CASTLE HALL

The Due Diligence Company

WIRECARD: DUE DILIGENCE LESSONS FOR THE ASSET MANAGEMENT INDUSTRY

The implosion of Wirecard is one of the most stunning corporate failures in recent years. The high flying company was the prestigious symbol of corporate Germany's pivot to fintech and a darling of the EU technology industry. In 2018 the firm joined the 30 companies in Germany's DAX stock index with a capitalization of €25bn, with the fintech payments processing company symbolically replacing "old economy" Commerzbank. Now Wirecard has the reputation of being the only member of the DAX ever to go into liquidation.

Castle Hall has identified four themes from the Wirecard debacle which are relevant to the asset management industry. As investors conduct due diligence, be it on hedge funds, private equity, real estate, infrastructure or long only funds, Wirecard provides valuable insights which can be applied to our own industry.

Perhaps the most obvious lesson of Wirecard is the one investors should always remember – if it looks too good to be true…it probably is.

1

AUDIT FAILURE

The starting point has to be the increasing likelihood that Wirecard may be one of the most stunning audit failures in financial history.

Castle Hall's senior team includes qualified accountants and ex-auditors. We certainly recognize that an audit is not infallible and that a testing and sample based review of transactions may fail to uncover a sophisticated fraud, especially when there is collusion between the company and third parties / counterparties. An audit is also subject to materiality – so small transactions may fall within the cracks, even if they are fraudulent.

In this case, Wirecard's auditor is the German unit of Ernst & Young. Per the Financial Times[1], on June 25 *EY said there were "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". The company argued that "even the most robust audit procedures may not uncover this kind of fraud".*

1. https://www.ft.com/content/8569779b-64e5-4008-a634-0a97a7cf9eb5 (subscription required)

Dan McCrum, a Financial Times journalist, has written extensively about Wirecard and potential problems and inconsistencies within the firm's business. In response to the EY statement, the FT notes: *it's incredible that Dan McCrum and the FT investigations team, having only access to certain documents, managed to figure out as early as 2015 that there was something amiss at Wirecard. Further investigation showed that third-party clients were probably fake and certain divisions were inflating income. Yet an auditor, with full access to Wirecard, couldn't do the same.*

However, the clearest sign of potential audit failure came the following day. Per the Financial Times[2] on June 26:

"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…[At the time Wirecard held assets in Singapore, before "moving" them to the Philippines].

People with first-hand knowledge told the Financial Times that the auditor between 2016 and 2018 did not check directly with Singapore's OCBC Bank to confirm that the lender held large amounts of cash on behalf of Wirecard. Instead, EY relied on documents and screenshots provided by a third-party trustee and Wirecard itself."

If this is true – and, as alleged, EY did rely on indirect confirmation of cash balances and documents given to them by Wirecard themselves – then this is an audit failure that, in our view, could reach the level of Enron. It is imperative for any auditor to independently confirm cash balances direct with the banking institution. This must especially be the case in a situation where there clearly is rumour and uncertainty around the company: cash should have been the number one audit risk when EY were planning their engagement.

We reserve judgement until more facts emerge. However, in Castle Hall's diligence work, we have seen other examples where auditors apparently accept documents given to them by the asset manager as audit "evidence", notably in private market strategies.

2. https://www.ft.com/content/a9deb987-df70-4a72-bd41-47ed8942e83b (subscription required)

- When valuing private equity portfolio companies, the foundational documents are the underlying company's accounts and budgets / projections. These numbers are then used to support either a discounted cash flow or multiples (revenue, EBITDA) based valuation. We have identified instances where the auditor will accept information on portfolio companies given to them by the asset manager (the GP), rather than contacting the portfolio company to obtain information independently. This creates an evident risk that the data given to the auditor by the GP could be fake, having been manipulated to support higher valuations. (It is also largely universal for third party appraisal agents providing valuations on PE portfolio companies to base those valuations on financial information given to them by the asset manager / GP, rather than sourced independently and directly from the portfolio company itself).
- In real estate, it is surprisingly common for the auditor to rely on documents such as quantity surveyor reports given to them by the GP, rather than independently sourcing the documents from the third party.

