The Analysis of Luckin Coffee's Accounting Scandal

Jinpeng He *

RDFZ Xishan School, Beijing, China

* Corresponding author: 196112306@mail.sit.edu.cn

Abstract. In recent years, a company called Luckin Coffee in China got caught up in a big money scandal that shook both Chinese business circles and global financial markets. This study dives into what happened with Luckin Coffee, trying to figure out why it happened, how it impacted other companies, people who put their money in, and the whole market, and what can be done to stop such problems down the road. By going through different articles and reports, this study will thoroughly look into the backdrop and particulars of Luckin Coffee's financial mishap, and its repercussions both in China and on a global scale. The objective is to dig out the true causes of such financial wrongdoings and propose solutions for better oversight of company finances to prevent a repeat of such scenarios. Through an in-depth analysis of the financial fraud incident of Luckin Coffee, this research not only has important theoretical and practical significance for understanding and preventing financial fraud, but also provides valuable experience and lessons for financial regulatory agencies and enterprises, and promotes financial management and supervision.

Keywords: Financial scandal, financial fraud, supervision.

1. Introduction

The Luckin Coffee scandal significantly rattled China's business community and its investment landscape. While financial deception is not unprecedented worldwide, Luckin's situation highlights unique obstacles that emerging market corporations face in terms of financial oversight and regulatory compliance. The problems that were solved by this study: What was the process and outcome of the Luckin Coffee financial fraud incident? What impact will this incident have on the company, investors, and the market? Besides, the purpose of this study is to Understand the process, beginning, and result of Luckin Coffee's financial fraud and analyze the impact of the incident on the company, investors, and the market.

In addition, Luckin Coffee's financial fraud incident provides us with material to improve the current financial supervision system. Through an in-depth study of this incident, we can provide not only valuable lessons for companies and regulators but also provide useful references for future financial regulatory reform. At the same time, this study will also provide an important theoretical and empirical basis for understanding and preventing financial fraud and contribute to the advancement of financial management and regulatory practices.

2. Background Research

2.1. Basic Information

Luckin Coffee once hailed as China's burgeoning rival to the global coffee giant Starbucks brewed a storm in the financial markets with an accounting scandal that sent shockwaves through the investment community. Established in 2017, this Chinese coffee chain was quick to position itself as a formidable challenger to Starbucks in the fiercely competitive coffee retail market in China. With a tech-savvy approach that seamlessly blended online ordering with offline coffee consumption, Luckin Coffee sought to redefine how Chinese consumers experienced coffee. The company's business model, which melded technological innovation with aggressive market expansion, helped it quickly proliferate across urban landscapes as well as underdeveloped areas. One of the shreds of evidence is that the number of Starbucks stores in China has reached 4,123. However, Luckin Coffee has surpassed Starbucks and has 4,507 physical stores, becoming China's number-one coffee chain

brand, and attracting the attention of investors [1]. By May 2019, the coffee chain was buoyant enough to go public on the NASDAQ, showcasing its meteoric rise in the caffeinated corporate landscape. Its meteoric rise, however, was juxtaposed with a dramatic fall when in early 2020, allegations of accounting fraud began to percolate through the media.

2.2. Specific Fraudulent Processes

2.2.1. The beginning of the fictitious transaction

According to a report by Ernst & Young [2], Luckin Coffee's financial fraud began in April 2019. Finance and management personnel fabricated numerous sales transactions and purchase orders through negotiations with third-party companies. Through in-depth investigation, it was found that these third-party companies are usually affiliates or partners of Luckin Coffee.

2.2.2. False revenue and costs

Through fictitious transactions, Luckin Coffee inflated a large amount of revenue, costs, and expenses. This approach allowed Luckin Coffee to show extremely positive revenue growth and market share in its financial statements, thus attracting more investment and market attention.

2.2.3. Fake advertising and marketing

Luckin Coffee further attracted consumers and investors through false marketing and advertising. At the same time, big data and technical means are also used to create an illusion of increased market demand and increased user activity.

2.2.4. Failure of external audit

Although Ernst & Young is Luckin Coffee's external auditor, due to Luckin Coffee's failure to provide an audit report for its 2019 financial report, Ernst & Young failed to detect and reveal financial fraud in a timely manner [3, 4].

