2023

Wirecard and Potential U.S. Audit Issues

Benoit Boyer
Sacred Heart University

Danny A. Pannese

Paul N. Iannone
Sacred Heart University

Recommended Citation

Boyer, B.N., Pannese, D.A., & Iannone, P.N. (2023). Wirecard and potential U.S. audit issues. *Journal of Forensic and Investigative Accounting, 15*(3). https://www.nacva.com/jfia-current#2

Journal of Forensic and Investigative Accounting
Volume 15: Issue 3, Special Issue 2023

Journal of Forensic and Investigative Accounting
LEARN MORE

Wirecard and Potential U.S. Audit Issues

Benoit N. Boyer
Danny A. Pannese
*Paul N. Iannone**

Introduction

The final chapter of the Wirecard AG, ("Wirecard") saga has not been written at the time of this writing. A bankruptcy filing, regulatory investigations, and even criminal investigations are ongoing in Germany. There are allegations of financial statement misrepresentation including inflated profits and nonexistent assets. Wirecard's auditor, EY, is also at the center of attention. As this story continues to unfold, auditors around the world will take note and hopefully be reminded that financial statement audit procedures are designed to protect the client's constituency, including investors and creditors.

This article is not intended to place blame or be accusatory and is not intended to be critical of EY. The purpose of this article is to relate what has been reported in the news regarding Wirecard's financial profile at that time to what would be required of a U.S. auditor under the Public Company Accounting Oversight Board (PCAOB) rules and regulations. Wirecard is a German company, and to our knowledge, is not under investigation by the United States PCAOB and is not under the PCAOB oversight. The "facts" described here are "alleged facts" due to the continuing nature of the investigation and the lack of any evidence proffered in a court of law. Therefore, based upon what has been reported in the financial news, this article will highlight critical audit procedures under U.S. auditing standards that should apply when certain signposts or red flags appear.[1]

Wirecard Background

The following background information of the Wirecard affair has been gleaned from press reporting of the *Financial Times* (FT.com). Therefore, this background information has not been independently verified by the authors.

Wirecard is a payment processing company headquartered in Germany. A payment processing company is an intermediary between a financial institution and a customer. A license is required to operate as a payment processor. The payment process for goods and services involves several steps.[2] To pay for goods and services, the customer provides the merchant with a credit card, such as a Mastercard or a VISA. The credit card information is submitted through a payment gateway (i.e., a payment processing portal and is sent to a payment processer). The payment processor then initiates the transaction and sends the credit card information to the credit card company. The credit card company will either approve or disapprove the transaction. If approved, the credit card company communicates with the payment processor and the merchant is allowed to finalize the transaction with the customer. The payment processor instructs the bank that issued the credit card to transfer funds to the merchant's bank.[3] The payment processor is paid an authorization fee for each transaction processed.

The following series of events and timeline were obtained from Dan McCrum's article, "Wirecard: The Timeline," published by *Financial Times* on June 25, 2020. Wirecard was incorporated in Germany in 1999 and had financial trouble during the dotcom crash. In 2002, Wirecard hired Marcus Braun as a new CEO who was a former consultant from KPMG. Wirecard merged with Electronic Business Systems in 2002. In 2005, Wirecard became a public company on the Frankfurt stock exchange by acquiring a defunct call center group. At that time, Wirecard's primary business was processing payments involving online gambling and pornography. In 2006, Wirecard acquired a bank, XCOM, and renamed it Wirecard Bank. At that time, Wirecard could now issue credit cards and process funds for merchants.

Trouble for Wirecard began in 2008. A German shareholder association issued a report that outlined balance sheet inconsistencies and irregularities. Wirecard engaged EY to address the complaint and perform a special audit and later engaged EY to become Wirecard's auditor, replacing a small firm. Two men who were associated with the above complaint

*The authors are, respectively, Professor and Associate Professors in the Accounting and Information Systems Department of the Jack Welch College of Business and Technology at Sacred Heart University.

were prosecuted for not disclosing their stock positions in Wirecard. Jan Marsalek was hired as chief operating officer in 2010. Wirecard announced that it will operate in English to expand globally.

