Anatomy of a fraud

The money isn't missing… it wasn't there in the first place

25/6/20

Accounting frauds usually start small. A growing public business can be under pressure to meet earnings expectations for a quarter and have a contract unexpectedly slip by a few days. It can be easy for a crooked executive to fake a signature, recognize revenues with an account receivable, get paid their bonuses and watch the value of their stock holdings go up. If the "mistake" can be quickly rectified, and is truly a timing issue, that fraudulent event will be overshadowed by the business resuming its former course. However, if the business has been impaired, the fraud must grow over time for management to cover up increasingly illegitimate revenues and still hit their targets, rather than reflect economic reality.

But sometimes accounting frauds start bigger, from an obvious business event. For example, based on our information, in 2010 Wirecard was generating a material amount of their revenues from processing offshore US gambling payments. US poker was shut down overnight in April 2011 but Wirecard's revenue trajectory was unchanged; reported revenue grew 19% YoY in 2Q11, up from 18% growth in 1Q11. We believe this was the start of the accounting fraud, when it may have been tempting to ignore the revenue shortfall, continue as if nothing had happened and fudge the numbers however possible.

The challenge with masking an accounting fraud of scale is that fake profits do not deliver cashflow. Every year management needs to find a way to explain to investors the lack of cash generated by the fake profits. The explanations are often plausible, but increasingly at an unreasonable scale.

One method employed by fraudulent companies is to over-pay to buy assets from controlled entities, and then funnel the over-payment back into the business to pay down aged receivables. Our research has found that Wirecard's acquisitions in South Africa, Malaysia, Singapore and most notably India, were purchased from entities partly or totally controlled by Henry O'Sullivan of Senjo Group, who himself has strong ties to Wirecard.

The India deal was the most egregious of these; Wirecard purchased an asset for >€300M, 8x the price it had sold for just weeks earlier, despite recently admitting in the London courts that they were aware at the time that the prior transaction had taken place. We believe the majority of the profits given to the intermediary in the transaction were funneled back into Wirecard as high-margin software sales and to pay down Senjo receivables.

After the India deal received substantial international scrutiny in 2015, it appears as though Wirecard took an increasingly aggressive approach to this "fake-cash" management, by using three shadowy offshore partners now known as third-party acquirers (TPAs). The TPAs generated substantial and growing EBITDA contributions at three Wirecard subsidiaries. But instead of transferring the cash directly to Wirecard as one might expect, the TPAs claimed to be remitting funds into an equally shadowy "trust account" to be held as a sort of risk reserve against merchant default. Wirecard managed to persuade EY that the trust accounts should be treated as cash and equivalents, though press reports suggest EY never confirmed the validity of these funds from 2016 to2018. It is now clear that the trustee funds never existed.

In 2016, according to Wirecard's own numbers, the three subsidiaries that faced the TPAs generated 54% of total profits. By 2018 this had grown to just over 100% of total profits as the group profits excluding the TPAs turned negative. Analysts occasionally noted the increasingly odd profit split reported in Wirecard's German filings, but were placated by management's explanation of "internal pricing allocations for tax purposes". A plausible explanation at an improper scale.

The all-important trustee turned out to be Citadelle, a lowly company formation business in Singapore, also closely linked to Henry O'Sullivan of Senjo Group. When questioned by KPMG in November, Citadelle apparently stopped answering requests, but not before claiming to transfer the assets to a new trustee, a family lawyer in the Philippines. We now know that the new trustee faked banking confirmations to EY, but it was clear to those paying attention that there was no cash in the trustee accounts, as the transactions and profits generated by the TPAs never existed. The German press has reported that EY never received banking confirmations for the trustee cash, which, if correct, truly brings into question the value of an audit. If EY did receive banking confirmations from Citadelle, it seems likely they were also faked and EY were duped.

Wirecard also looked for other methods to mask fake profits. In late 2018 they invented a lending program called merchant-cash advance (MCA), claiming to be lending €400M to individual merchants, when in fact they made direct loans to the TPAs that they labelled as MCA. In an attempt to make MCA appear legitimate, management claimed their MCA lending was occurring in geographies where lending was plausible, but where investors were unlikely to investigate, in Brazil and Turkey. This was when we started publishing on Wirecard – as it was abundantly clear that management were lying to investors about the whereabouts of hundreds of millions of euros due to the size of Wirecard's operations in each of these countries. When confronted with the facts, Wirecard management tried to pivot from explicit but implausible statements to vague amounts of lending also occurring in Asia and Europe. It was very clear that they were directly and deliberately misleading investors.

When presented with the evidence of false statements by management, many analysts simply ignored the facts. They would not question managements changing geographical statements as unreasonable, and/or that Central Bank of Brazil data and Wirecard Turkey audited financials must be false.

KPMG found no evidence that those loans went to merchants. One of the three MCA loans went to a company called OCAP Management, a company run by a former Wirecard EVP who is married to a current Wirecard EVP, that was set up by Henry O'Sullivan of Senjo Group for this purpose. We pointed out this loan in our work analyzing local accounts, and Wirecard denied the loan to OCAP repeatedly when questioned by analysts. OCAP is also owned by Senjo Group per historical local accounts that were confirmed by KPMG.

Wirecard also reported a further €350m of "fintech loans", and it remains unclear to this day to whom those loans were made.

There are clearly actions that need to be taken against the management team that was obstructive to KPMG, and likely instructed hackers and surveillance teams to look at critics for many years. We wrote multiple letters to the Supervisory Board over the past nine months, that all went unanswered, calling upon them to suspend the Management Board to prevent further shareholder losses.

One final note regarding our rationale for remaining anonymous. Wirecard has consistently brought legal action against and/or threatened to sue anyone who was willing to question their accounts. We were keenly aware that individuals and firms were the target of significant cyber-attacks, proved by the involvement of internationally renowned cyber specialists Citizen Labs. We wished to protect our firm and employees as best we could.

At this juncture, we are pleased that German authorities and EY, spurred by the special audit by KPMG, appear to be taking the fraud at Wirecard seriously. It is deeply unfortunate that investors and employees have been so negatively impacted by the acts of the Management Board. If supervisory bodies had properly investigated and shut down Wirecard years ago it would have prevented a great deal of pain for many people.

Thanks to all who have helped bring the truth to light; whistleblowers, journalists, and the rest.