

## Banking Union: Wirecard

*The briefing provides a short overview (based on public information) to the insolvency of Wirecard AG, a group that provided electronic payment processing and that includes a less-significant banking entity (which is not part of the insolvency proceedings).*

*The case is not directly linked to the corona crisis, but it brings to the fore relevant issues related to supervision of payment-related services and the role of auditors.*



### The Wirecard group

Wirecard AG is a German fintech company that essentially provided electronic payment processing services. Its shares are listed in [Frankfurt Stock Exchange](#). Operating internationally, Wirecard held issuing and acquiring licenses from all major payment and card networks (e.g. Mastercard, Visa etc.), and offered to companies to set up for them end-to-end online payment infrastructures. For years, the company reported rapid growth, notably across Asia.

In 2006, Wirecard integrated a banking subsidiary into its group, Wirecard Bank AG, which holds a full German banking license. The Wirecard Bank is subject to supervision by the German Federal Financial Supervisory Authority (BaFin) and is a member of the Deposit Protection Fund of the Association of German Banks.

The website of Wirecard Bank discloses hardly any relevant information on its business activities, there are no annual reports available, nor financial statements, management reports, disclosure reports, or facts & figures on key metrics such as total deposits, capital ratios etc. The [annual report 2018](#) of the Wirecard group at least says that (p. 68) "*Wirecard Bank generates most of its revenues within the Wirecard group through the sales structures of its sister companies.*" Another entity in the group is Wirecard Card Solutions Ltd., based in Newcastle (UK), which holds an e-money license from the UK's Financial Conduct Authority (FCA), listed in the European Banking Authority's register for payment and e-money institutions. The FCA, however, imposed strict [limitations](#) on the activities Wirecard Card Solutions on 26 June.

### Recent events

Wirecard AG filed an application for the opening of insolvency proceedings, due to impending insolvency and over-indebtedness (DGAP [ad hoc news](#) of 25 June 2020, a compulsory disclosure of inside information).



Wirecard Bank AG is not part of the insolvency proceedings, according to the [Company statement](#) of 25 June 2020. That statement furthermore says that BaFin has already appointed a special representative for Wirecard Bank AG, but there is currently no corresponding information on the website of BaFin.

The insolvency basically follows revelations of a multiyear accounting fraud. Already in 2015, the Financial Times argued that there are inconsistencies in the accounting of Wirecard (see, for example, the discussion about sources of profit and the rise of intangibles on the balance sheet in the articles of [27 April 2015](#) and [23 July 2015](#)), which has been audited by Ernst & Young for the last decade. In early 2019, the Financial Times then revealed whistleblower allegations of serious accounting fraud (see, for example, the articles of [30 January 2019](#), [7 February 2019](#)). On [29 March](#), the journalists reported that *“Further investigations by the FT have identified a vivid mismatch between the supposed scale of the partner businesses to which Wirecard entities have ascribed substantial revenue, and the modest reality on the ground in countries such as the Philippines.”*

In 2018, the last year for which audited accounts are publicly available, the group claimed to have processed EUR 125bn worth of credit and debit card transactions, on which it generated EUR 2bn of revenues. Much of that may have been fabricated. In the wake of the allegations made by the FT, the audit company KPMG was tasked to perform a special investigation into the situation; its [report](#), however, did not clarify all issues at stake<sup>1</sup>. A particularly relevant question was whether a cash amount of EUR 1.9bn actually existed that was supposedly held on an escrow account at Singapore’s OCBC Bank. On 3 May, Wirecard issued a [statement](#) summarising the report’s main findings and concluding that *“none of the accusations and suspicions circulating publicly since January 30, 2019, have been confirmed”*.

That position, however, could not be upheld: On 22 June, Wirecard issued a very different [statement](#) saying that *“there is a prevailing likelihood that the bank trust account balances in the amount of 1.9 billion EUR do not exist”*.

## Past business development

Wirecard AG was founded in 1999, and has grown over two decades. The more rapid growth in the last decade was in particular linked to its expansion across Asia.

In 2018, the company reported revenues of EUR 2.016 billion, net profits of EUR 347 million, equity of EUR 1.923 billion, and a staff size of 5.154 employees in total (for an overview over the past business development, see annex 1). On [7 June 2020](#), a Management Board press release still expressed confidence with its outlook for 2020: *“confirms its outlook and expects earnings before interest, taxes, depreciation and amortization (EBITDA) in a range of EUR 1.0 billion to EUR 1.12 billion”*.