During the years 2011 through 2014, Wirecard raised €500 million and acquired other payment processing companies in Asia. Wirecard experienced rapid growth during this period. Its Singapore acquisition became its Asian headquarters. In 2015, the *Financial Times* published its "House of Wirecard" on FT Alphaville which raised concerns about the group's accounting. The *Financial Times* claimed that there was €250 million missing from its accounts. Wirecard reacted by hiring a UK law firm and FTI Consulting in London to handle its public communications and relations.

In October of 2015, Wirecard acquired an Indian payment processor for €340 million, its largest acquisition to date. A report issued by J. Capital research claimed that Wirecard's Asian operations were not as large as Wirecard claimed. Wirecard responded that short sellers were behind the report. Anonymous short sellers under the pseudonym "Zatarra" issued a report in 2016 alleging money laundering. Wirecard denied the allegations. The German regulator, BaFin investigated Zatarra for market manipulation. Also in 2016, Wirecard announced that it was purchasing a prepaid payment card company from Citigroup in order to enter the North American market.

EY issued a clean audit opinion in 2017 showing an improved cash position. The Wirecard stock price more than doubled in price. Wirecard announced that they would acquire Citigroup's payment processing operations in eleven countries across Asia. At Wirecard's Singapore headquarters, in March of 2018, Wirecard's legal group began an internal investigation into activities of three employees in the finance department. The internal investigation was spurred on by a whistleblower who raised questions concerning potential fraudulent payments to India in a "round tripping" scheme (a series of transactions between companies or economic units that have little or no economic substance). By August of 2018, Wirecard's stock price was at an all-time high, and the company was valued at approximately €42 billion. Wirecard claimed that it had 5,000 employees and processed payments for 250 merchants. In September of 2018, Wirecard joined the Dax 30 index, replacing Commerzbank. In October of 2018, whistleblowers informed the *Financial Times* that they were concerned that the internal investigation in Singapore was discontinued.

In January 2019, the *Financial Times* published an article regarding the Singapore investigation. Wirecard claimed that the story is false. BaFin began an investigation of the *Financial Times* over allegations of market manipulation. A raid by the Singapore police occurred in February 2019. The share price of Wirecard fell in 2019 and BaFin halted short selling of Wirecard's shares. In March of 2019, the *Financial Times* continued its investigation and found that many of the Asian offices of Wirecard to be non-existent. Wirecard sued the Singapore authorities and the Financial Times over the investigation. Singapore authorities pointed to eight Asian subsidiaries and five Wirecard employees as suspects. In April 2019, SoftBank invests €900 million in Wirecard. The *Financial Times* published another article that most of Wirecard's profits were generated through three partner companies in the Philippines, Singapore, and Dubai. EY issued an audit opinion for 2018 with only minor qualifications that related to Singapore. Wirecard issued €500 million in bonds that were sold as investment grade by Moody's. Wirecard sued the *Financial Times* for misuse of trade secrets for the January and February 2019 articles. In October 2019, the *Financial Times* published another article claiming that most of the transactions in Dubai and Dublin reflected fraudulently inflated profits and that customers that were shown in documents provided by Wirecard to EY were nonexistent. Wirecard denied all allegations and engaged KPMG to perform a special audit to exonerate itself. The *Financial Times* published another article that claimed that cash held in escrow accounts was included in the cash accounts on the audited financial statements.

In March 2020, the KPMG report was scheduled to be released but was delayed to April. The 2019 EY audited opinion was also delayed to April. Documents from a trustee in the Philippines were provided to EY that showed €1.9 billion were held at two banks in the Philippines. KPMG issued its special report in April 2020. KPMG claimed that it could not verify the majority of profits from 2016 to 2018 due to obstacles in performing their audit work. KPMG also questioned a cash balance of €1 billion citing lack of evidence confirming the bank balance. It noted that the only evidence were documents provided by a Singapore trustee that severed its relationship with Wirecard when the KPMG special audit commenced. Marcus Braun informed investors that EY had no problem with the financial statements and would issue their report in June.

In June 2020, as part of a criminal investigation by German authorities against Marcus Braun and three board members, the police searched Wirecard's offices. BaFin issued a complaint against Wirecard for possibly misleading investors regarding certain statements made by Wirecard to investors in advance of the KPMG special audit. On June 16, Philippine banks notified EY that documents evidencing the €1.9 billion bank balances were questionable. Wirecard did not issue its financial statements, but instead declared that €1.9 billion was missing and probably did not exist. Marcus Braun resigned as CEO and Jan Marselek was fired. On June 23, Marcus Braun was arrested on allegations of improper accounting and market manipulation. Wirecard filed for insolvency.

