

# FINTECH REGULATIONS: WHAT WE CAN LEARN FROM THE COLLAPSE OF WIRECARD

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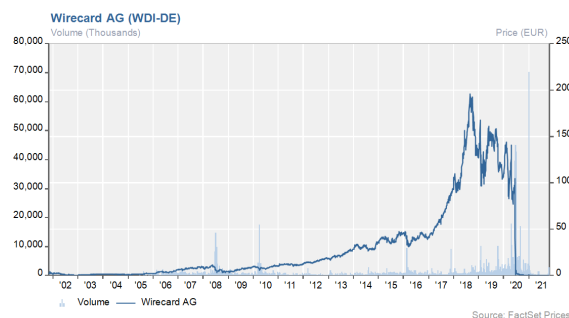
## ABSTRACT

This is a case study about the rapid collapse of German fintech giant Wirecard AG in about 6 months of time. The purpose is to formulate an understanding of what factors may have contributed to the firm's rise and downfall, and what lessons we can learn from it.

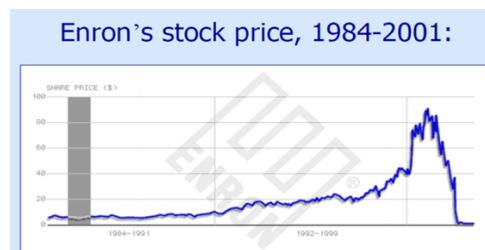
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## INTRODUCTION

A major global scandal during the pandemic in the summer of 2020 was the collapse of German fintech giant Wirecard AG. It filed for insolvency after it was discovered that €1.9 billion was lost from its balance sheets in 2020. The speed of falling from grace is unprecedented and can be observed in the following stock price chart.

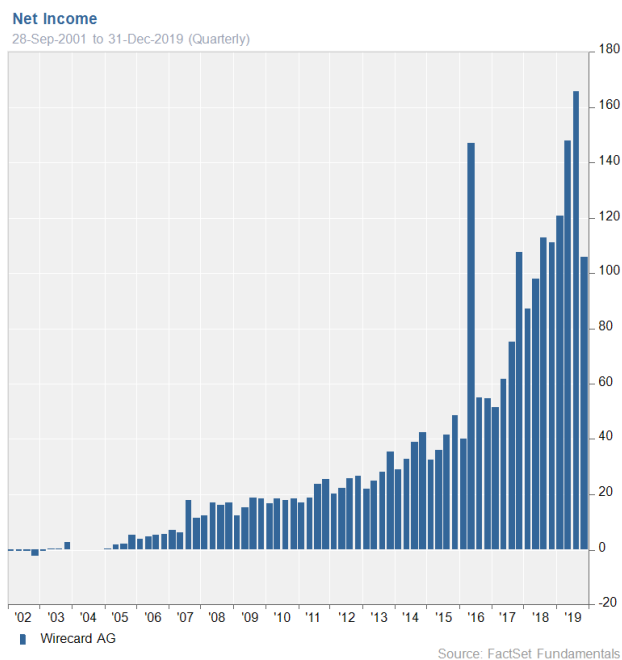


In many ways, Wirecard's rise and fall is very similar to Enron's. It is a Germany version of US' Enron. Enron's fall in 2002 became one of the biggest auditing failures in U.S. history. Below is a stock price chart of Enron<sup>1</sup>. The purpose of this case study about Wirecard is to formulate an understanding of what factors have contributed to the rise and downfall, what lessons we can learn from this, and what improvements can be made so that similar events can be prevented in the future.



## WIRECARD'S RISE

Wirecard's primary business in payment processing. It took about 20 years for the firm to grow from a small Munich start up to a prominent European or global FinTech player. For many years, Wirecard stood as a gold standard for German business. In August 2019, about 4 months before Wirecard starting its short journey of falling from grace, news about Wirecard were still very positive and aspiring. In its 2019 half-year financial report<sup>2</sup>, Wirecard was described to have continued strong growth, with consolidated revenues increased by 36.7 percent, EBITDA increased by 35.8 percent, earnings after tax up by 50.7 percent, and expected 2020 increase. The rosy picture of Wirecard's strength was evident in the following net income graph up to the end of year 2019.



## FACTORS BEHIND THE RAPID COLLAPSE OF WIRECARD

To Wirecard, everything looks good until it's not. Below is an analysis of a list of potential factors when we look back its 20 some years of history.

### 1) Wirecard has long been controversial

The company had been plagued by controversies from as early as 2005<sup>3</sup>, such as dealings with porn and gambling industries, as well as accusations of working with gangs, and the infamous hacking organization, Dark Basin. But the beginning of the collapse started in December 2019 when the *Financial Times*, published a swath of investigations into the company, all of which called out various malpractices, including the act of fabricating business partners to bolster Wirecard's self-worth as an attractive investment for big name corporations such as SoftBank. Other schemes were used as well, the most popular of which was "round-tripping," which is the

act of faking numbers for profit. This strategy was utilized particularly in Wirecard's Singapore headquarter and was used to gain access in territories such as those under Citigroup, a partner of Wirecard, who fell victim to said practice<sup>4</sup>.

