headline should have been an alert to Germany's supervising agencies and institutions and a wake-up call to investors and creditors. "Internal company spreadsheets, along with related correspondence between senior members of Wirecard's finance team, appear to indicate a concerted effort to fraudulently inflate sales and profits at Wirecard businesses in Dubai and Ireland, as well as to potentially mislead EY, Wirecard's tier-one auditor."

McCrum and Palma go on: "In its defence, Wirecard has claimed that FT reporters have facilitated market manipulation in collusion with short sellers. These allegations have been widely circulated in the German media and are the subject of a legal complaint in Germany, an investigation by BaFin, the German financial regulator, and a probe by prosecutors in Munich."

Germany's political and business elites were blinded by the rise of what some saw as a "German PayPal."

In an effort to counter the damaging *Financial Times* accusations, in October 2019 the company hired KPMG, EY's competitor, to conduct an independent investigation of the company's books. During the following months, Wirecard's top managers predicted confidently that KPMG would vindicate its accounting and deliver a final repudiation to its critics.

But things turned out quite differently. On April 28, 2020, the publication of KPMG's report saw Wirecard shares in the DAX crash 26 percent as investors learned that KPMG investigators had faced obstacles in their attempt to verify that large parts of the business were real. Wirecard shares fell again the next day, to close down another 8 percent.

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The KPMG report, as it transpired, was also the end of "Project Panther," an audacious plan by CEO Braun to take over Deutsche Bank with its stock market valuation of €14 billion, roughly the same as Wirecard, but with assets of €1.4 trillion. First reported by Bloomberg, Braun had hired McKinsey consultants to work out a plan according to which the new combined "Wirebank" would by 2025 generate €6 billion in additional profit and could double its stock market valuation to €50 billion. Such a takeover would offer a way to hide the massive Wirecard fraud in the huge balance sheets of both companies.

When EY, Wirecard's auditor for over a decade, refused to sign off on the 2019 accounts, forcing Braun to admit that €1.9 billion of its cash probably did not exist, Wirecard's bankruptcy could not be avoided.

Government failings

Opposition parties in Germany's Bundestag have been able to expose many of the spectacular government failings and absurdities leading to the protracted Wirecard disaster. The Free Democrats took the lead in pushing for a committee of inquiry, especially Frank Schäffler, who sits on the supervisory board of Germany's Federal Financial Supervisory Authority (BaFin).

Schäffler considered BaFin's weak internal controls for employees who were speculating on Wirecard stock without respect for conflicts of interest as a scandal. Together with his Free Democrat colleagues, he forced the German finance ministry to undertake a special inquiry into Wirecard trades by BaFin employees. In another blow to the regulator's reputation, BaFin issued a press release in January 2021 saying that it had suspended an employee in its securities supervision department for insider trading in structured products of Wirecard stock.

Also embarrassing was that Ralf Bose, the head of the Auditor Oversight Body, the agency that regulates auditors in Germany, was relieved of his duty over personal dealings in Wirecard shares weeks before the collapse.

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In the wake of the scandal, the government decided to terminate its contract with the Germany's private-sector accounting watchdog, the Financial Reporting Enforcement Panel. It is expected that in the coming reform effort, BaFin will get a broader mandate to start enforcement actions on financial reporting on its own.

FREP was established in the aftermath of the Enron accounting scandal. The body has only fifteen staff members, and operates under a modest yearly budget of €6 million.

What came out in the Bundestag hearings was that BaFin in early 2019 asked FREP to start a probe into Wirecard in reaction to reports by the *Financial Times* of allegations by whistleblowers of accounting manipulation. A single auditor was charged to work on Wirecard, and little progress was made. That is taken as an indication of how much is wrong with the two-tier system of enforcing of financial reporting in Germany.

Heavy criticism regarding the German two-tier system of financial reporting enforcement also came from the Paris-based European Securities and Markets Authority, which was charged with investigating the events leading up to the collapse of Wirecard. In November 2020, ESMA presented a "Peer Review" assessing the events leading to the collapse of Wirecard and how the dual supervision by BaFin and the FREP failed to meet the challenge.

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Sven Giegold, the financial policy spokesperson of the Greens party in the European Parliament, concluded that the Wirecard report by ESMA shows that the German system of joint financial reporting enforcement by BaFin and FREP was unworkable. "If confidentiality rules thwart effective communication between the authorities and they sometimes disagree on their respective roles, it becomes too easy for fraudsters," he stated.

In the Bundestag hearings on Wirecard so far, both the ruling coalition parties were taken to account for their failings. For the Merkel-Scholz-Söder coalition of SPD and CDU/CSU, the Wirecard collapse can be seen as a huge embarrassment and a chance for opposition parties, especially the FDP, the Greens, and the Left Party, to attack the government. How this will play in the coming national elections is not yet clear.

It's plain that Germany's political and business elites were blinded by the rise of what some saw as a "German PayPal," and defended for too long BaFin's notion of short sellers and their media helpers badmouthing a promising German fintech.

The Bundestag's hearings on Wirecard reached up to Chancellor Angela Merkel, asking about her promotion of Wirecard in China. Before her China visit in September 2019, former defense minister Karl-Theodor zu Guttenberg, then a Wirecard lobbyist through his firm Spitzberg Partners, met with Merkel to request her help in trying to persuade Chinese officials to open doors for Wirecard in the digital payment market in China. After the visit, Merkel confirmed through her chief economic adviser Lars-Hendrik Röller that she had been able to make her plea. Other high officials from the coalition parties also have acted in support of Wirecard with or without being paid.

