

# Analysis of Financial Fraud and Audit Implications of Luckin Coffee

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**Abstract:** With the development of the capital market, CPA audit gradually matures, and its importance is increasing day by day. This article selects the classic case of Luckin Coffee as the research object, analyzes Luckin's research on financial fraud methods, and conducts financial analysis on cash flow, total asset net interest rate, and operating profit margin, and discovers Luckin's fraud process and reasons for fraud. And summarize the corresponding audit countermeasures. In addition, through the Luckin incident, the enlightenment of the company's equity structure and operating methods in the capital market has been drawn.

## 1. Introduction

CPA audit is rooted in the capital market,. With the continuous development of the world economy, the importance of CPAs in the operation of the capital market is self-evident. In recent years, financial frauds in domestic and foreign enterprises, such as "Green Earth" and "Kang de Xin Pharmaceutical", and so on, and certified public accountants are therefore responsible for auditing. It is undeniable that in these cases where the CPA and the enterprise collaborated to cheat, but most of the audit failures are caused by the limitations of the audit tools, not intentionally.

Therefore, this article chooses a representative case of audit failure, taking Luckin Coffee as the research object. The financial fraud incident of Luckin Coffee has become a huge scandal in China concept stocks, which has caused irreparable damage to the development of Luckin itself and other China concept stocks. Negative impact. This article will discuss Luckin Coffee's financial fraud methods and the reasons for the failure of the CPA audit, and propose corresponding countermeasures to improve the auditing standards of certified public accountants.

## 2. Background Introduction

At the end of January 2020, on the eve of the financial report disclosure season, Muddy Waters, a well-known short-selling agency, pointed out that Luckin Coffee's financial fraud with an 89 -page anonymous report, fabricated the company's financial and operating data, and exaggerated sales by more than 60%. Luckin's stock price fell sharply on the allegations. Afterwards, although Luckin Coffee firmly denied all the allegations made by Muddy Waters, in the face of class action lawsuits filed by a large number of investors and the delisting pressure from the US Securities Regulatory Commission, Luckin Coffee had to set up a self-inspection committee, and finally on April 2 It blew up that its sales data of up to 2.2 billion yuan from the second quarter of 2019 to the fourth quarter of the same year was false, and the stock price plummeted 80% for this , and it plummeted several times to stop trading.

Luckin Coffee (China) Co., Ltd. was established on March 28, 2018 and is headquartered in Xiamen. Since its establishment, Luckin has attracted domestic consumers with its overwhelming marketing and low-price discounts, and has rapidly expanded in China. market share. As of December 2019, Luckin had more than 4,400 stores and was listed on Nasdaq in the United States within 18 months of its establishment. It has become the leading brand in the domestic coffee industry in just two years of operation. After financial fraud and delisting After the turmoil, it is still the leading chain coffee shop in China. It has not been affected by it, and the number of stores is still increasing.

### **3. Luckin's Financial Fraud Methods**

Listed companies mainly carry out financial fraud through three methods. The first is to manipulate profits by falsely reporting operating income and forging operating costs and expenses. Under the huge operating pressure, Luckin Coffee involved the above three financial fraud methods at the same time in order to create the illusion of good management. In April 2020, Ernst & Young, which is in charge of Luckin's audit business, stated that it found that Luckin's executives inflated revenue, costs and expenses in the second, third and fourth quarters of 2019, and by falsifying transactions with related parties. The specific means of financial fraud include:

#### **3.1 Inflate Orders as Well as Revenue by Skipping Orders**

Luckin Coffee mainly skips orders during store transactions. Under normal circumstances, the daily order growth order of stores should be linearly increasing in the order of Arabic numerals, but Luckin Coffee is not the case. For example, Luckin should have superimposed sales orders in the order of 1 2 3 4 , but in fact, the chat screenshots of Luckin's internal employees showed that the company asked to jump directly from order No. 271 to No. 273, and No. 272 disappeared in the middle. That is a false order. Muddy Waters once sent its staff to 981 Luckin stores to conduct on-the-spot surveys around the clock. After monitoring the operating conditions of Luckin stores and collecting and analyzing their sales data, it was concluded that Luckin Coffee stores are increasing randomly every day. The number of orders issued has created the illusion of a skyrocketing order volume, and even the same store used the illegal method of skipping orders with the meal code to falsely report the number of 34 orders as 232 within a day, which skyrocketed in the third and fourth quarters respectively 69% and 88%, these astonishing figures are not actual sales at all, but fake sales data of Luckin Coffee.

#### **3.2 Inflated Revenue from Other Products**

The main business of Luckin Coffee is the sale of coffee drinks. At the same time, the store will also sell some light meals, raw materials and peripheral items, such as salads and other light meals, coffee beans and other packaging products. These are included in Luckin's other product revenue. Luckin uses the advantages of the online platform in sales channels. Muddy Waters has collected more than 20,000 original sales receipts from consumers. After statistics and analysis, it is calculated that Luckin Coffee's other product revenue accounts for only 2% of the total sales revenue, and Luckin has expanded this proportion. About 4 times, false reporting to nearly 6.2%.

#### **3.3 Inflating Average Sales Price**

Muddy Waters collected 25,843 sales receipts and found that in order to attract new customers, the actual selling price of a single cup of Luckin Coffee is at a relatively low level in the tea industry, with an average actual selling price of only 9.97 yuan per cup, compared to 11.2 yuan per cup in Luckin's official financial report, indicating that Luckin has fabricated at least 12.3% of false revenue. At the same time, the management of Luckin Coffee also misrepresented the proportion of sales revenue. In fact, the sales price accounted for 46% of the listed price, but management claimed that the sales price accounted for 55%, inflating the revenue share by almost 9%.

#### **3.4 Prepare False Contracts to Inflate Costs and Expenses**

Luckin exaggerated advertising spending in the third quarter of 2019. According to a survey by the US CCTV Market Research Department, in the third quarter of 2019, