

Case study of luckin coffee financial fraud based on theory of fraud risk factors

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Abstract: Since the formation of the capital market, financial fraud events centering on listed companies occur frequently. The credit mechanism of the capital market is seriously frustrated, and investors have suffered huge economic losses. In this paper, luckin coffee as an example, from the five aspects of theory of fraud risk factors, through the representation of luckin coffee financial fraud, analyzes the internal causes of its fraud. Through the case study, it is found that the occurrence of financial fraud in luckin coffee is the result of internal and external factors. On the one hand, it has sounded the alarm for the standardized operation of new retail enterprises in China, and on the other hand, it has provided enlightenment for the country to improve relevant laws and regulations and strengthen the cost of fraud punishment.

Keywords: Theory of fraud risk factors; Financial fraud; Motivation

1. Introduction

Financial fraud refers to the premeditated and deliberate use of deceptive means and illegal behaviors by enterprise groups or individuals to obtain improper interests. Since the beginning of the 21st century, Enron Corporation and other companies broke out in the international financial fraud events, and domestic also exposed many listed companies financial fraud problems. Financial fraud has become a stubborn disease of listed companies, the capital market is experiencing an unprecedented "credit crisis", and financial fraud seems to become the main culprit of this "credit crisis".

This paper will take luckin coffee as an example, starting from the five elements of the theory of fraud risk factors, analyze the reasons for its financial fraud from five aspects of moral quality, motivation, opportunity and exposure possibility, and punishment degree, in order to provide beneficial enlightenment for the improvement of the company's internal governance and the optimization of the external regulatory environment.

2. Case Background

2.1. Introduction of luckin coffee

Luckin coffee was founded in 2017. Since July 2018, luckin has completed several rounds of financing, including round A and round B. In April 2019, luckin submitted the prospectus document and was officially listed on NASDAQ on May 17.

Luckin coffee mainly deals in beverage and food series and is the largest chain coffee brand in China. Since its establishment, luckin coffee has exploited the rapidly developing big data platform to explore a new model of online retail. At the same time, it also carries out in-depth cooperation with major suppliers. In January 2018, it launched trial operation in 13 cities including Beijing and Shanghai. By May 2018, 525 stores have been completed. After it went public, its share price soared, peaking at \$50.02 per share.

2.2. Review of luckin Coffee fraud

Muddy Waters Research, 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. Fraud case analysis of Luckin Coffee based on theory of fraud risk factors

3.1. Moral quality analysis

Luckin's chairman and largest shareholder, Lu Zhengyao, founded China Auto Rental(CAR) before luckin. At that time, CAR occupied the market by burning money to fight price war in the early stage, borrowing financing and then listing dividends to cash out, a series of operations, so that the majority of investors suffered huge losses. But by comparison, the original investors in CAR earned a 380% return. In addition, Qian Zhiya, Li Hui and Liu Erhai, who co-founded luckin coffee with Lu Zhengyao, were all from CAR. A comparison of the board members and major investors of luckin and CAR reveals a similar composition. Then luckin coffee financial fraud incident, it is not difficult to connect with the lack of moral quality of the company's managers.

3.2. Motivation factor analysis

3.2.1. Financing needs of the company

Since its inception, luckin coffee has grown rapidly with the goal of becoming the “Starbucks” of China. Through a series of bombing publicity, issuing a large number of coupons and various promotional and discount activities, luckin has been wildly sought after by consumers in the consumer market for a period of time. However, the income from the low-end products and services created by luckin from the very beginning is not enough to support the capital costs consumed under its current business model. As can be seen from Table 1, luckin coffee's net cash flow from operating activities has been negative for more than one year since the second quarter of 2018, while its net cash flow from financing activities has been basically positive. So luckin, which is expected by investors to continue its expansion plans, still needs continued financing. Therefore, in order to achieve the goal of presenting good performance and attracting financing, the management of luckin finally whitewashing the financial statements by means of falsely increasing income and related party transactions.

Table 1: Luckin coffee cash flow analysis unit: 100 million yuan.