When considering the problems with Wirecard was no mystery, even as far back as 2014. During this time, Wirecard was attacked by Mark Hiley, a founder of "The Analyst," who went after the growing German fintech by writing 43 reports "highlighting why Wirecard was what he called 'a house of cards.'"<sup>5</sup> In 2015, too, Wirecard was exposed in the *Financial Times*' article blog, "Alphaville," which highlighted many of Wirecard's unclean accounting practices.<sup>6</sup>

## **2) The Dysfunctional Regulators**

The German equivalent to the SEC, BaFin, did not prevent the fintech firm's inevitable downfall. On the other hand, BaFin even outright refuted and even defended Wirecard against those fraudulent claims without investigation.

According to PYMNTS.com and *The Wallstreet Journal*, BaFin was warned about Wirecard's potential fraud and money laundering activity by "investors, U.S. authorities, journalists, and others"<sup>7</sup> as far back as 2008, when accusations of working within the porn industry were reaching its peak. Despite warnings, "BaFin didn't take any action...instead playing them down for years. The regulator handed the ball to other authorities, and in some cases, put off investigating the company's accounts."<sup>8</sup> Furthermore, "according to new documents seen by WSJ...BaFin saw former Wirecard CEO Markus Braun as more trustworthy than his critics because of his large number of shares in the company."<sup>9</sup>

## **3) The Dysfunctional Management Team**

Many of those issues or attacks raised against Wirecard were waved off by Wirecard management. In 2010, when Wirecard was attacked by whistleblowers, Braun had no interest in entertaining allegations. In fact, when Wirecard's banking firm, Wirecard Bank, was in question, Braun "strenuously denied any connection to fraud."<sup>10</sup> It was not until 2015, when larger organizations such as the Financial Times began their own assault against the German fintech. Accusing Wirecard of being a "House of Cards," the Financial Times began publishing a series of articles on "FT Alphaville," which raised questions "about inconsistencies in the group's accounts," suggesting that there was a "€250m hole in the group's balance sheet."<sup>11</sup> Unsurprisingly, Braun's response to these allegations was rather diminutive. Though Wirecard acknowledged accusations through a series of letters, the only real actions taken were hiring "FTI Consulting in London to manage its [Wirecard's] external public relations."<sup>12</sup> In a way, damage control seemed more relevant than actual investigatory action. This bad management practice continued to the collapse of Wirecard.

Though claims of fraudulency have plagued Wirecard for much of its past, none took meaningful holdings until 2019, when KPMG discovered a missing €1.9 billion from Wirecard's balance sheets. The blatant negligence of Wirecard's CEO and CTO, Markus Braun, is just one of many reasons for this scandal's existence.

After KPMG's executionary audit, top management team members either have resigned and been sought after for arrest or run away. For example, one of the main players in Wirecard's story, the COO of Wirecard, is believed has fled to Russia.

#### **4) The Foul Play of Cryptocurrency**

A German newspaper, Handelsblatt, as well as the cryptocurrency news site, Cryptounit.com, have suggested that former Wirecard COO had used cryptocurrency to transfer significant amount of funds to his hiding place in Moscow, where he is protected by Russian secret servicemen. According to Kommersant, a Russian newspaper, "the funds originated from Dubai and landed in Russia."<sup>13</sup> However, details on the amounts in currency, how the COO was able to attain these funds, and if he did so through Wirecard, are all significant factors that are unexplored.

### **THE LESSONS WE CAN LEARN**

#### **1) Improvements of Accounting Practice**

Within weeks of the WorldCom's scandal, US congress passed the Sarbanes-Oxley Act, introducing the most sweeping set of new business regulations since the 1930s<sup>14</sup>.

Wirecard's fall can also be viewed from accounting fraud or accounting scandal perspective. It may be an inflated accounting from the beginning. This means that 2B euros are not missing, they may not exist at all. All was a made up.

It could also be related to hypothetical accounting which put future financial predictions as current realizations, and there is no risk control in place.

The real improvement in accounting practice is the move from traditional double entry to triple entry, with the third entry to a blockchain dedicated to auditing. This dedicated blockchain can make concurrent auditing as accounting data is entered to the traditional accounting system.

#### **2) Regulators Accountability**

Regulators and auditing bodies should further raise the bar for regulations so that future scandals can be quelled before they begin. The evolution of accounting scandals has plagued FinTech's for a long time. For example, with Enron's fall, the SEC immediately began to raise the bar for regulations.<sup>15</sup> The improvement is that action should be taken before hand not after scandal.

Accountability of staff and regulatory bodies are just the beginning of the regulations that need to be reformed.

Furthermore, throughout its lifetime, Wirecard had many extensions situated within several other regions such as the Philippines, India, and Singapore, where its Asia-Pacific headquarters was placed. Given this, global collaborations among regulators should be formed and enhanced.

### 3) The Auditors' Accountability

Auditors such as EY and KPMG may need to assume some regulatory roles that they are not necessarily intended to perform. Shared responsibility is the key here.

A blockchain dedicated to auditing should be the future to allow concurrent and real time auditing, in order to capture problem upfront instead of afterwards.

#### SUMMARY

New technologies like a blockchain dedicated to auditing should be studied. Traditional double entry accounting system should be improved to allow real time auditing. And global wide collaborations of regulations and regulators should be formed to deal with the global scope of FinTech firms.

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