Financial Engineering and Risk Management (2023)
Clausius Scientific Press, Canada

DOI: 10.23977/ferm.2023.060716
ISSN 2523-2576 Vol. 6 Num. 7

Luckin Coffee Financial Fraud Case Analysis

Du Wei*

School of Accounting, Zibo Vocational Institute, Zibo, China
15488415@qq.com
**Corresponding author*

Keywords: Luckin Coffee; Financial fraud; Corporate governance; Supervise

Abstract: In recent years, many Chinese companies have gone public in the United States, which has brought opportunities for their development and made these Chinese companies the focus of regulatory agencies. Luckin Coffee only took more than one year from its establishment to its listing, attracting more attention. At the beginning of 2020, the short selling report of Muddy Water Company was released. In April 2020, Luckin Coffee also admitted financial fraud. So far, Luckin Coffee has been pulled down from the altar. This article first combs the development process of Luckin Coffee, analyzes the motivation of financial fraud of Luckin Coffee based on GONE theory, and analyzes the enlightenment from the case.

1. Case Background

Luckin Coffee was registered in Xiamen in June 2017. Within half a year, it had set up trial outlets in 13 cities, including Beijing. On May 17, 2019, after the IPO price was determined, Luckin Coffee was officially listed on NASDAQ, becoming the fastest company in the world from establishment to IPO. At the end of 2019, the number of Luckin Coffee stores exceeded that of Starbucks, becoming the coffee enterprise with the largest number of stores in the Chinese market. On January 31, 2020, Muddy Water released a short report on Luckin Coffee, which claimed that its financial fraud and business model had fundamental problems. Before April 2, 2020, Luckin Coffee issued an announcement admitting its financial fraud. After the announcement, the closing price of Luckin Coffee fell by more than 75%. On May 15, 2020, Luckin Coffee received the delisting notice from the U.S. Securities and Exchange Commission. On June 29, 2020, Luckin Coffee announced its delisting in NASDAQ.

2. Analysis of financial fraud motivation of Luckin Coffee

2.1 Greed factors

Corporate executives and accountants who lack professional ethics are prone to financial fraud and other behaviors when they encounter various pressures and temptations of interests [1]. Many managers of Luckin Coffee have had bad career experiences: Qian Zhiya, CEO of Luckin Coffee, is one of the actual controllers and major shareholders of the company. Qian Zhiya uses his 16% equity of Luckin Coffee to pledge and cash out; Shao Xiaoheng, an independent director of Luckin

Coffee, was once a director of some companies with suspicious purposes listed in the United States, and the public investors of these companies suffered huge investment losses; Yang Fei, the co-founder of Luckin Coffee, also served as the chief marketing officer, but was sentenced to 18 months' imprisonment for the crime of illegal operation when he was in Beijing Word of mouth Marketing Planning Co., Ltd. Such corporate executives lack professional ethics, and it is not uncommon for them to engage in financial fraud.

2.2 Opportunity Factors

From the perspective of the regulatory process, because Luckin Coffee is listed in the United States, American and other foreign investors do not understand the operation of Luckin Coffee, and there is a very serious information asymmetry [2]. If there is no such phenomenon, investors can fully withdraw, but because foreign investors do not know the operation of domestic companies in China, Luckin Coffee will lack supervision. In addition, no matter whether the enterprise is profitable or not, it can be listed on NASDAQ, which provides an opportunity for the fraud of Luckin Coffee [3].

2.3 Factors Needed

Since its establishment, Luckin Coffee has achieved a rapid nationwide distribution through overwhelming advertising, low price sales and other means, and even exceeded Starbucks in the total number of stores[4]. In this way, the income of Luckin Coffee is actually lower than the cost, and this kind of operation mode is not desirable. Under the low price sales, most of the customers of Luckin Coffee are middle and low-end customers, who are very sensitive to the price. Once the price increases, the sales will decline significantly[5]. These brought great pressure to Luckin Coffee. In order to meet its expansion ambition, the management had to resort to financial fraud.

2.4 Exposure factors

The time span of Luckin Coffee from IPO to exposure of financial fraud is less than one year, and the supervision and management institutions in the United States have not had enough time to find out its financial fraud; At the same time, Luckin Coffee's business is all in China, and it is difficult for the supervision and management institutions in the United States to find its financial fraud[6]. In addition, if the execution of criminal responsibility for Luckin Coffee executives involves extradition agreements between China and the United States, the process is more complex.

3. Case inspiration

Looking at the financial fraud of Luckin Coffee, Luckin Coffee has only been 18 months since its establishment to ring the bell of NASDAQ IPO, breaking the world record for the fastest listing of an enterprise; In January 2020, Muddy Water released a short report on Luckin Coffee, which pushed Ruixing to the forefront of public opinion again; On April 2, 2020, Luckin Coffee admitted its financial fraud, which led to a precipitous decline in its share price on that day and the loss of its market value of more than 30 billion yuan. All sectors of society discussed its financial fraud in succession, and triggered the overall trust crisis of China Concept Shares.