Function of the PCAOB

In response to several accounting scandals and financial irregularities of public companies in the early 2000's (such as Enron and WorldCom), Congress enacted the Sarbanes-Oxley Act (SOX or "the Act") in July of 2002. The PCAOB was created under the Act to oversee audits of public companies and to regulate the auditors of public companies. The Act "[e]stablishes the Public Company Accounting Oversight Board (Board) to: (1) oversee the audit of public companies that are subject to the securities laws; (2) establish audit report standards and rules; and (3) inspect, investigate, and enforce compliance on the part of registered public accounting firms, their associated persons, and certified public accountants." [4] The PCAOB publishes an annual report and the preamble of the 2021 Annual Report states the following:

The PCAOB (or "the Board") is a nonprofit corporation established by Congress to oversee the audits of public companies. The PCAOB also oversees the audits of brokers and dealers registered with the U.S. Securities and Exchange Commission (SEC).

The five members of the Board are appointed to staggered five-year terms by the SEC, after consultation with the Chair of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. The SEC has oversight authority over the PCAOB, including the approval of the Board's rules, standards, and budget.

> Mission: The PCAOB oversees the audits of public companies and SEC-registered brokers and dealers in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports.
>
> Vision: The PCAOB will be a trusted leader that promotes high quality auditing through forward-looking, responsive, and innovative oversight. At all times, we will act with integrity, pursue excellence, operate with effectiveness, embrace collaboration, and demand accountability.[5]

The PCAOB requires registration of audit firms, conducts investigations, and imposes sanctions on auditors and audit firms.[6] It has written a body of auditing standards that are published on the PCAOB website and have been approved by the SEC. Registered audit firms must adhere to these audit standards. These rules include Auditing Standards, Ethics and Independence Rules, Quality Control Standards, and Attestation Standards.[7]

This article will identify and describe certain PCAOB audit standards, and where applicable, the AICPA Generally Accepted Auditing Standards ("GAAS"), that may apply to the alleged Wirecard events described above, assuming Wirecard was a hypothetical U.S. public company. The PCAOB standards cited in this article are current as of June 2022. The PCAOB audit standards generally take precedent over GAAS, but the auditor should also consider auditing interpretations issued by the AICPA.[8] "The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his audit has been made in accordance with the standards of the PCAOB."[9]

Red Flags and Potential Audit Issues Under PCAOB And GAAS

Independence and the Appearance of a Conflict of Interest

A potential impairment to independence which can lead to a conflict of interest is for an audit firm to be engaged by management for a special project or audit to address financial inconsistences alleged by an external group, and then subsequently be engaged by management to conduct the audit of the financial statements. Independence may be impaired if it was previously hired, in effect, to represent and/or defend management.

PCAOB AS 1005.01 provides that "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." PCAOB AS 1005.02 provides that:

The statement in the preceding paragraph requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

PCAOB AS 1005.03 provides further in part that "To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners."

AICPA GAAS 102-6 emphasizes this point as follows:

> Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the service.

Rapid Growth

A company's financial statements that reflect rapid growth, as shown in Figure 1, over a brief period of time should be especially scrutinized for financial irregularities or aggressive financial reporting positions. [See Figure 1, pg. 376]

PCAOB AS 2110.03 provides that "[t]he objective of the auditor is to identify and appropriately assess the risks of material misstatement, thereby providing a basis for designing and implementing responses to the risks of material misstatement." PCAOB AS 2110.05 provides examples as follows:

Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its activities, and internal control over financial reporting. *For example, external or company-specific factors can affect the judgments involved in determining accounting estimates or create pressures to manipulate the financial statements to achieve certain financial targets* ... (Emphasis added).