While those numbers would be impressive for a start-up company, such revenues, profits, and staff numbers are actually very small if compared to the averages of significant banks, or averages of companies normally listed in the DAX 30, the German a blue-chip stock market index.

Nevertheless, in September 2018 Wirecard became part of the 30 companies that form the DAX 30 index, the composition of which is regularly reviewed and adjusted to reflect market capitalization and trading volumes. Driven by share price developments that favour the business models of fintechs, Wirecard replaced in the index Commerzbank, Germany’s second-largest bank, which in terms of staff size for example was ten times larger.

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<sup>1</sup> The report recognises, in particular, that *“the results of our investigation cannot include an assessment of the accuracy of the published annual or consolidated financial statements as a whole”* (page 6) and refers to an annex containing a Management letter relating to the escrow accounts (which is not available).

## Implications

### 1) For banks and investors that provided funding

A consortium of banks has provided funding to Wirecard and is hence exposed to the consequences of the insolvency proceedings.

The [Company statement](#) of 25 June sets out that *"Wirecard AG in the normal course of business has drawn upon credit from financial institutions. Wirecard AG has conducted negotiations with the lending institutions, taking into account recent developments. In the absence of an agreement with the lenders, there was a likelihood of termination and expiry of loans with a volume of EUR 800 million on June 30, 2020, and EUR 500 million on July 1, 2020."*

Among the banks that are reportedly part of the consortium are inter alia Commerzbank, LBBW, and ING, which as significant institutions are all supervised by the ECB.

In September 2019, Wirecard managed to [place its first bond](#) that initially carried an investment-grade rating by Moody's (Baa3, issuer and issue rating, a grade at the lower end of the investment-grade spectrum; on 22 June 2020, Moody's has [withdrawn](#) those ratings), with a total volume of EUR 500 million, listed on the Euro MTF of the Luxembourg Stock Exchange. In recent days, the bond lost 80% of its nominal value, reflecting the doubts about the chances of repayment.

### 2) For the auditor

The audit company Ernst & Young (EY) has audited Wirecard for the last decade. On 26 June 2020, the Financial Times [reports](#) that *"EY failed for more than three years to request crucial account information from a Singapore bank where Wirecard claimed it had up to €1bn in cash — a routine audit procedure that could have uncovered the vast fraud at the German payments group."* If that allegation is true, it would show a severe violation of auditing standards.

A fundamental principle of auditing is that auditors need to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. What is considered material is a matter of judgement, depending on the circumstances. [Wirecard's statement](#) that there is a prevailing likelihood that bank account balances in the amount of EUR 1.9 billion do not exist, however, points to a magnitude that is without doubt material – in terms of size, the amount missing is roughly equivalent to the whole of annual revenues, and roughly equivalent to the total equity of the company.

According to [Reuters](#), Ernst & Young claims that *"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"*.

A higher awareness for the risk of deliberate deception, however, could have resulted from two particular circumstances: on the one hand, Wirecard has already been several times publicly accused of accounting manipulation. In comparison, the US company Enron, which collapsed in 2001 as a result of accounting manipulations which in turn led to the dissolution of its audit company, Arthur Andersen, did not have a long-lasting record of such allegations. On the other hand, awareness could have arisen from the fact that Ernst & Young was once itself tasked with a special investigation into allegations of accounting manipulation at Wirecard, a mandate that enabled the company to replace Wirecard's former external auditor in 2010 (see Box 1 with an excerpt from Wirecard's annual accounts for the year 2010).

### 3) For the supervisor

The supervisory bodies in Germany have quickly come under political pressure as regards how it has handled the situation at Wirecard. The Commission VP Dombrovskis has [asked](#) the European Securities

and Markets Authority to assess BaFin's handling of the situation. Germany's economy minister Altmaier [demanded](#) a full investigation, and the German finance minister Scholz [announced](#) that the supervisory structures will be scrutinised and changed, if necessary.

In concrete terms, the authorities are said to be preparing for transferring powers from the current body responsible for the enforcement of financial reporting (Deutsche Prüfstelle für Rechnungslegung, aka Financial Reporting Enforcement Panel, a privately organised institution) to BaFin, which has sovereign authority.<sup>2</sup>

In the weeks to come, the role and responsibilities of the supervisor BaFin will have to be further clarified. Questions may be asked about the role of the banking entity within the Wirecard group and the supervision thereof, but also about whether Wirecard complied with anti-money laundering regulations, market transparency information<sup>3</sup> and appropriate internal controls, as suspicious transactions should, in a reasonable timeframe, have been brought to the attention of the authorities in charge.