HOW WIRECARD AVOIDED SUPERVISION

Overlooked by many was that only the Wirecard Bank—a not-so-large part of Wirecard AG's worldwide operations—was supervised. Most of the Wirecard Group, seen as Germany's leading fintech success story, was not even designated as a financial holding company.

According to a letter from Andrea Enria, head of ECB banking supervision, to Martin Schirdewan, member of the European Parliament, the Wirecard Bank was categorized as a "less significant institution" and as such would be supervised directly by the "national competent authority," meaning BaFin and FREP under Germany's two-tier system of financial reporting enforcement.

According to Enria, BaFin was responsible for the decision not to designate Wirecard AG as a financial holding company. As Bloomberg noted, Wirecard AG as a financial holding company would have had to operate under much stricter accounting controls. As Enria noted in the letter, Wirecard was not subject to payments oversight as the firm's services and entities did not qualify as a payment system or payment scheme.

The Wirecard disaster makes a mockery of long-standing reform efforts in Germany and the European Union to improve financial market supervision, audit regulation, and accounting enforcement to better protect investors and creditors in a global market place.

Why the major business areas of Wirecard were barely supervised—and misused for creating fake sales and profits as well as becoming a global money-laundering operation—is high on the list of questions for investigations on Wirecard's bankruptcy.

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WAVE OF LITIGATION

It is not surprising that news articles predict a coming wave of litigation, especially against EY, Wirecard's auditor for ten years.

EY came out after the insolvency with the blatant statement: "There are clear indications that this was an elaborate and sophisticated fraud, involving multiple parties around the world in different institutions, with a deliberate aim of deception." EY auditors for years were unable to get proof of whether or not there was money in the faked escrow accounts with banks in Asia.

For a decade, EY's reputation as one of the Big Four accountancy and auditing firms has helped to rebuff

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criticism of Wirecard's questionable reporting and business practices.

Business and financial daily *Handelsblatt* sees the broad reshuffling of EY's top management and the positioning of former German Finance Minister Theo Waigel (CSU) to chair an independent commission of experts as moves to regain lost confidence in the accounting firm. Former German Economic Minister Brigitte Zypries (SPD) will also be part of the commission in a possible effort to get both leading German political parties on board. In a convoluted reshuffling of top personnel, EY's German head since 2016, Hubert Barth, will step down and take other European responsibilities.

It is also not surprising that there is talk of "Germany's Enron disaster with a difference." When Enron, an American energy company, declared bankruptcy in October 2001, its accountant Arthur Anderson, then one of the five largest audit and accountancy partnerships in the world, was dissolved. In response to Enron, WorldCom, and other notable accounting scandals, the U.S. Congress came up with new benchmark legislation and regulation to improve the supervision of financial reporting for public companies by passing the Sarbanes-Oxley Act in July 2002, with its far-reaching extension of U.S. laws to the rest of the world.

RADICAL OVERHAUL NEEDED

It took more than half a year after Wirecard's bankruptcy before embattled Finance Minister Olaf Scholz (SPD) forced BaFin's bosses out, arguing that BaFin "needs to be reorganized, so that it can fulfil its supervisory role more effectively."

Felix Hufeld, head of BaFin since 2015, and his deputy Elisabeth Roegele, who was in charge of financial market supervision, were pushed out without naming any successors.

"More 'bite" for a more flexible and effective Financial Supervisory Authority, and a promise to focus more heavily on preventive action and to investigate suspicious cases more swiftly and efficiently" is the German government's lesson from the Wirecard disaster.

Scholz, who at times backed the controversial BaFin stance of suspected market manipulation by short sellers and journalists, and disregarded press allegations against Wirecard, now wants to pursue three overarching

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goals: Make supervision and auditing more effective; streamline internal structures and procedures and allocating responsibility more clearly, and supervise the financial market more effectively.

Assisted by the consulting firm Roland Berger, Scholz came up with a seven-point plan to restructure BaFin, including a "forensically trained task force" for audits, and better data. When presenting this reform plan, Scholz drew attention to the new draft

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legislation, the "Act to Strengthen Financial Market Integrity."

Hopefully Scholz has looked at the February 6, 2021, issue of *The Economist* reacting to his seven-point roadmap. "The finance minister wants to hire more experts, in particular auditors: currently, only five of the roughly 2,700 employees of the watchdog are auditors." *The Economist* also quotes Fabio De Masi from the Left Party, who sits on the Wirecard committee. De Masi draws attention to what is urgently needed but not addressed by the finance minister: BaFin needs to become independent from the finance ministry.

That is also the key demand coming from the investigators at the EU level, the Paris-based European Securities and Markets Authority, which published a fact-finding report on the Wirecard disaster. ESMA sees "a heightened risk of influence by the Ministry of Finance given the frequency and detail of reporting by BaFin, sometimes before actions were taken."

From ESMA's rebuke, one can conclude that much of what BaFin did and didn't do in the Wirecard crisis was what Scholz's ministry was involved in. So let's not bash BaFin too much, and let's make Berlin's finance ministry also responsible for the Wirecard calamity. ◆