Based on the above analysis, the financial fraud of Luckin Coffee mainly stems from its imperfect financial equity structure and governance system; Information asymmetry and lack of regulation; The increasing pressure in the business process, including competitive pressure and congenital defects in the business model; The greed of executives and other reasons. At the same time, the Luckin Coffee incident sounded an alarm bell for us and gave us the following enlightenment:

3.1 Establish and improve corporate governance structure

Firstly, the internal governance structure of the company should be sound, and the company's supervisory personnel should be independent and have the power to implement supervisory responsibilities, to avoid situations such as inadequate supervision and self-supervision. Secondly, there is a diversification of investor levels. We should attract investors from financial institutions such as banks, and use their professional advantages to suppress major shareholders within the company, in order to avoid absolute control over the enterprise by major shareholders. Thirdly, it is necessary to establish and improve the selection system for independent directors within the company. Under the condition of ensuring the independence of independent directors, independent directors with good reputation and great importance to their own reputation should be hired.

3.2 Improving regulatory laws and regulations

With the development of social economy, the sales model of the Internet has brought huge challenges to the capital market, and the original regulation is not easy to play a regulatory role; Many laws and regulations are also relatively backward, which brings opportunities for some people to take advantage of. Therefore, the country should promptly improve relevant laws and regulations such as the Accounting Law, Company Law, and Securities Law.

3.3 Improving the company's internal control system

Firstly, enterprises should establish and improve internal control systems that adapt to their development, and effectively implement them in the business process to reduce their operational risks; By establishing an anti-financial fraud mechanism, we can fundamentally control the occurrence of financial fraud. Secondly, establish and improve the performance evaluation system for enterprise executives. Enterprises often use performance as the core evaluation indicator, which can lead to financial fraud. Therefore, enterprises need to optimize their performance evaluation system and assess their senior executives from multiple levels. Thirdly, strengthen the training of employees' professional ethics and professional literacy, and strengthen their legal awareness.

We establish an internal control information disclosure mechanism. Enterprises, especially listed companies, generally only disclose financial and accounting information to the public, and people are also concerned about figures such as earnings per share. People often neglect internal control in enterprises. Independent auditors, on the other hand, experience the authenticity and reliability of information, which comes from the internal control of the enterprise. The better the internal control, the more reliable the information will be, and the substantive testing of the audit can be correspondingly reduced; Although certified public accountants may evaluate the internal control of enterprises during audits, they generally focus on internal accounting control, and due to the limitations of audit time and technology, the internal control situation of enterprises cannot be fully understood and disclosed; In order to enhance the awareness of internal control and improve the quality of information, it is necessary for enterprises to publicly disclose their internal control information to the society after conducting self-assessment of internal control.

3.4 Improve business performance and improve financing channels

In response to the reasons for financial fraud caused by enterprises' inability to make ends meet and poor business models, enterprises should fundamentally control the above issues. Enterprises should focus on improving their business performance, actively strive for multi-channel financing, reduce financial pressure on enterprises, and avoid financial fraud.

Diversified financing methods.There are many ways for corporate financing, such as bank loans, equity financing, bond financing, trust financing, leasing financing, crowdfunding financing, etc. When choosing financing methods, enterprises should choose financing methods that are suitable for themselves based on their actual situation, diversify as much as possible, and avoid excessive reliance on a particular financing method. By diversifying financing methods, financing costs can be reduced, financing efficiency can be improved, and financing risks can also be reduced.

Enterprises should establish a sound financial management system, including financial reporting system, budget management system, cost management system, internal control system, etc. Through a sound financial management system, enterprises can improve their financial transparency, enhance investor confidence, and thus enhance their financing capabilities.

3.5 Overcoming business model deficiencies and eliminating underlying fraud drivers.

At the beginning of its establishment, Luckin Coffee tried to promote consumption scenarios by virtue of its new retail business model, so as to occupy a place in the Chinese coffee beverage market. However, based on the current situation of Ruixing's high-profile listing and dismal delisting, Ruixing has not achieved its expected goals, which indirectly reflects the shortcomings of its new business model. The significant shortcomings of Ruixing's business model are high cost, low profitability, and lack of core competitiveness. To overcome this flaw, the first step is to build one's own competitive barriers, optimize products and services to obtain stable user traffic, and convert traffic into long-term consumption power, thereby reducing recruitment costs and improving profitability.

References

[1] Cai Ning, Liang Lizhen. Empirical Analysis of the Relationship between Corporate Governance and Financial Fraud [J]. Financial Theory and Practice, 2003 (06): 80-84

[2] Lou Quan. The Four Factor Hypothesis of Financial Reporting Fraud and Its Empirical Test [D]. Department of Accounting, Xiamen University, 2004

[3] Mei Xinshun. Analysis of the Causes and Countermeasures for Financial Fraud in Listed Companies [J]. Financial and Accounting Communication, 2009 (13): 96-97

[4] Hong Hong, Hu Huaxia, Guo Chunfei. Identification of Financial Reporting Fraud in Listed Companies Based on GONE Theory [J]. Accounting Research, 2012 (8): 84-90

[5] Huang Shizhong. Analysis on Extended Financial Fraud of Kangmei Pharmaceutical [J]. Monthly Journal of Finance and Accounting, 2019 (17): 3-6

[6] Han Hongling, Chen Shuaidi, Lu Xumi, Chen Hanwen. The Ruixing Incident and Cross border Securities Regulatory Cooperation between China and the United States: Review and Prospects [J]. Friends of Accounting, 2020 (9): 6-13