Wirecard Scandal: Lessons for Corporate Governance

Lois Mwende Musikali*

Abstract

This article is a commentary on the Wirecard scandal. Wirecard AG (Wirecard) is a German processing and financial services company that was among the most valuable companies listed on the German Stock Exchange between 2010 and 2018. Between 2010 and 2018, Wirecard reported consistent revenue growth and profitability. However, Wirecard's success story unravelled in late 2019 when the Financial Times started raising questions about its accounting practices. In 2020, it was revealed that Euros1.9 billion was missing from its balance sheet. Investigations that followed uncovered a massive accounting fraud that had lasted years and Wirecard eventually filed for bankruptcy. Wirecard's executives were charged with fraud and market manipulation, and Wirecard's auditors, credit-rating agencies, indexes and the German Stock Exchange regulator were criticised for failing to detect and prevent fraud. The aim of this article is therefore to highlight the governance difficulties that emanate from the emergence of Fintech companies in the financial sector. It begins by describing the Wirecard scandal, an examination of how internal and external corporate governance mechanisms failed to prevent the Wirecard scandal follows and culminates with stating the corporate governance lessons that can be learnt from this scandal.

Keywords: Corporate Governance, Stock Exchange Financial Sector, Internal Control.

1. Introduction

German DAX-listed[1] Wirecard AG ("Wirecard"), is a Fintech payment processing company, once lauded as the beacon of innovation and success, that was involved in a 15-year long accounting fraud. Wirecard, was launched in

* Associate Professor and Dean, African Nazarene University, School of Law

1 The Deutscher Aktien Index (DAX) is the equivalent of New York's Dow Jones Index and the FTSE in London.

1999[2] as a payment processor assisting websites to collect credit card payments from their customers. In an online transaction, Wirecard would essentially collect payment from the customer, provide it to the credit card issuer, and then the credit card issuer would issue a commission to Wirecard. Wirecard offered its services in over one hundred currencies and connected to over 200 international payment networks (card networks, banks and payment solutions).[3] Suffice to say, Wirecard was positioned as a disruptor in the traditional banking industry.[4]

As a company, Wirecard was shaky from the start. Wirecard almost went into liquidation in the early 2000s. In 2002, Markus Braun, a former KPMG consultant took over as the new Chief Executive Officer (CEO) of the company. Wirecard went public in 2002 by taking over the listing of a defunct call center group, thereby avoiding the scrutiny usually applied to an Initial Public Offer (IPO). By 2006, Wirecard moved into banking, meaning that it could both issue credit cards and handle money on behalf of merchants. This was an unusual hybrid of banking and non-banking businesses, and that made them difficult to compare with their peers and helped them to persuade investors to rely on the company's adjusted versions of financial statements. In the last decade, Wirecard bought small companies across Asia in a number of restructuring deals.[5]

Unlike a regular company, Wirecard grew very quickly as a company which is atypical for many Fintech companies. However, companies that tend to irrationally expand tend not to be fully compliant with accounting and regulatory standards.[6] In this regard, Wirecard was issuing financial statements that essentially did not make sense. Since 2019, Dan McCrum of the Financial Times had been reporting that German Fintech company, Wirecard, was

2 Explained Desk, 'Explained: What is the Euro3.5 billion wirecard scam?', The Indian Express, (India, 22 July 2020).

3 Teichmann, F., Boticiu, S. R. and Sergi, B. S., 'Wirecard Scandal. A Commentary on the Biggest Accounting Fraud in Germany's post-war history' (2023) Journal of Financial Crime.

4 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie, 'Accounting Fraud and Bankruptcy: The Case of Wirecard AG' in *Theory and Practice of Illegitimate Finance* (IGI Global 2023) 224.

5 Pering, F., 'Zattara research & investigations - wirecard reports' (2020) < http://viceroyresearch.org/2020/07/03/zatarra-research-investigations-wirecard-reports/ > accessed on 8 February 2021. For an updated version of the foregoing report see https://viceroyresearch.org/wp-content/uploads/2020/07/final-main-report-zatarra-edited-3.pdf > accessed on 29 July 2024.