We recognize the value of the audit, and the contribution of thousands of professional accountants across the asset management industry to support the quality of investment fund financial reporting. But the audit profession is justifiably under attack, notably in the UK, where a string of high profile corporate bankruptcies have revealed both professional incompetence and blatant conflicts of interest between audit work and more lucrative consulting contracts. We strongly support a complete separation of audit businesses from consulting and, in our own industry, feel that auditors could and should do more to support investors – who of course pay the auditors' fees through the funds in which we invest.

- At the most basic level, auditors should be ready to independently confirm their appointment as auditor of a fund without entering into liability disclaimers. The auditor is the only service provider who will not freely participate in this most basic due diligence check.
- Auditors should ensure that all investment fund audit opinions are addressed to the "Board of Directors *and Shareholders*" or "General Partner *and Limited Partners*", rather than just to the Board or GP. This latter model seeks to distance the auditor from the investors, again to reduce the auditors' liability for their work.
- We would strongly welcome auditors to be subject to more detailed due diligence, including discussions around the scope of the audit and specific procedures performed. Once more, this is the level of due diligence to which all other service providers in the investment industry are subject.

2

QUALITY OF BUSINESS OPERATIONS

Due diligence should verify that an asset manager has adequate books and records in place and an overall accounting and operational control environment which is sufficient to both prevent fraud and to support the business needs of the manager and the investment strategy. In the asset management industry, core accounting and operational controls are often supported by capable third party administrators. This actually gives many investment funds "better" controls than publicly traded companies: corporations like Wirecard generally do not have third party administrators to oversee asset existence, valuation and cash movements.

It may not be surprising to find that Wirecard seems to have been ineffective in its own internal controls. In late 2019, KPMG were hired to complete a forensic examination of Wirecard's accounting (the full KPMG report is available **here**).

Once more, we turn to the Financial Times[3], who commented that the KPMG report had revealed a "complex process" and "missing paperwork".

According to KPMG's report, Wirecard referred payment-processing clients to the three partners.

Processing international payments across time zones via multiple parties requires precise reconciliation of transactions to ensure exchange rates and commission payments are accurate.

Once a quarter, each partner emailed statements to Wirecard that outlined "credit card transactions processed in the respective periods and the commissions subsequently due", KPMG said. Two of the partners broke down the data by "account names", while the third sent only a summary.

On the basis of those emailed spreadsheets, Wirecard, a financial technology provider, booked revenues and costs.

Actions taken by Wirecard's finance team to minimise risks, known as "control activities", were limited to "plausibility assessments" and comparison of the figures provided by the partners "with the 'sales forecasts' of contracts the Wirecard sales units responsible for the respective customers", KPMG said.
The set-up was not sufficient "to fully ascertain the amount and existence of the revenues", KPMG said, adding that Wirecard provided contracts governing the relationship with the partners that in some cases were incomplete or lacked signatures."

Once more, it is quite staggering that a DAX 30 public company was apparently relying on third party spreadsheets with little to no underlying detail to book millions of dollars of revenue. It is also alarming that, based on these FT reports, EY were seemingly prepared to continue to audit underlying account records with this alleged lack of detail or support for material revenue.

3. https://www.ft.com/content/cc64ac71-9232-4815-b2df-41c46a73a5f0 (subscription required)

For asset management due diligence, core questions of back office and operational competence are always relevant.

- Does the asset manager have an appropriate accounting system to ensure that investment transactions (buys, sells, corporate actions, dividends, derivative trades etc.) are accurately recorded? Reliance on Excel – while not unknown, even in 2020 – is clearly not best practice.
- Does the asset manager have an adequately staffed back office, headed by an appropriately qualified COO or CFO? In particular, the COO and / or CFO should have the professional experience and gravitas within the asset manager's organization to own and be accountable for operational quality, drive ongoing improvement, and ensure that key controls around segregation of duties are universally enforced.
- We strongly support the appointment of a third party administrator. Importantly, the administrator's primary function is not to act as an outsourced back office for the asset manager, despite a slide in the admin industry to use the language of "outsourcing" ever more frequently, especially in private equity. The administrator, who's fees are once more paid by fund investors, is an independent, external party tasked with maintaining the investment fund's books and records. This third party oversight creates a higher level of control quality and investor protection.

3

DOES THE BUSINESS PASS THE COMMON SENSE SMELL TEST?

Exactly how did Wirecard make its money? It seems that a key part of the firm's business was working with acquirors, who held banking licenses in various countries where Wirecard itself was not a regulated financial entity. Wirecard then stepped in "behind" the acquirors, to process the credit card transactions passed through. However, even though these acquirors were third party companies (assuming they did actually exist at all), Wirecard appears to have, in essence, consolidated their revenues 100% as if they were wholly owned subsidiaries.

