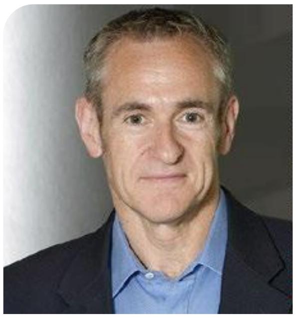

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Wirecard's spectacular collapse raises questions for auditors, regulators and agencies

The passing of an investment-grade company is typically a long, tortured affair, made longer and more tortured by easy money and ever-looser covenants that encourage the creation of multiple layers of secured debt before investors turn off life support.

However, there are some situations when the agony is much shorter. Either a company is faced with a liability that presents an insurmountable existential threat (think of the then A3-rated Johns Manville in 1982) or fraud is involved. The latter is mercifully rare, but in German payments processor Wirecard, which went from Baa3 to bankruptcy credit event in a week, we have a fresh example.

Auditing industry faces questions

First and foremost, Wirecard has (again) shaken the faith placed in market sentinels — the auditors, agencies and regulators. The former (in this case EY) have been publicly condemned. Its assertion that the Wirecard incident was "an elaborate and sophisticated fraud... with a deliberate aim of deception" rings hollow if the FT's assertions are true that the auditor failed on multiple occasions to verify cash balances at a Singaporean bank.

However, it would be wrong to single out EY for criticism: the entire audit industry has issues. The UK Financial Reporting Council's (FRC) inspections found that 33% of auditors required "more than limited improvements" (a situation it deemed unacceptable). The FRC highlighted "insufficient challenge of, and standing up to, management in areas of complexity and forward-looking judgment."

While regulators will look afresh at ring-fencing the audit function from other juicier activities and possibly mandating shorter rotations (EY had audited Wirecard since 2009), the problem may be cultural. Accountancy firms deploy their greenest bean-counters on audits (a necessity for their training) who, without adequate support from skilled and seasoned peers, and possibly cowed by a hierarchical reporting structure, may be ill-placed to challenge either the chief financial officer of the audited company or, indeed, the audit partner.

The initial reaction of the German regulator BaFin was also bizarre. Rather than at least probe the allegations, BaFin sought to initiate a criminal complaint against the journalists.

However, while investors should be able to have faith in the efficacy, independence and integrity of regulators and fiduciary agents, in the end, they are responsible for what they buy. There were aspects of governance at Wirecard that should at least have prompted questions.

Warning signs were there

Of note was the size of the company's supervisory board and its ability to undertake its role. In its April 2017 statement of compliance, the size of the supervisory board (five members) was said to preclude it from forming committees. With a market capitalisation of €11.5bn, would a company the size and complexity of Wirecard not warrant a sufficiently large and appropriately skilled supervisory board from which to field appropriate committees (not least among them an audit committee)?

Prior to February 2017, the company also had no whistleblowing contingency in its compliance management system: a rather troubling oversight for a company involved in payment services. Senior executive remuneration might also have raised a few questions. While compensation was linked to ebitda, stock price and total shareholder return, the payment was in hard cash with no obvious malus or clawback provision.

In an era when ESG analysis has become de rigeur, it seems odd that governance still gets relatively short shrift. Unlike environmental and social factors, it does not lend itself easily to quantitative analysis in an investment industry that is understandably numbers-focused. Moreover, when the objectively analysable structure of governance is stripped away, investors are left to make an essentially subjective call on individuals and their actions. But these are what ultimately determine the fate of companies. The 'smell test' is a valid analytical tool.

> Wirecard shows that in an era of ESG analysis, governance still gets relatively short shrift