PCAOB AS 2110.07 provides guidelines and recommendations. The auditor should obtain an understanding of the company and its environment ("understanding of the company") to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. Obtaining an understanding of the company includes understanding:

a. Relevant industry, regulatory, and other external factors;
b. The nature of the company;
c. The company's selection and application of accounting principles, including related disclosures;
d. The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and
e. The company's measurement and analysis of its financial performance

Client Acceptance

A threshold quality control mechanism for any audit firm is establishing criteria, policies, and procedures for accepting and/or continuing of client engagements. Before initiating an audit, PCAOB requires that the auditor "[p]erform procedures regarding the acceptance of the client relationship and the specific audit engagement."[10] PCAOB QC Section 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice includes guidance with respect to client acceptance as follows: 20.14. Policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized. Establishing such policies and procedures does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to any person or entity but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its client relationships and the professional services it will provide. 20.15. Such policies and procedures should also provide reasonable assurance that the firm:

a. Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.

b. Appropriately considers the risks associated with providing professional services in the particular circumstances.

Multi-location Engagements: Audit Planning

During the years 2011 through 2014, Wirecard began to expand globally by acquiring other payment processers outside of Germany. Singapore became its Asian headquarters. The global expansion continued and in 2015, Wirecard acquired an Indian payment processor. In 2016, Wirecard announced that it was purchasing a prepaid payment card company from Citigroup in order to enter the North American market. In or around 2017, Wirecard announced that they would acquire Citigroup's payment processing operations in eleven countries across Asia.

Special considerations in planning the audit should be undertaken when the engagement involves an audit client that has operations in several countries. The determination of whether the audit should be performed at certain locations as well as the critical determination and assessment of material risks associated with a global operation is of paramount importance in planning the audit. The PCAOB Auditing Standards list certain "factors that are relevant to the assessment of the risks of material misstatement associated with a particular location or business unit and the determination of the necessary audit procedures"[11] including:

a. The nature and amount of assets, liabilities, and transactions executed at the location or business unit, including, e.g., significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature ("significant unusual transactions") executed at the location or business unit;

b. The materiality of the location or business unit;

c. The specific risks associated with the location or business unit that present a reasonable possibility of material misstatement to the company's consolidated financial statements;

d. Whether the risks of material misstatement associated with the location or business unit apply to other locations or business units such that, in combination, they present a reasonable possibility of material misstatement to the company's consolidated financial statements;

e. The degree of centralization of records or information processing;

f. The effectiveness of the control environment, particularly with respect to management's control over the exercise of authority delegated to others and its ability to effectively supervise activities at the location or business unit; and

g. The frequency, timing, and scope of monitoring activities by the company or others at the location or business unit.[12]

Sharp Stock Price Increases and Eventual Sharp Price Decline

Extreme stock price volatility is most likely not considered direct audit evidence. Nevertheless, sharp stock price increases and decreases are indirect or external circumstantial "evidence" that may cause investors to become sensitive to instability either in management or reliability of public company financial data. Such stock price volatility should prompt an auditor's professional skepticism. PCAOB AS 1015.07 advises that:

> Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.

Regulatory Scrutiny and Negative Press

The auditor has a responsibility to carefully plan the audit so that the audit is "conducted effectively."[13] PCAOB AS 2101, "Audit Planning," instructs the auditor to adopt a broad approach when determining the appropriate planning activities. "The nature and extent of planning activities that are necessary depend on the size and complexity of the company, the auditor's previous experience with the company, and changes in circumstances that occur during the audit."[14] In PCAOB AS 2101.07, the PCAOB provides a list of important considerations when developing the audit strategy and audit plan.

Among the enumerated considerations, the auditor should evaluate the "[l]egal or regulatory matters of which the company is aware."[15] Regulatory actions into Wirecard affairs included both internal and external investigations. As noted above, in response to a whistleblower's concerns over "round tripping" in March of 2018, Wirecard's legal group began an internal investigation into activities of three employees in the finance department. In 2019, the Singapore police raided Wirecard's Singapore operation. In 2020, BaFin issued a complaint against Wirecard for possibly misleading investors and a criminal investigation by German authorities had begun against Marcus Braun and three board members.

Audit planning should also take into account any public information about the company, especially negative publicity. In particular, the Audit Standards provide that "[p]ublic information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting"[16] should influence audit procedures and strategies. Beginning in 2015, the *Financial Times* began its investigative reporting of Wirecard. With the aid of whistleblowers, it published a series of articles questioning the propriety of Wirecard's financial operations.