One of the controversial issues is the question whether it wise to enact a short selling ban, as BaFin did in February 2019. In the notice setting out the terms of the short selling ban, BaFin points to press reports on misdoings at Wirecard that led share prices to drop significantly. BaFin justifies the measure as aiming to avoid the situation escalating to "general market uncertainty" and the company "importance for the economy". ESMA gave a positive opinion to the short selling ban.

[For Bini Smaghi](#), chairman of Société Générale and previously an executive board member of the ECB, the Wirecard case indicates that an excessive proximity between supervised financial entities and their respective supervisors persist, a situation that can from his point of view only be overcome by a single financial markets supervisor.

**Box 1:** excerpt from Wirecard's annual accounts for the year 2010 (p. 107):

The investor protection association Schutzgemeinschaft der Kapitalanleger e.V. (SdK) filed an action before Regional Court Munich I to challenge the resolutions adopted at the Annual General Meeting in 2008 concerning a discharge of the Board of Management and Supervisory Board as well as a petition for a court order to have the (individual) annual financial statements of the Company for fiscal 2007 be declared null and void. Arguments in favor of these actions are predominantly based on alleged deficiencies in the financial statements of the Company. In the fall of 2008, the Supervisory Board of the Company had arranged for Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft to prepare a comprehensive expert opinion on the key issues and perceives no need for any corrections in light of the audit findings. The hearing is still under way. If Wirecard AG loses this court case, it would need to assume the costs of litigation of the plaintiff and its own court costs. An additional cost would result if the annual financial statements for 2007 were declared null and void.

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<sup>2</sup> The enforcement of correct financial reporting is notably a different issue than the oversight over the audit profession as such. In Germany, the Wirtschaftsprüferkammer is responsible for the disciplinary oversight of auditors and audit firms, monitoring whether its members complied with their professional duties.

Jörg Kukies, State Secretary in the German Ministry of Finance, mentioned that "self-regulation by the auditors doesn't work properly" and "So we will inevitably have to question whether the bodies that currently regulate the industry should continue to do so in their current form". He also called for a "European supervisory regime for payment service providers".

<sup>3</sup> BaFin imposed a fine to Wirecard in April 2019 for failing to appropriately disclose its 2018 half-yearly financial report (see [here](#)).

## Annex 1: Wirecard – a short summary of its past development

Year	Revenues, audited (€m)	Net profit, audited (€m)	Equity, audited (€m)	Auditor / Audit opinion	Employees	Company history / events	Annual report
2020				Ernst&Young		<a href="#">KPMG reports</a> on results of its independent investigation on 27 April. On 25 June, Wirecard AG applies for insolvency proceedings.	
2019				Ernst&Young		On 29 March, the <a href="#">FT reports</a> about inconsistencies in the accounts. On 31 October, KPMG starts an independent special investigation.	
2018	2016	347	1923	Ernst&Young unqualified	5154	Listed in German blue chip market index Deutscher Aktienindex (DAX)	<a href="#">Link</a>
2017	1490	260	1635	Ernst&Young unqualified	4449	Purchase of Citigroup's customer portfolio, expansion in Asia/Pacific region	<a href="#">Link</a>
2016	1028	267	1475	Ernst&Young unqualified	3766	Entry North American market, acquisition of Citi Prepaid Card Services	<a href="#">Link</a>
2015	771	143	1281	Ernst&Young unqualified	2300	Launch of "boon.", app for smartphone payments	<a href="#">Link</a>
2014	601	108	1073	Ernst&Young unqualified	1750	Expansion in Europe, Middle East and Africa, Asia/Pacific	<a href="#">Link</a>
2013	482	83	608	Ernst&Young unqualified	1025	Strategic expansion in SE Asia (Singapore, Indonesia, Malaysia, Thailand, Vietnam)	<a href="#">Link</a>
2012	395	73	542	Ernst&Young unqualified	674	M&A transaction in Asia (Indonesia)	<a href="#">Link</a>
2011	325	61	341	Ernst&Young unqualified	498	Further expansion into Asia and Europe	<a href="#">Link</a>
2010	272	54	290	RP Richter GmbH and Ernst&Young unqualified	500	New cooperative ventures, such as with Diners Club	<a href="#">Link</a>
1999						Foundation	