

Study on Financial Fraud and Internal Control of Luckin Coffee

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Abstract: Luckin Coffee, as a new retail enterprise, was exposed to financial fraud that shocked the capital markets in 2020. Analysis of its reasons, and the company's internal control failure has a significant relationship. Based on the five elements of internal control, this paper analyzes the problems existing in Luckin Coffee's control environment, risk assessment, control activities, information and communication, internal supervision. And put forward to optimize the internal environment, strengthen risk management, improve the key link control activities, strengthen information and communication, strengthen the internal supervision of targeted suggestions.

1. Introduction

The construction of internal control is very important for the long-term development of enterprises. The investment of enterprises in the construction of internal control can bring sustainable, stable and healthy development to enterprises. Compared with the west, China's modern enterprise management system started a little later, and the construction of internal control is not perfect. And most of the enterprises that commit financial fraud have some problems in internal control. In order to promote the healthy development of the capital market, China needs to pay attention to the construction of internal control and optimize the management environment of the company.

In this paper, Luckin Coffee financial fraud as a case, from the five elements of internal control. From the control environment, risk assessment, control activities, information and communication, internal supervision, this paper analyzes the internal control failure, thus affecting its financial fraud. And made the corresponding improvement suggestions, in order to provide useful enlightenment for the improvement and optimization of the company's internal control, reduce the occurrence of financial fraud.

2. Review of Luckin Coffee's Financial Fraud

Muddy Waters, one of the famous short sellers, forwarded dozens of pages of anonymous short selling report in early 2020, pointing out Luckin Coffee's financial fraud, business model defects and other signals. It caused a great sensation in the capital market, causing Luckin's stock price to drop by more than 24% in a single day, and closed down 10.47%.

In April 2020, Luckin Coffee reported false transactions from the second quarter to the fourth quarter of 2019, resulting in an inflated revenue of 2.2 billion yuan. According to the official investigation, Luckin Coffee has forged transaction records since April 2019, falsely increasing its 2019 revenue by nearly 2.2 billion yuan and its costs and expenses by more than 1.3 billion yuan. In September 2020, the State Administration for Market Regulation imposed an administrative penalty on Luckin Coffee (China) Co., Ltd. for its illegal acts of unfair competition, and fined Luckin 2 million yuan.

3. Analysis of Internal Control Defects of Luckin Coffee

Luckin Coffee's financial fraud event is greatly related to its failure of internal control. According to the elements proposed in the Internal Control Integration Framework by COSO and the basic Norms for Enterprise Internal Control issued by China, we analyzed and studied the

internal control of Luckin Coffee from five aspects: internal environment, risk assessment, control activities, information and communication, internal supervision.

3.1 Internal Environment

The internal environment is mainly reflected in the ownership structure, governance structure and corporate culture, which are components of the internal control environment and affect the possibility of financial fraud.

3.1.1 Equity Structure

In the shareholding structure of Luckin Coffee, it can be obviously found that there is a very large proportion of individual shareholders. According to Luckin's 2020 prospectus (see Table 1), Lu Zhengyao holds the largest share, followed by Qian Zhiya, the other founder, while Lu's sister holds the third largest share after Qian Zhiya. The combined control of the top three shareholders is 62.55%, which is enough to control the major decision-making power of Luckin Coffee. Luckin Coffee's overly centralized and unreasonable holding structure makes it unable to form effective constraints in internal decision-making. Lu Zhengyao, the former chairman of CAR, also took Luckin under his own control. There is a problem of excessive concentration of equity inside.

Table 1 : Luckin Coffee Shareholding Ratio

Name	Position	Equity ratio
Lu Zhengyao	CAO	30.53%
Qian Zhiya	CEO	19.68%
Lu's sister	\	12.34%
Li Hui	\	11.90%
Liu Erhai	\	6.75%
Source: Luckin Coffee's 2020 prospectus		

3.1.2 Governance Structure

Luckin Coffee, as a newly developed retail industry, has a relatively single governance structure. This kind of new retail enterprises are usually small in scale, widely spread, suitable for flexible management mode, internal organizational structure tends to be “flat”. At the same time, such a management mode makes the range of management of top managers wider. In addition, Luckin Coffee skillfully uses the “Internet +” mode, which gives it more space to operate financial fraud through the Internet. The major shareholders are closely related and their power is above the system. The internal environment of Luckin Coffee is destroyed, and the lack of effective internal control restrains the trend of financial fraud.