6 See generally, Musikali, L. M., 'The Law Affecting Corporate Governance in Kenya: A Need for Review' (2008) 19(7) International Company and Commercial Law Review 213-227; Shams, S., Bose. S., Gunasekarage, A., 'Does Corporate Tax Avoidance Promote Managerial Empire Building?' (2022) 18(1) Journal of Contemporary Accounting & Economics.

overstating some of its revenue. In response, Wirecard fought back accusing Macromack of conspiring with short-sellers[7] to push back its stock.[8]

These compliance shortcuts led to a situation where 1.9 billion Euros was missing. Short-sellers such as Chanos said that it was unlikely that these 1.9 billion Euros ever existed.[9] The 1.9 billion Euros was meant to be held in 'escrow accounts' which are third-party trust accounts that were governed by the trustees, but in reality, the accounts were non-existent.[10] These third-party companies were in the Philippines, Dubai, Singapore, countries where Wirecard did not have licenses to operate. Wirecard was sending business payments to these companies and essentially receiving commission from these third-party companies that they owned. The essence of this scandal is that Wirecard stated there was more cash on their balance sheet than there actually was. Wirecard has since filed for insolvency as they had Euros 2 billion in outstanding loans that needed to be paid. Eventually, Wirecard collapsed with its share value going below zero.[11] Wirecard is currently going through a restructuring: selling assets, closing its operations and cutting jobs. This will result in a much smaller Wirecard corporation than the Euro Giant that operated in Germany.

Not only does the Wirecard scandal have great implications for corporate governance within the Fintech sector, but also for corporate governance in general. Of particular concern is the effectiveness of internal and external control mechanisms. Neither were corporate governance mechanisms incorporated into the Board of Wirecard nor was external gatekeepers such as auditors, credit rating agencies, indexes and regulators effective in forestalling the Wirecard scandal. The Wirecard scandal has also had far-reaching consequences for both shareholders and stakeholders: many investors lost their life savings and thousands of Wirecard employees lost their jobs.[12]

---

7 Short selling involves borrowing a security whose price one thinks is going to fall and then selling it on the open market. One then buys the same stock back later, hopefully for a lower price than they initially sold it for, return the borrowed stock to their broker, and pocket the difference.

8 McCrum, D., 'Wirecard: Inside an accounting scandal', *Financial Times* (London, 7 February 2019).

9 Bloomberg Markets and Finance, 'Chanos says wirecard was probably never profitable (22 June 2020) < https://theglobalherald.com/business/chanos-says-wirecard-was-probably-never-profitable/ > accessed on 29 July 2024.

10 Litigation Financiers, 'Wirecard damages: Class action lawsuit for investors' (2020) < https://en.wirecardclaim.com/> 1 July 2020. See also Broadridge, 'Wirecard AG – The Class Action Case Files: September 2020 < https://www.broadridge.com/report/wirecard-ag > 29 July 2024.

11 Litigation Financiers (n 10) & Broadridge (n 10).

12 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 223.

2. Corporate Governance Failures and Lessons

The internal control function

A great starting point is to evaluate the robustness of Wirecard's internal control mechanisms. Control mechanisms generally ensure transparency, accountability and ethical conduct within corporations. Generally, internal control mechanisms consist of systems - designed to mitigate risk and safeguard shareholder and stakeholder interests, policies and procedures. In Germany, the primary internal corporate governance control mechanism or system is the dual-board structure also known as the two-tier board.

Wirecard had a dual-board structure consisting of both a Management Board and a Supervisory Board. The Management Board consisted of four members at the time of its insolvency and was led by the Chief Executive Officer (CEO) Markus Braun who was also the Chairman of the Management Board.[13] The Supervisory Board, responsible for the company's strategic direction, consisted of six[14] members at the time of its insolvency. Wirecard also had a Compliance Department that was responsible for ensuring ethical and legal business practices. The Compliance Department at Wirecard was headed by a Chief Compliance Officer and was responsible for implementing policies and procedures.[15]

Wirecard's internal control mechanisms failed spectacularly beginning with its dual-board system. Germany's Management Boards are usually checked by the Supervisory Boards whose membership includes industry experts and investors.[16] An interesting aspect of Wirecard's share-ownership was that its largest shareholder was its CEO, Markus Braun.[17] Not only was Braun doubling as Chair/CEO of the Management Board, he was also the largest shareholder of Wirecard therefore exerting great influence on the Supervisory Board. Wirecard's legal department consisted of young professionals instead of experienced lawyers.[18] This weakness created an environment where executives could manipulate financial statements and mislead other shareholders, creditors,

13 Jo, H., Hsu, A., Llanos-Popolizio, R. and Vergara-Vega, J., 'Corporate Governance and Financial Fraud of Wirecard' (2021) 6(2) European Journal of Business and Management Research 99.