There was a slight problem. Per the FT[4]:

"Agostin Antonio was mystified. A retired seaman living quietly with his extended family of 12 in a suburb of the northern Philippine city of Cabanatuan, he had no idea why a company called ConePay International had used his address.

But the name did ring a bell. Avoiding the laundry drying in the front porch and stepping over his grandchildren playing at the kitchen door, Mr Antonio disappeared back into his typical single-storey home, emerging a few moments later with a large white envelope.

Addressed to ConePay, the letter had arrived in the mail about a year ago, a single missive from an entity called Wirecard Bank. It was a 10-page set of statements for empty German bank accounts held in a string of currencies — Australian, Canadian and Singaporean dollars and British pounds.

Mr Antonio didn't know anything about Wirecard Bank either. "This house was my mother's. It's been with the family for 50 years."

Other large corporate frauds have similarly been found at companies which offered a business which simply seemed too good to be true. Elizabeth Holmes' Theranos pharmaceutical company never actually made the breakthrough medical testing machines she promised. Back in 2011, Canada's largest corporate fraud, Sino-Forest, imploded when it turned out that many of the firm's assets in China did not exist – the CEO, Allen Chan, was subsequently found liable for $2.63 billion in damages.

4. https://www.ft.com/content/cd12395e-4fb7-11e9-b401-8d9ef1626294 (subscription required)

For investors, there must always be a question of whether a strategy seems plausible and, especially, an understanding of what it is that allows a certain manager to report superior performance to other experienced, top tier asset managers. Investors should always understand the source and drivers of outperformance, and be comfortable that it is simply not too good to be true.

With hindsight, what exactly was "split-strike conversion" (the infamous "strategy" pursued by Bernie Madoff.) Tom Petters' great performance running a direct lending strategy (which would now be called alternative credit) was actually the result of a $3.65 billion Ponzi scheme. The Weavering Fund posted excellent global macro performance until it collapsed in 2009, helped by $637 million of interest rate swaps where the counterparty was Weavering Capital Finance, a BVI company controlled by the asset manager. The fund's financial statements did not include any mention of Weavering Capital Finance, let alone as a related party. More recently, the Woodford Equity fund prevented redemptions in the aftermath of style drift and investment in unlisted, private equity companies now being liquidated at significant losses. Per Institutional Investor[5], the founders of the recently shuttered Malachite volatility hedge fund thought that they were not picking up nickels in front of a steamroller, but "$100 bills in front of a Tyco truck".

Many asset managers are highly skilled and are key partners to their institutional investor clients, generating outperformance over full investment cycles. However, an effective asset manager will provide good transparency as to their strategy, style, positioning and performance attribution, building confidence as to the bona fides and sustainability of the investment process. The manager will also enable investors to facilitate operational due diligence to "trust but verify". Thereafter, one of our top indicators as to asset manager professionalism and culture is whether a manager is open to feedback as to any potential weaknesses identified during the diligence process. Top tier asset management businesses are hungry to continuously improve and eagerly seek input if an investor has observations which could help the firm become more effective and profitable.

5. https://www.institutionalinvestor.com/article/b1m6kkzscgqrl0/How-to-Lose-a-Billion-Dollars-Without-Really-Trying

4

THE CULT OF THE CEO

Markus Braun became CEO of Wirecard in 2002. Braun was the dominant face of the company, and a shining tech billionaire.

Per the FT[6]: *"Mr Braun, a former management consultant, cloaked himself in a formality that stood out in the casual atmosphere of a technology company. He secluded himself on a floor where key card access was only available to senior management, their assistants, and the team that dealt with high-risk payments processing for online gambling*."

Per the Wall Street Journal[7]: *"Markus Braun was the self-styled visionary behind German payments giant Wirecard AG. An instantly recognizable fixture at tech conferences, recently adopting Steve Jobs-style black turtlenecks, Mr. Braun became known for grand predictions about the future of payments, big data and artificial intelligence".*

Steve Jobs shows us that visionary companies have visionary leaders: but, equally, an effective business will have a broad executive management team. Following this point, in asset management, it is always important to consider the depth of both the investment and business management teams – although we recognize that, especially for smaller asset managers, there may be no "succession plan" as the manager is wholly dependent on the founding principal to remain in business.