2.2.5. Disclosure of fraud

On April 2, 2020, Luckin Coffee disclosed that it had fabricated transactions totaling 2.2 billion yuan, which led to a steep decline in its share value on the Nasdaq stock market in the US [5]. The China Securities Regulatory Commission subsequently launched an investigation into the incident and found that Luckin Coffee, its relevant managers, and third-party companies fabricated large-scale fictitious transactions and inflated revenue, costs, and expenses.

2.2.6. Disclosure of fraud

Following the revelation of the scandal, authorities in both China and the U.S. scrutinized Luckin Coffee. On February 4, 2021, the company filed paperwork with the U.S. SEC, demonstrating compliance with an earlier settlement. The agreement involved Luckin Coffee paying a penalty of $187.5 million, which is about 1.2 billion yuan, to avoid further SEC prosecution [6].

3. Influences

3.1. Overview of Luckin Coffee and the Company's Engagement in Financial Misreporting

On the last day of January 2020, Muddy Waters Research, known for betting against companies, alleged possession of a detailed 89-page report anonymously authored, accusing Luckin Coffee of manipulating its financial records [7]. Luckin Coffee refuted these claims on February 3. By April 2, several American law firms were alerting investors of the looming deadline to join a collective legal action against Luckin Coffee. That same day, Luckin Coffee conceded to having inflated its revenue by 2.2 billion yuan [8]. This admission sent its shares tumbling down by 85%, as depicted in Figure 1. The following Friday saw a further decline of nearly 16% in the company's share value. On April 7, Luckin Coffee halted trading of its shares and by April 19, it was entangled in four different class-action lawsuits.

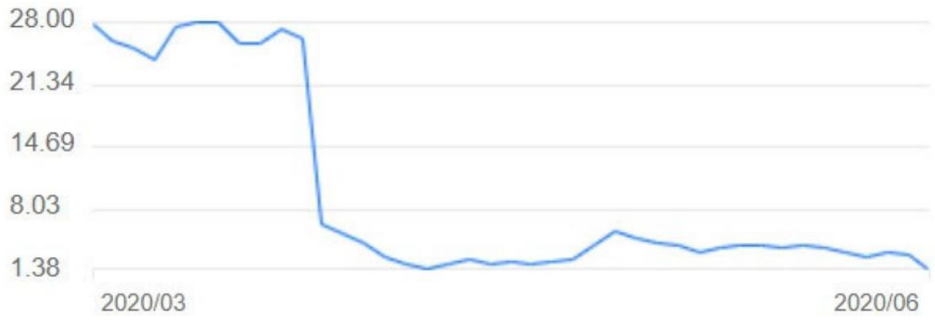


Figure 1. Share price

3.2. Data Analysis

$$R_{it}=\alpha_i+\beta_i Rm_t+\varepsilon_{it} \quad (1)$$

The return rate of a market-weighted index stock for a specific time period, referred to as "t", is calculated by subtracting the market's closing index on the previous day (t-1) from the closing index on the current day (t). In this context, αi represents a constant term, βi is the coefficient indicating the rate of change in the regression analysis, and εit is the term for the residual value, which is the portion of the return not explained by the model. When the data from an estimation period ranging from day -149 to day -54 is crunched in Excel, we find that the constant α is 0.0005 and the change coefficient β is 0.8306. Based on these figures, the yield curve for Luckin Coffee, as illustrated in Figure 2, can be expressed by the equation y = 0.8306x + 0.0005, where y is the predicted return and x is the independent variable in the model.