14 Jo, H., Hsu, A., Llanos-Popolizio, R. and Vergara-Vega, J. (n 13) 101.

15 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 232.

16 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 231.

17 Teichmann, F., Boticiu, S. R. and Sergi, B. S. (n 3).

18 Teichmann, F., Boticiu, S. R. and Sergi, B. S. (n 3).

credit rating agencies, indexes and regulators about the financial health of Wirecard.

Wirecard's Corporate Governance Report and Corporate Governance Statement[19] issued on 29 March 2019 declared that the company had complied with the recommendations of the Government Commission German Corporate Governance Code (German Corporate Governance Code) with the following exceptions:

(i) Until the first quarter of 2019 there were no committees in the Supervisory Board.

(ii) Due to the special expertise and experience possessed by the Chairman of the Supervisory Board, the Chairman was also holding the position of Chairman of the Audit Committee.

The appointment of Mr Matthias as both Chair of the Supervisory Board and Chair of the Audit Committee is a contravention of the German Corporate Governance Code which recommends that the Chairman of the Supervisory Board should not also be the Chairperson of the Audit Committee.[20] An audit committee's main role as an internal control mechanism is to oversee and ensure the integrity of a company's financial reporting and auditing processes. This typically involves: reviewing the company's financial statements to ensure that they are accurate and comply with relevant accounting standards and regulations; appointing external auditors; monitoring the effectiveness of the company's internal control systems; and addressing any issues related to financial mismanagement or fraud. Despite Wirecard's accounting practices being called into question time and time again, the Supervisory Board did not exercise its duty of care by conducting an independent internal investigation of the allegations relating to Wirecard's accounting malpractices. Perhaps this was because Mr. Matthias was both the Chairman of the Supervisory Board and the Chair of the Audit Committee: how could he report himself? The absence of an Audit Committee in Wirecard's Supervisory Board prior to 2019 provides an explanation for why the Supervisory Board failed to conduct an independent internal investigation into the allegations on Wirecard's accounting practices much earlier. Not only was Wirecard's Supervisory Board dysfunctional when it came to its audit function, its decisions were also questionable. Wirecard's

19 Wirecard AG, 'Statement of compliance with the German Corporate Governance Code pursuant to section 161 of German Stock Corporation Act (AktG) as of 29 March 2019' <https://www.wirecard.com/wp-content/uploads/2021/02/2019_Wirecard_CG_2019_EN.pdf > accessed on 16 September 2024.

20 Section 5.3.2(3) Clause 3 German Corporate Governance Code.

Supervisory Board permitted the CEO, Markus Braun to borrow Euros 150 million from Deutsche Bank using his shareholding at Wirecard as security without considering the conflict of interest and the effect this would have on the stability of the company.

The Wirecard scandal underscores the importance of strengthening internal control mechanisms in supervisory boards. It has since been recommended that supervisory boards of members of Germany's DAX Index must also form audit committees[21]whose chairperson should be an independent financial expert.[22] Listed companies should not only be required to have an adequate and effective internal control system but also consider an external audit of their internal control systems.[23]

Whilst the presence of internal control mechanisms is essential for mitigating risks and ensuring accountability, their effectiveness ultimately depends on a number of factors: the commitment of companies to upholding ethical standards, whether the board members are able to avoid 'group think'[24] and the effectiveness of external control mechanisms.

The external control function

External control mechanisms in corporate governance are tools and practices outside the corporation that ensure that companies are managed properly and ethically. These include but are not limited to legal and regulatory frameworks, auditors, credit-rating agencies, indexes and the media.

