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When the Tide Goes

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The recent revelation of fraudulent activity in the German payment processor and financial services company, Wirecard AG, has once again dented investor trust in auditors. Wirecard was previously a member of the DAX 30, the German equivalent of the DOW 30 in the USA. For a company of such size, importance, and prestige to be revealed as a fraud came as a shock to most investors.

For all the criticism that auditors will receive for this fraud, it is important to note that company directors prepare the financial statements, not the auditor. However, the specific details of this fraud are shocking. Most accounting frauds involve overstated revenues, understated costs, and off-balance sheet liabilities. These are harder to spot because they often involve very liberal interpretations of legal accounting standards.

However, lying about cash balances involves no subjectivity; the cash is either there or it is not. And for Wirecard, €1.9bn of cash was missing. This is more than the combined profits the company had made over the last 10 years. If a company can lie about its cash balance, it can lie about anything.

According to American investor Jim Chanos, the biggest clustering of financial frauds usually occurs during and after the biggest bull markets. When the stock market is going up, investors and auditors suspend disbelief.

Pick a financial bubble, and you will find major instances of fraud revealed during or after the bubble collapses. Ivar Kreuger of International Match during the 1929 bubble collapse, Enron after the dot com bubble collapse, Bernard Madoff during the global financial crisis of 2008.

How can investors protect themselves from such fraud? This is a very complicated question, so the answer is naturally complicated.

Quantitative metrics like the Beneish score have been shown to work. This quantitative method did in fact highlight Enron as an accounting fraud before the company collapsed. Analysing the complexity of a piece of text, like the annual shareholder letter, can also be insightful. The Flesch score measures the complexity of a piece of text. Enron, Global Crossing, ImClone and Tyco, well documented frauds uncovered after the dot com bubble, all had shareholder letters that were so indecipherable, their Flesch score was similar to the UK Income Tax Act. A shareholder letter that reads with equal complexity as a Tax Act should be a red flag.

However, these quantitative methods all suffer from a high false positive rate i.e. they often wrongly highlight a non-fraudulent company as an accounting fraud. There is no magic quantitative bullet that can spot all accounting frauds.

Investigative journalists and short sellers (investors who make money when prices fall) are usually the first to spot accounting frauds. Journalists at the FT started questioning Wirecard as early as 2015. A good five years before its ultimate collapse.

Perhaps the most insightful method of spotting accounting frauds is how the company responds to allegations of fraud. Attacking short sellers and initiating criminal investigations against journalists for simply asking questions are a red flag. This happened with Wirecard.

Some greater good does usually come after large accounting frauds. The 1930s securities laws, which are the foundation of modern securities regulation, probably would not have existed without the fraudulent activities of Ivar Kreuger. New regulation will come in place that should safeguard against similar types of accounting fraud as has occurred with Wirecard. However, regulations can only do so much. Unethical behaviour cannot be regulated away, and accounting frauds will continue to thrive as long as investors and auditors suspend disbelief.