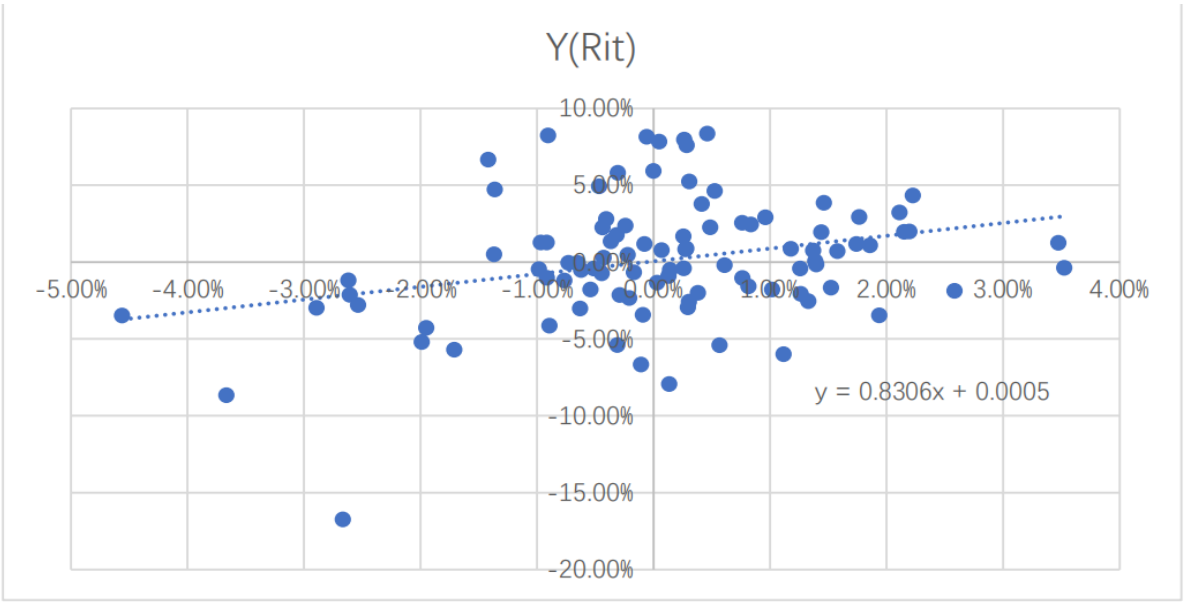


Figure 2. Luckin Coffee yield curve

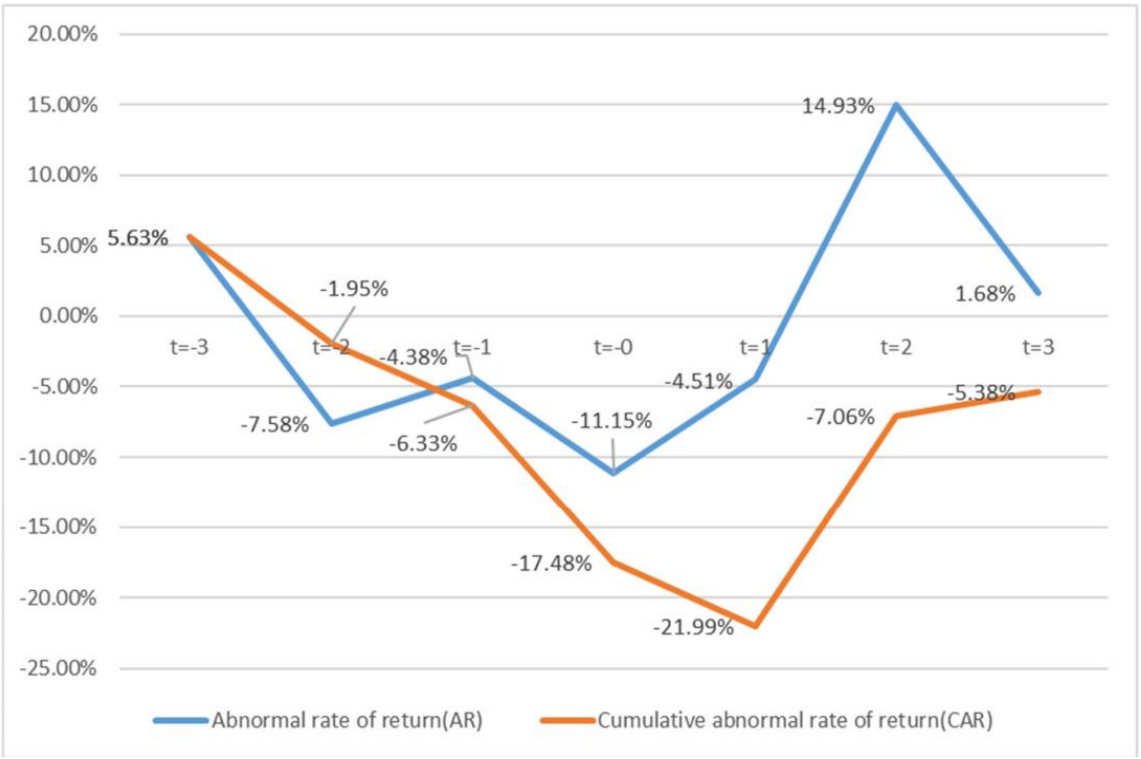


Figure 3. AR and CAR of Luckin Coffee

Figure 3 shows a decline in abnormal returns (AR) to -4.38% and -4.51% just before and after the announcement of financial fraud by short-sellers. However, on the day the fraud was made public, the AR plummeted to -11.15%, indicating the market reacted more intensely when the news broke than on surrounding days. The marginal decrease in AR prior to the announcement hints that some information might have slipped out early. On February 3, 2020, corresponding to t=1 in the figure, Luckin Coffee disputed the accusations by Muddy Waters, which caused a temporary uptick in the AR and provided a brief boost to its stock value.

The cumulative abnormal return (CAR) fell from 5.63% to -6.33% three days preceding the fraudulent data disclosure and plummeted to -17.48% on the disclosure day, signaling information disclosure existence. After the news was disclosed, CAR kept falling on the initial trading day. However, it rebounded from -21.99% to -7.06% after Luckin Coffee denied accounting fraud allegations and maintained a rising trend shortly, showing that the market's response improved post-denial despite the CAR remaining negative. This reflects the comprehensive influence of the false financial data exposure on Luckin Coffee's stock value.

3.3. The Influences on Chinese Companies

3.3.1. Impact on overseas investment and listing

Due to the Luckin Coffee scandal, the credibility of Chinese companies in the international capital market has been damaged, which may make international investors and regulators scrutinize Chinese companies more strictly. Guo Yafu, the founder and CEO of TJ Capital Management, expressed that the incident is a regrettable one, significantly tarnishing the standing of Chinese firms listed in the U.S. market [9]. This may affect Chinese companies' overseas investment and listing activities.

3.3.2. Calls for regulation