Financial indicators	2018.06	2018.09	2018.12	2019.03	2019.03	2019.03
Net cash flows from operating activities	0.3	1.05	0.39	0.94	0.54	0.17
Net cash flows from investing activities	0.22	1.89	0.49	0.11	3.43	0.96
Net cash flows from financing activities	2.03	1.56	2.08	0.13	8.07	0.22

Data source: luckin coffee 2018 and 2019 financial reports

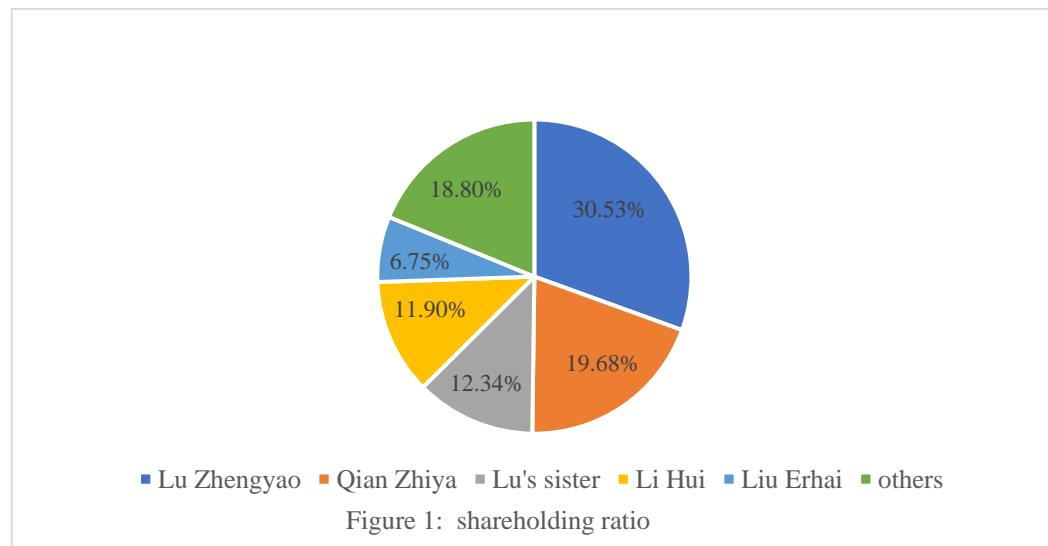
3.2.2. Avoid the need to be regulated

In general, large fluctuations in the performance of listed companies will attract the attention of regulators, but for those listed companies with relatively stable performance, attention is obviously not enough. Therefore, in order to avoid attracting the attention of regulators, listed companies will try to maintain their performance at a relatively stable level, which may reduce the vigilance of regulators and thus reduce the possibility of being investigated. Therefore, listed companies are often out of the need to avoid alerting regulators, and financial fraud. Luckin coffee is an emerging enterprise with a very short growth period and rapid development. If its business performance changes too much at this time, it is very likely to attract the attention of the regulatory authorities, which will hinder its business expansion plan. So, to avoid attracting regulatory attention, luckin chose to create the illusion of a healthy business by dressing up its financial statements.

3.3. Opportunity analysis

3.3.1. Unreasonable ownership structure

Luckin coffee's shareholding structure has a significant proportion of one person. According to Figure 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, the company's management structure has no practical usefulness. The excessive concentration of control provided opportunities for luckin coffee to commit financial fraud.



Source: luckin coffee's 2020 prospectus

3.3.2. Weak external supervision

(1) From the perspective of government supervision, luckin coffee, as a new enterprise, has been listed for a short time; Secondly, luckin coffee chose to be listed in the United States, while operating in China. Therefore, the above two points have obstructed the effective supervision and review by the regulatory authorities.

(2) From the perspective of investors, many domestic investors have some difficulties in obtaining complete and effective relevant financial information due to the difference between the place of business and the place of listing. The majority of investors are very easy to receive the wrong information of their modified appearance of good operation, which also weakens the supervision role of the public participating in investment.

(3) From the perspective of the industry, luckin coffee, as a new retail enterprise making full use of big data platform, may no longer be applicable to some traditional audit supervision methods. So it gives them the opportunity to commit financial fraud when regulatory approaches may lag behind those of emerging industries.

3.4. Exposure possibility analysis

Luckin coffee is mainly operated in China, but registered and listed in the United States, so there is a certain information difference between the place of operation and the place of listing. As a result, it is difficult for foreign regulatory agencies to grasp the business situation of luckin in a timely manner, and their jurisdiction is difficult to play an effective role. At the same time, domestic investors may not be able to obtain the financial reports and other data disclosed by luckin abroad in the first time, which may cause certain information lag or error. Based on the above reasons, it makes it more difficult for regulators and investors to supervise luckin, thus reducing the probability of its fraud exposure and providing the possibility for its later fraud.