The first indicator of a problem in the external control function of Wirecard was the presence of a complex corporate structure[25] which was very similar to the case in Enron. Enron was a high-flying US energy stock in the late 1990s, before it was met with a USD 74 billion accounting scandal that shook the corporate and financial world. Special purpose vehicles (SPVs) were used to conceal the fact that Enron was highly financially indebted. The same appears to be the case in Wirecard: its 'third party' companies created the picture that

21 Reuters, 'Germany's DAX Index gets Shake-up in the Wake of Wirecard Scandal' (Frankfurt, 24 November 2020).

22 Economic Governance Support Unit (EGOV), What are the Wider Supervisory Implications of the Wirecard Case? (P.E 651.385- November 2020).

23 Teichmann, F., Boticiu, S. R. and Sergi, B. S. (n 3).

24 Groupthink is a psychological phenomenon where the desire for harmony or conformity within a group leads to irrational or flawed decision-making..

25 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 233.

it was a successful company through a 'round tripping'[26] scheme. In both cases, the correct financial position of the company was never reflected in annual financial statements.[27]

Second, there was failure of the audit function as a gatekeeper. As was the case in previous scandals such as the Enron scandal, the Wirecard scandal involved both executives and auditors. There were warning signs. Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft (EY) has been sued for failing to provide financial statements for three years. EY had audited Wirecard since 2012 and issued it with unqualified audit certificates until 2018 despite signs of irregularities. EY is thought to have acted too late to the account irregularities in Wirecard.[28] KPMG, the external auditor, stated that they were unable to verify Wirecard Financial Statements since 2019, as they were requesting crucial information from the Singapore branch where Wirecard claimed that it had up to 1 billion Euros in cash.[29] This is a routine audit procedure that would have uncovered the vast fraud but it transpired that they did not get the information they requested. KPMG also states that it could not obtain the documents from banks in the Philippines to confirm the documents provided by Wirecard to the accounting firm EY.[30] The documents provided were of a spurious nature and appeared forged. It is generally felt that EY failed to monitor Wirecard as a company: they reacted too late to save this situation.[31]

The Wambach Report,[32] an audit into Wirecard following its collapse, cited more than 150 internal EY documents which were considered classified under German law, and found that EY did not fully implement professional guidelines and relied on verbal assurances from executive directors on critical questions, as well as failed to detect indicators of fraud.[33] EY's failure highlights the need for

26 Round-tripping is the unethical practice of purchasing and selling shares of the same security over and over again in an attempt to manipulate observers into believing that the security is in higher demand than it actually is with a view to creating fake trading volume.

27 PYMNTS, 'Wirecard, Enron and warning signs across two decades' (29 June 2020) < https://www.pymnts.com/news/security-and-risk/2020/wirecard-enron-warning-signs-across-two-decades/ > accessed 29 July 2024.

28 Litigation Financiers (n 10) & Broadridge (n10).

29 Granville, K., 'Wirecard, a payments firm, is rocked by a report of a missing $2 billion' *The New York Times* (NewYork, 19 June 2020).

30 Explained Desk (n 2).

31 Litigation Financiers (n 10) & Broadridge (n 10).

32 The Wambach Report was written by Martin Wambach, a partner at accounting firm Roedl & Partner, on behalf of a parliamentary inquiry committee into the Wirecard scandal.

33 Storbeck, Olaf, 'EY Files Criminal Complaint over Leaking of Classified Wirecard Report,' Financial Times (22 November 2021).

regulatory reforms that enhance transparency, accountability and independence of audit processes. In particular, a reform of external audits is recommended to strengthen auditor accountability coupled with a review of the effectiveness of existing public audit oversight bodies.[34] Effective regulation of auditors is not only crucial for the protection of investors and stakeholders but is also key in maintaining the integrity of financial markets.

Third, there was failure of the regulator as a gatekeeper. The German Federal Financial Supervisory Authority (BaFin) bears some responsibility for the Wirecard scandal as it allowed itself to fall into the hands of a charismatic self-dealing financial front man- the CEO, Markus Braun - who would wage a campaign against constant complaints by 'predatory' short-sellers. To understand this, it is important to examine the core of the Wirecard fraud.