Questionable Evidence for Cash Account Confirmation

PCAOB AS 2310 contains detailed guidance regarding the confirmation process. The process includes:

- Selecting items for which confirmations are to be requested.
- Designing the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining the response from the third party.
- Evaluating the information, or lack thereof, provided by the third party about the audit objectives, including the reliability of that information.[17]

The last step of the confirmation process listed above, i.e., evaluating the information, is probably the most critical step. Audit experience and keen judgement are indispensable traits in performing this final step. In performing that evaluation, the auditor should consider (a) the reliability of the confirmations and alternative procedures; (b) the nature of any exceptions, including the implications, both quantitative and qualitative, of those exceptions; (c) the evidence provided by other procedures; and (d) whether additional evidence is needed. If the combined evidence provided by the confirmations, alternative procedures, and other procedures is not sufficient, the auditor should request additional confirmations or extend other tests, such as tests of details or analytical procedures.[18]

During the confirmation process for the two bank accounts in the Philippines, KPMG noted in its special audit report, that the only evidence were documents provided by a Singapore trustee that severed its relationship with Wirecard at the commencement of the KPMG special audit. Individual payments of payments into the escrow or trusts accounts could not be verified by KPMG on the basis of account statements.[19]

Cash Equivalents: Legal Ownership

Whether a cash account is a legal asset of the company or whether the cash is merely held in escrow for another's benefit, is important for balance sheet classification. We note that the SEC has questioned at least one company (unrelated to Wirecard) regarding the balance sheet presentation of cash held in an escrow account.[20] The SEC commented to a CoreLogic response to a question regarding cash held in an escrow account as follows:

> We note your response to prior comment 9. We note your statement that "[w]e earn interest income on the funds on deposit in this escrow account, and bear the theoretical risk of any loss from investment." Explain why these two factors do not support reflecting the asset and liability on your balance sheet. Since you have custody of the assets, have an obligation for losses, and the rights to earn income from holding these investments, please explain in greater detail why these investments should not be presented on your balance sheet. Indicate whether a trust that you analogize to would also be subject to these factors. Please advise.

Under the above SEC "CoreLogic" inquiry, Wirecard would also need to establish that it bore the risk of loss with respect to the cash residing on its balance sheet.

Special Audit by KPMG: Obstacles to Completing Audit

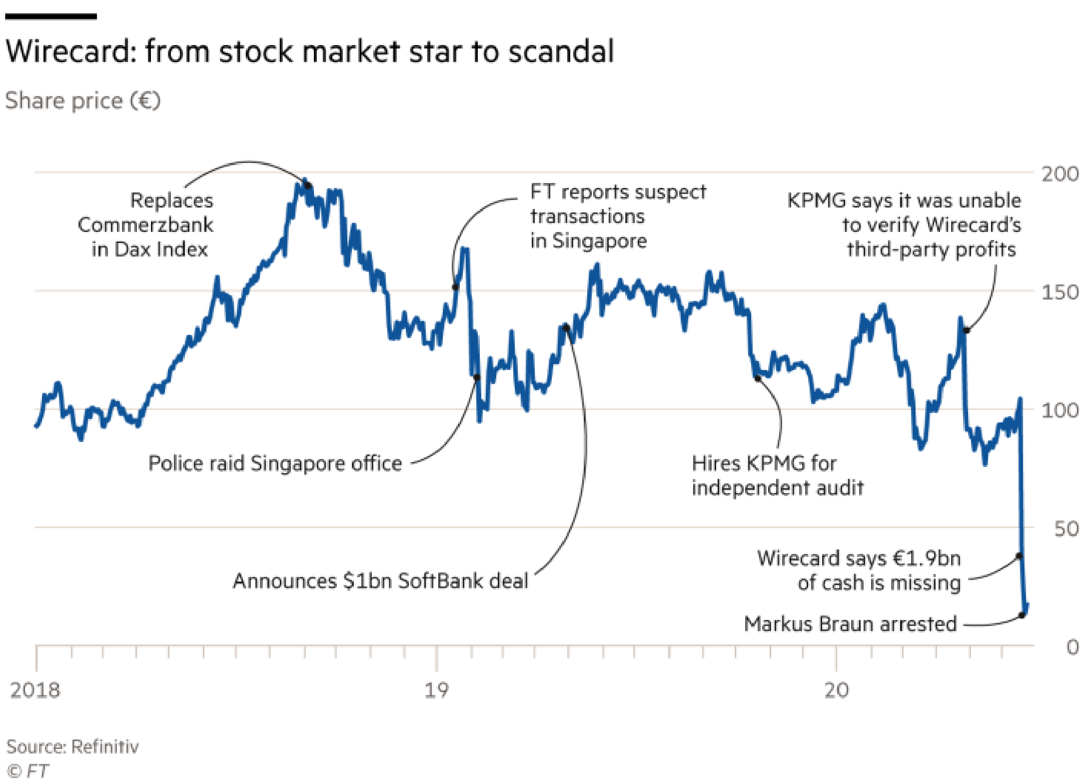
In 2019, Wirecard engaged KPMG to conduct a special investigative audit resulting from accusations against Wirecard made in the *Financial Times*. The inconclusive investigation dealt with several issues, including revenue recognition as well as cash allegedly held in two escrow bank accounts. The KPMG Report was issued on April 27, 2020. In general, KPMG's investigation was hampered by incomplete evidence and documents it could not authenticate. Numerous documents were presented to KPMG as copies or scans. KPMG could not assess whether these documents corresponded to the originals.[21]