The recent case of Quadriga gives a clear example of an asset manager dependent on one key individual. In this case, the firm's founder, 30 year old Gerald Cotten ran a Canadian crypto currency exchange. On his sudden death in India, investors in the platform found that they could not access $200 million. (For more on Quadriga, Castle Hall wrote a detailed article in June 2019.[8])

In June 2020, the Ontario Securities Commission issued their final report[9]:

"Staff determined that Quadriga collapsed due to a fraud committed by Cotten. Cotten opened accounts under aliases and credited himself with fictitious currency and crypto asset balances, which he traded with unsuspecting Quadriga clients. Cotten sustained real losses when the price of crypto assets changed, thereby creating a shortfall in assets available to satisfy client withdrawals. Cotten covered this shortfall with other clients' deposits – in effect, operating a Ponzi scheme. Staff calculated that the bulk of the $169 million in client losses – approximately $115 million – arose from Cotten's fraudulent trading.

Staff also determined that Cotten misappropriated millions in client assets to fund his lavish lifestyle."

6. https://www.ft.com/content/ec986d0e-5d92-4e66-a595-0f8645f1aaf0 (subscription required)
7. https://www.wsj.com/articles/markus-braun-storyteller-behind-wirecards-rise-and-fall-11592592549 (subscription required)
8. https://www.castlehalldiligence.com/blog/quadriga-john-grisham-could-write-about-this-crypto-hedge-fund
9. https://www.osc.gov.on.ca/en/NewsEvents_nr_20200611_osc-publishes-investigative-report-quadrigacx.htm

As Castle Hall works with investors to conduct due diligence on asset managers worldwide, we have seen a spectrum of business practices from the innovative and excellent to the compromised and wholly ineffective. However, the deep investigation conducted by journalists into Wirecard – especially by the Financial Times – delivers insights of value to both asset owners and asset managers. We await further developments as the legal and regulatory process unfolds over the coming months.

HOW CASTLE HALL CAN HELP

Castle Hall, the Due Diligence Company, helps investors worldwide analyze the operational, ESG, cyber and investment risks of asset managers.

DiligenceExpress allows investors to review and monitor information on more than 20,000 investment managers and 70,000 funds based on data reported to the US Securities and Exchange Commission on the form ADV. **A DiligenceExpress account is free of charge**, and enables investors, managers, service providers and academics to review data, compare ADV filings and receive notifications each time a new form ADV is filed.

DiligenceProfessional offers clients tech driven due diligence across all asset classes, including OpsMonitor and OpsReview, Castle Hall's flagship due diligence program.

ESGDiligence offers investors the opportunity to review asset managers' investment decision making processes to identify "greenwashing". Castle Hall's **Responsible Investment Strategy** due diligence reports validate that the manager has the resources and process necessary to meaningfully incorporate E, S and G into each portfolio decision. Castle Hall's **Responsible Investment Manager** program reviews the manager's own business, considering environmental, social and governance factors at the management company level, including diversity and inclusion, gender pay gaps, modern slavery policies and #metoo actions and claims. Our dedicated website, esgdiligence.com, provides more information about Castle Hall's ESG due diligence programs.

NORTH AMERICA

MONTREAL

1080 Beaver Hall, Suite 904
Montreal, QC H2Z 1S8, Canada
Tel: +1 450 465 8880

HALIFAX

84 Chain Lake Drive, Suite 501
Halifax, NS B3S 1A2, Canada
Tel: +1 902 429 8880

EUROPE

LONDON

1 Pancras Square, Kings Cross
Gridiron Building
London, N1C 4AG
United Kingdom
Tel: +44 20 3036 0828

MIDDLE EAST

ABU DHABI

24th Floor Al Sila Tower, Suite 2422
Abu Dhabi Global Market Square
Al Maryah Island
PO Box 5100738
Abu Dhabi, UAE
Tel: +971 (2) 694 8510

ASIA

SYDNEY

Level 36 Governor Phillip Tower
1 Farrer Place Sydney 2000
Australia
Tel: +61 (2) 8823 3370

MANILA

Ground Floor, Three E-com Center
Mall of Asia Complex
Pasay City, Metro Manila,
Phillipines, 1300

castlehalldiligence.com

esgdiligence.com

CASTLEHALL

The Due Diligence Company