The basis of the Wirecard fraud was tied to a small Dubai-based third-party acquirer called Al Alam Solutions.[35] Acquirers are the link in the payment chain that collect money from card issuers and deposit it in store owners accounts. Merchants will usually negotiate directly with the acquirers to process payments on their behalf. For each payment that acquirers help the merchants collect, they charge a fee. On paper, Al Alam was one of Wirecard's most valuable assets processing billions worth of payments across Europe, the Middle East and the United States. Yet when the Financial Times investigated this priced asset, they found an operation which had about six or seven full-time employees. When the Financial Times reached out to the biggest customers of Al Alam, 15 said that they had never heard of Al Alam and 8 of them had actually closed down their operations a year prior in 2017. More significantly, neither Visa nor Mastercard even had a relationship with Al Alam.[36] Wirecard was therefore inflating revenue by reporting false transactions. These false transactions led to commissions that were reported and recognized but never truly existed and were deposited in fake off-shore bank accounts. Over the course of ten years, this led to approximately 2.2 billion dollars that was reported but never actually existed. The Financial Times wrote various posts giving detailed analysis of Wirecard's financial and accounting inaccuracies. Each time Wirecard would cry foul and complain to anyone who would listen that the Financial Times were conspiring with short-sellers to bring their stock price down. The most pertinent aspect was that it

34 See Teichmann, F., Boticiu, S. R. and Sergi, B. S. (n 3). Public oversight bodies such as the Public Company Accounting Oversight Board (PCAOB) in the USA oversee the audits of public listed companies with a view of protecting shareholder and stakeholder interests.

35 McCrum, D. and Storbeck, O., 'Wirecard's Dubai business partner enters liquidation', *Financial Times* (London, 15 May 2020).

36 McCrum, D. and Storbeck, O. (n 35).

actually worked: BaFin actually filed a complaint against the Financial Times and banned short-selling of Wirecard stock.[37]

This ban on short-selling was the first time that Germany's Financial Regulatory Authority had ever banned the short-sales of an individual stock. Matt Levine from Bloomberg states that companies that are not doing fraud, when asked about whether they have faked their revenue, usually respond by explaining where their revenue comes from. Companies that are doing fraud, when reporters ask about their revenue, usually call the police to try and get the concerned reporters arrested.[38] This is an important lesson that can be taken from the Wirecard scandal. The Wirecard scandal highlights the dangers of unchecked corporate ambition particularly blind trust in charismatic CEOs. BaFin's blind trust in Wirecard fostered a culture of fear and intimidation, thereby discouraging whistleblowers from reporting any concerns they had about the management of Wirecard. This contributed greatly to creating an environment where Wirecard's fraudulent activities could go on unchecked and unchallenged leading to the loss of billions of Euros by investors and creditors. For this reason, the Wirecard scandal is a German embarassment: Germany's prospective investors are now concerned about the effectiveness of BaFin as a regulator.[39]

Fourth, some credit-rating agencies did not play an effective part in the monitoring process. Moody's rated Wirecard's bonds as being 'investment grade' until the end of June 2020 when it downgraded Wirecard and eventually withdrew the credit rating.[40] The auditors did not spot this and neither did the credit rating agency nor the equity investors. The same case applied to indexes. At the time of its collapse, Wirecard had been a member of the DAX Index for two years. Before September 2021, the DAX Index consisted of the 30 largest blue-chip German companies trading on the Frankfurt Stock Exchange.[41] The collapse of Wirecard has resulted in an exit from the DAX Index by companies including Vanguard, German Stalwarts Commerzbank, ThyssenKrupp and

37 Granville (n 29).

38 Ippolito, M., 'How Wirecard became the new Enron' (Blockworks Group, 23 June 2020) < https://blockworksgroup.io/blog/how-wirecard-became-the-new-enron > accessed 1 July 2020.

39 Dw.com, 'Germany to overhaul regulator after Wirecard scandal' (2020) < https://www.dw.com/en/germany-to-overhaul-regulator-after-wirecard-scandal/a-54061884 > accessed on 29 July 2024.

