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The curious case of Wirecard

In hindsight, there were early signs of trouble affecting the firm

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Before the earth-shattering scandal last month, Wirecard was a global fintech company with its headquarters in Germany. It started in 1999 by helping websites collect payments from customers. PHOTO: AGENCE FRANCE-PRESSE

On June 18, global fintech company Wirecard admitted that large parts of its Asia business were misrepresented and that €1.9 billion (S$3 billion) in cash reported on their financial statements did not exist.

Five days later, the company filed for bankruptcy protection from creditors, and Wirecard's share price collapsed from more than €100 to less than €3.

In the largest auditing scandal since Enron, Wirecard's auditing firm of more than 10 years did not carry out even basic auditing procedures such as checking directly with banks to confirm that Wirecard held large amounts of cash in these banks.

While most experts will focus on deciphering dubious accounting practices and puzzling auditing failures, this article will focus on three non-auditing issues.

None of these issues were indicators of potential fraud but, combined, they start to look suspicious. Admittedly, however, everything looks obvious in hindsight.

REGULATORY CRACKS

Before the earth-shattering scandal last month, Wirecard was a global fintech company with its headquarters in Germany. It started in 1999 by helping websites collect payments from customers.

More specifically, it operated on the fringes of electronic payment processing business servicing online gambling companies and pornographic websites.

While traditional payment processing companies stayed away from these sectors due to high risk and small margins, Wirecard filled the gap.

As the past two decades witnessed a plethora of businesses moving online and away from traditional cash payments, this darling of the fintech industry experienced spectacular growth. In 2018, Wirecard became a payment processing giant worth almost €25 billion and was included in the prestigious German blue-chip index – the DAX.

After Wirecard acquired XCOM in 2006, the renamed subsidiary was licensed to issue credit cards and handle money on behalf of merchants.

Thus Wirecard became a fintech hybrid with banking and non-banking operations.

These hybrid fintech firms are not subject to the same rules as banks and financial firm. If a company does not meet the typical threshold of 50 per cent of its business in lending and taking deposits, it is not scrutinised like the banks.

Hence, while Germany's financial regulator BaFin regulated Wirecard's banking arm, it did not do the same for its payments processing business, which fell through regulatory cracks.

REVERSE TAKEOVER

Founded in 1999, the company was listed in 2005 via a reverse takeover of a defunct call centre group which was publicly listed.

A reverse takeover or a reverse merger is the process of going public via a back-door listing. In short, the private company buys shares of a public company and takes control. So effectively, the private company becomes a publicly traded one. This allows the private company to transfer its business operations into the public entity and bypass the complex process of going public via initial public offering (IPO) – a much more common method for going public.

Compared with IPO, reverse mergers happen at much lower costs, in much shorter time and with few regulatory requirements and little overseeing. Also known as back-door listing, this unusual method avoids the intense scrutiny and regulatory procedure of a typical listing via IPO.

Several have documented that reverse merger firms are typically smaller, less profitable and riskier than IPO firms, consistent with the notion that reverse merger is a way for smaller and less developed firms to become publicly listed.

Notoriously, a boom in reverse mergers of China-based firms in the United States ended due to a series of financial scandals in 2011, when more than 20 of such companies were delisted and as many as 42 out of 150 were accused of fraud.

PRICE MANIPULATION VERSUS PRICE DISCOVERY

Short-sellers had expressed concerns about Wirecard as early as July 2014, but every time they were met with accusations of price manipulation.

For example, when the Financial Times reported claims of forged documents in Wirecard's Asia headquarters in January last year, oddly, BaFin launched a probe into the FT reporting and an alleged attempt at share price manipulation.

In an unprecedented move, BaFin imposed a ban on short-selling of Wirecard's shares a month later. Even though BaFin banned the short-selling of banks during the global financial crisis in 2008 due to concerns of price manipulation, this was the first time that Germany's watchdog had banned the short-selling of a single company.

In 2016, short-sellers under the pseudonym Zatarra published money-laundering allegations against Wirecard. Again, BaFin started investigating the accusers for alleged price manipulation.

Soon after, critics of Wirecard started receiving "spear-phishing" e-mails in an online bullying attempt.

Finally, Wirecard hired KPMG to conduct a special audit, but the auditors were not able to clear the company.

Despite short-sellers' allegations of Wirecard's transgressions since 2014, it was not until June this year that EY, its auditor of more than 10 years, refused to sign its financial statements due to fraud concerns.

It was only in June that BaFin stopped blaming whistleblowers, journalists, investors and short-sellers and started probing Wirecard.

The example of Wirecard shows the value of short-selling when viewed from the perspective of price discovery and not price manipulation. The non-auditing issues should have given rise to suspicion among investors and, especially, Germany's financial watchdog.

While investors and BaFin cannot go back in time for a do-over, they can, at least, pay more attention to similar concerns in future.

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