3.1.3 Corporate Culture

Luckin Coffee's strategic goal since its establishment is to become the Chinese version of Starbucks. Under such assumption, Luckin Coffee failed to create a corporate culture comparable to Starbucks. In addition to developing coffee, Starbucks lays more emphasis on providing customers with a high-quality consumption environment. Luckin Coffee has been established for a very short time and has grown rapidly. As a result, it is difficult to find a solid foundation to support its corporate culture, and the loyalty of employees is insufficient. In addition, Luckin Coffee focuses on coupon issuance and other activities to attract consumers, and only pursues fast coffee sales, which results in unstable product prices and difficult formation of brand value and image.

3.2 Risk Assessment

Risk assessment, as a particularly important part of the company's internal control, aims to establish a scientific risk prediction and assessment system. Through quantitative and qualitative analysis of identified risks, specific risk response measures can be obtained. The risk that Luckin Coffee can tolerate is higher than its strategic goal, and in the actual operation and strategic implementation, there is no substantive risk assessment system in effect, and risk assessment

institutions do not make reasonable disclosure in the annual report, so Luckin Coffee has a lack of risk assessment links, and internal control cannot play a role.

3.3 Control Activities

As an emerging retail enterprise, Luckin Coffee's sales and cash receipts cycle is a very important cycle. Therefore, improving and strictly implementing the internal control sales and cash receipts cycle is of great strategic significance to the capital cycle, value chain management and sustainable development of the enterprise. In Muddy Waters' report on Luckin Coffee, Luckin used jumping orders to commit fraud, and they fabricate those order in their financial records. It can be seen from the random jumping of sales orders of Luckin Coffee in retail terminals that it has serious lack of control activities in sales and cash receipts cycle.

3.4 Information and Communication

When the fraudulent means of jumping orders occurred in the sales process of Luckin Coffee Company, its internal financial system did not effectively check and correspond with the relevant objects. The inflated advertising costs and related contracts have not been matched and information feedback. Luckin's prospectus and other documents show that the company has established a good information and communication system. However, in fact, the behavior of jumping orders during sales not only reflects the serious inflated income of Luckin Coffee, but also indicates the failure of information and communication in its internal control.

3.5 Internal Supervision

The audit committee and internal audit institutions set up by listed companies perform their internal supervision functions within specific scopes. Luckin Coffee has set up the relevant audit committee according to the Listed Company Governance Standards. The members of the audit committee are Respectively Shao Xiaoheng and Thomas, and Shao Xiaoheng serves as the chairman of the audit Committee. However, Luckin's 2018 and 2019 annual financial reports did not disclose any details about the members of the internal audit committee. It shows Luckin's neglect of the internal audit committee. Meanwhile, the internal organizational structure revealed by Luckin Coffee shows that it has not independently set up relevant internal audit departments, which also indicates that the independence of its internal audit organization is not strong. Independence is the foundation of audit work. As a result, its financial reporting and internal organizational structure revealed the weakness of its internal oversight.

4. Suggestions on Improving Luckin's Internal Control

Through the analysis of the above five elements of internal control, we can find that there are serious problems in the internal control of Luckin Coffee, which is also an important reason for the financial fraud of Luckin Coffee. Therefore, it is necessary to improve and standardize its internal control system, improve the level of internal control and strengthen internal and external supervision, so as to further improve the internal control of enterprises. Starting from the five elements of internal control, the following suggestions are made.