40 Taylor, E. and Morales, N. J., 'Wirecard seeks new financing strategy after Moody's junk downgrade' (20th June 2020) < https://www.reuters.com/article/us-wirecard-accounts-ratings/wirecard-seeks-new-financing-strategy-after-moodys-junk-downgrade-idUSKBN23R0K5 > accessed on 29 July 2024.

41 See Reuters (n 21).

Lufthansa. This exit has necessitated a review of the quality of the DAX Index with a view to aligning it with international standards.[42] The now expanded DAX Index consists of 40 of the largest and most liquid German companies that trade on the Frankfurt Stock Exchange: this expansion is seen as bringing in "more diversification and more stability."[43] The new rules of joining the DAX Index require a profitability requirement. A company must have had positive earnings before interest, taxes, depreciation and amortization for two years prior to joining the index. The rules also allow for expulsion from the index after a 30-day warning where a company fails to publish audited accounts and quarterly earnings[44] – something that Wirecard failed to do prior to its collapse.[45]

Finally, the Wirecard scandal underscores the importance of independent and critical journalism in unearthing corporate scandals. Investigative reporting played a key role in exposing the fraudulent practices at Wirecard, heralding the recognition of the entry of another gate-keeper in corporate governance – the media. Through the Wirecard scandal, the media's role as a gate-keeper is more defined: the media is a watchdog that holds not only corporations but also regulators accountable. However, for the media to function as an effective external control mechanism, a safe environment for whistle-blowers is required. In addition, stock market regulators as an external control mechanism need to take reports by whistle-blowers seriously and commence investigations into the same immediately.[46]

3. Conclusion

The Wirecard scandal has been described as the biggest accounting fraud in postwar Germany. The CEO of Wirecard ultimately resigned and was arrested on charges of manipulation and false accounting.[47] Prosecutors in Munich are investigating the remaining Management Board for failure to disclose minutes. The Chief Operations Officer (COO) Jan Marsalek, was dismissed without notice and is said to have escaped to Asia before an arrest warrant was issued

42 See Reuters (n 21).

43 See Reuters (n 21).

44 George Geddes, 'Germany's DAX Tightens Rules Following Wirecard Scandal' (ETF Stream, 25 November 2020) < https://www.etfstream.com/articles/germanys-dax-tightens-rules-following-wirecard-scandal> accessed on 14 September 2024.

45 See Reuters (n 21).

46 Teichmann, F., Boticiu, S. R. and Sergi, B. S. (n 3).

47 Jo, H., Hsu, A., Llanos-Popolizio, R. and Vergara-Vega, J. (n 13) 96-106.

against him.[48] Other executives, including the Chief Financial Officer (CFO) were also arrested and charged with various offences related to accounting fraud.[49]

Not only has the collapse of Wirecard had far reaching consequences for both shareholders and stakeholders, but it has also highlighted various lessons for corporate governance. First, the need for transparency and accountability in the financial sector cannot be overstated. The Wirecard scandal has underscored the importance of doing thorough due diligence and maintaining a skeptical attitude towards financial reporting.[50] Secondly, the need for robust control mechanisms in corporations and effective regulatory oversight. The Wirecard scandal has raised serious questions about the role of auditors, credit-rating agencies, indexes and regulators in detecting and preventing corporate fraud and highlighted the need for improved monitoring and enforcement.[51]

In sum, the Wirecard scandal serves as a cautionary tale not only of the risks of unchecked corporate greed and the devastating consequences of corporate governance control mechanism failures but also of the risks associated with disruptive fintech companies and the potential vulnerabilities in their operations.[52] This article contributes to literature by illuminating the role of the media as a gate-keeper in corporate governance. Additionally, it calls for a regular external review of the effective function of internal corporate governance mechanisms with a view to creating a more resilient and trustworthy financial ecosystem that prioritizes integrity and sustainability. A key area of future research would be a comparative analysis on the form that an external audit tool for appraising internal control mechanisms would take in countries classified as having the Anglo-Saxon system of corporate governance and in those categorized as belonging to the European system of corporate governance.

48 Litigation Financiers (n 10) & Broadridge (n 10).

49 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 233.

50 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 225.

51 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 224.

52 Baranidharan, S., Ajekwe, Clement and Nakitende, Marie (n 4) 224.