The controversy has intensified demands for more stringent oversight of Chinese firms listed in the US and abroad, with a focus on enhanced financial monitoring and openness. In response, US legislators and regulatory bodies are advocating for more clarity and tighter control over these entities [10]. Reflecting this stance, the US Senate approved the Holding Foreign Companies Accountable

Act in May 2020, which threatens to remove foreign entities from US stock exchanges if they don't meet American audit regulations for three years in a row.

4. Conclusion

Luckin Coffee, a leading local coffee brand in China, has won widespread attention from the market and investors with its rapid expansion and innovative model. Since the birth of the brand, it has successfully landed on the NASDAQ exchange in the United States in just 18 months at an astonishing speed. In 2019, China's coffee market is booming. Even the world-famous brand Starbucks has increased its market presence in China, and the number of stores has exceeded that of the North American market. Luckin Coffee seized the opportunity and surpassed Starbucks with 4,507 stores, taking the leading position in the Chinese coffee market. However, due to the RMB 2.2 billion false trading scandal that broke out in 2020, investor confidence has been severely hit, and the market has also suffered a heavy blow.

The Luckin Coffee scandal served as a focal point for examining how financial misconduct affects publicly traded firms and the broader market. This study particularly scrutinized the repercussions of financial deception on Luckin Coffee's stock price and operational activities. The aim was to uncover the detrimental effects of such fraudulent activities on market integrity and corporate growth, as well as to investigate ways to enhance regulatory oversight to foster a more robust and steady market environment.

In summary, Luckin Coffee, as a temporary market leader, was severely hit by financial scandals, which also led to a decline in confidence in the entire market. Future research should aim at bolstering oversight of publicly traded companies to avert repeat occurrences of such incidents. This can be achieved by conducting in-depth research and analysis, which in turn will lead to the enhancement and regularization of market governance structures.

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