4.1 Optimize the Internal Environment

4.1.1 Optimize Corporate Governance Structure

The unreasonable shareholding structure of Luckin Coffee is an important reason for its financial fraud. Chairman Lu Zhengyao not only owns the largest shareholding, but also basically controls the management and decision-making power of Luckin Coffee. Therefore, the internal management right and ownership of the company should be strictly separated, and the supervisory function of the board of supervisors should be strengthened, so that the power of the company's top management can be effectively checked. Optimizing corporate governance structure can also maintain the organization operation of the company more effectively and prevent its financial fraud.

4.1.2 Strengthen the Construction of Enterprise Culture

Luckin Coffee should be established and form a complete enterprise culture, and transfer internal control, risk awareness, corporate value and other related concepts to employees. Guide employees to form a unified risk awareness, establishing belong to Luckin Coffee correct enterprise values. Improve staff professional ethics and standardize staff professional behavior. When an enterprise has formed its own corporate culture, the goal of all employees in the enterprise is to make the enterprise get better development and their own better growth. Then the internal environment of the enterprise must be developing in a good direction, and the possibility of its financial fraud will be greatly reduced.

4.2 Strengthening Risk Management

First of all, it is necessary to establish regular and irregular self-assessment systems. As a coffee company focusing on marketing operations, Luckin Coffee should pay attention to the identification and assessment of its operational and financial risks. In actual operation and strategy implementation, Luckin Coffee shall establish and improve its risk assessment system. On the other hand, should pay attention to the independent third party risk assessment institution for enterprise internal control construction and implementation Suggestions about evaluation. And the evaluation opinion will be reasonably disclosed in the annual report, to further ensure the effectiveness of internal control in risk management.

4.3 Improve the Key Link Control Activities

As a beverage retail enterprise, the most important thing for Luckin Coffee is the control process of sales and cash receipts cycle. In this cycle, controls that are incompatible with separation of duties should be established. In view of the situation of jumping orders, Luckin Coffee sales orders can be handled by sales staff. At the same time, a matching receipt will be generated separately, which will be obtained and recorded by financial personnel. The two responsibilities are separated. And, in various business processes, the responsibilities of all business departments and employees should be clearly stipulated, cross-link implementation should be strictly prohibited, and unauthorized related personnel are strictly prohibited to handle business. Strictly control each link, especially the key link, strengthen its control activities, and strictly accountability of the relevant person, improve internal control to reduce the possibility of financial fraud.

4.4 Strengthen Information and Communication

Luckin Coffee should strengthen the accuracy and transparency of internal information and reduce the impact of information asymmetry. Under the new retail mode, the unimpeded information of sales and cash receipts cycle is particularly important. Management should be accurate and neutral when communicating information to avoid information deviation. At the same time, an information group can be set up inside the company, so that the company can directly obtain relevant information in the sales and cash receipts cycle, and also convenient for the sales and cash receipts cycle employees to obtain more accurate information from their superiors. Form a good cycle of mutual supervision and communication.

4.5 Strengthening Internal Supervision

Luckin Coffee as a new retail enterprise with rapid development momentum, its internal supervision is relatively weak. Therefore, for this kind of emerging enterprises, the supervision function of internal audit should be strengthened. First of all, in the face of its sales characteristics different from traditional enterprises, more specific and scientific rules of internal control system should be formulated. Secondly, should strictly selecting the independent directors, reasonable use of the independent director supervision function. In addition, the internal audit committee may be composed of independent directors who are well evaluated by the industry. Responsible for the selection and entrustment of external audit firms, which can not only maintain the independence of internal audit, but also avoid collusion between the company's management and accounting firms.

5. Conclusion

The financial fraud of Luckin Coffee caused great fluctuations in the capital market, and many investors began to take a wait-and-see attitude. From our case analysis of Luckin Coffee, we can see that internal management is very important for a company. Through this fraud incident, listed companies should see the importance of internal control and take warning. This paper analyzes and studies the internal control situation of Luckin Coffee, hoping to provide some reference for enterprises in the same industry. In this way, cause vigilance, self-correction, self-examination, find their own internal control loopholes, and constantly improve the internal control environment. Form a virtuous circle of the whole industry and the market, and promote the healthy and vigorous development of Chinese capital market.

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