The basis of our investigation and evaluation were the documents received and information provided, but it was not possible for us to verify the completeness and authenticity of the documents and documentations provided to us. Consequently, we cannot make any conclusive statement as to whether these documents and information are complete, accurate, and free of contradictions. Nor can we conclusively assess whether all information and evidence relevant to the assessment has been made available to us. In this respect, we also cannot rule out the possibility that we would have come to a different conclusion if we had been aware of additional information or documents.[22]

Conclusion

The Wirecard saga is yet to be fully written. Similar in scope perhaps to Enron and others in the early 2000's, many lessons will be learned for company executives, regulators, and especially auditors worldwide. For U.S. companies and auditors, the PCAOB has promulgated comprehensive audit standards and procedures designed for public companies, but these standards could also have ancillary application to private companies for auditors when planning the audit engagement. The red flags and audit issues that manifested in the Wirecard events will likely provide the financial and academic communities with robust case studies as well as prudent warning signals that can potentially lead to material financial statement irregularities.

Figure 1:



[1] An independent accounting firm in Germany has written a detailed report regarding EY's audit of Wirecard. The report was prepared by Martin Wambach, an auditor in Germany at the request of the Bundestag (the German federal parliament). It is a comprehensive report that examines the audit work of EY. This article will not provide any commentary with respect to this report.
[2] See Woock, Kurt, "What is a Payment Processor?" NerdWallet, September 3, 2021.
[3] Ibid.
[4] H.R. 3763, 107th Congress (2001–2002), Sarbanes-Oxley Act of 2002, Title I, Public Accounting Oversight Board.
[5] PCAOB 2021 Annual Report, "About the PCAOB," p. 3.
[6] See Steven B, Harris, Board Member, "Background on the PCAOB," speech presented to Kennesaw State Graduate Student Meeting, Washington, DC, May 16, 2013.
[7] See PCAOB website, "Rules of the Board."
[8] PCAOB Auditing Standard (AS) 1001.10.
[9] PCAOB Auditing Standard AS 1001.01.
[10] PCAOB (Audit Planning), AS 2101.18(a).
[11] PCAOB AS 2101.12.
[12] Ibid.
[13] PCAOB AS 2101.02; PCAOB AS 2101.04.
[14] PCAOB AS 2101.07.
[15] PCAOB AS 2101.07 (see 7th bullet point).
[16] PCOAB AS 2101.07 (see 10th bullet point).
[17] PCAOB AS 2310.04.
[18] PCAOB AS 2310.33.
[19] KPMG Report: Concerning the Independent Special Investigation, Wirecard, AG, Munich, April 27, 2020, p. 15.
[20] CoreLogic letter addressed to Stephen Krikorian, Accounting Branch Chief, Securities and Exchange Commission, February 10, 2012 (public document).
[21] KPMG Report: Concerning the Independent Special Investigation, Wirecard, AG, Munich, April 27, 2020, p. 7.
[22] Ibid., pp. 6–7.