3.5. Degree of punishment analysis

Before the implementation of the new Securities Law on March 1, 2020, China's Securities Regulatory Commission will impose a maximum fine of 600,000 yuan on the fraudulent behavior of listed companies, which is of low illegal cost. Many companies through fraud gains much higher than the amount of punishment for fraud, so listed companies to profit by financial fraud means. In the financial fraud case of luckin coffee, China's Securities Regulatory Commission (CSRC) only imposed a fine of 100,000 yuan on Lu Zhengyao, the main fraudster of luckin Coffee, which was far less than the benefits from the fraud. Therefore, the financial fraud did not form a huge deterrent force, which also led to the listed company's financial fraud repeatedly.

4. Conclusion and enlightenment

4.1. Research conclusions

During the decades since the establishment of China's securities market, financial fraud has occurred repeatedly. With the continuous development of China's securities market, listed companies fraud problem is becoming more and more intense, the development and progress of emerging industries, but also makes all kinds of fraud means more and more complex, more and more hidden. In this background, this article takes luckin coffee as an example, from the five elements of theory of fraud risk factors, through the presentation of financial fraud, luckin coffee analyses the inner factors of the fraud, research conclusions are as follows: (1) in terms of moral quality, luckin coffee mainly are greatly influenced by the major shareholders, management, lead to the existence of serious potential risk for fraud.(2) In terms of motivation, luckin coffee is in urgent need of financing and is under pressure to avoid supervision, thus prompting its fraudulent behavior. (3) In terms of opportunity factors, the unreasonable shareholding structure of luckin Coffee and the loopholes of external supervision give the management the opportunity to commit financial fraud.(4) In terms of the possibility of exposure, luckin coffee benefited from the information difference between the place of supervision and the place of operation, which greatly reduced the possibility of being exposed to financial fraud and made luckin coffee have fluke mentality.(5) In terms of the degree of punishment, China's Securities Regulatory Commission only imposed a fine of 100,000 yuan on Lu Zhengyao, the main fraudster. Such a small penalty, but also did not make the implementation of financial fraud people fear.

4.2. Research enlightenment

According to the five factors of luckin coffee's motivation for financial fraud, this paper puts forward suggestions on preventing financial fraud from three aspects: optimizing the corporate structure, strengthening external supervision and increasing the cost of fraud.

4.2.1. Optimize the company structure

(1) Improve the 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.

(2) Strengthen the internal audit function.

Luckin coffee as a new retail enterprise with rapid development momentum, its internal audit 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, independent directors should be strictly selected and their supervisory role should be reasonably used. In addition, the internal audit committee may be composed of independent directors to be responsible for the selection and entrustment of firms required by external audit, which can not only maintain the independence of internal audit, but also avoid the collusion between company management and accounting firms.

4.2.2. Strengthen external supervision

(1) Improving laws and regulations

Faced with problems such as the difficulty of new retail enterprises like luckin coffee in auditing and the lag of relevant laws, specific laws and regulations related to emerging industries should be updated in a timely manner to provide a reference basis for market supervision.

(2) Strengthening supervision in other places

Through the study of this case, it can be found that due to the difference in information acquisition between Chinese and overseas regulatory authorities, enterprises like luckin coffee seize the opportunity to cheat. Therefore, in view of this situation, we should strengthen the contact between China and overseas regulatory agencies, expand the scope of supervision, timely exchange of information, and prevent the difficulty of remote supervision caused by information occlusion.

4.2.3. Increase the cost of fraud

Through the analysis of luckin company, it can be found that the earnings obtained through financial fraud are far higher than the punishment. Mr Lu and others, who used to work for CAR, are unfazed by the CSRC's punishment. Therefore, in view of this situation, China should increase the amount of financial fraud penalty, and relate the amount of the penalty to things like the company's price-to-earnings ratio, in order to prevent the actual controller profit while minority shareholders pay the bill. In addition, heavier punishment can be imposed on those responsible for financial fraud, such as increasing the criminal responsibility of managers who commit serious financial fraud. Through the above methods to increase fraud cost to restrain the financial fraud of listed companies.

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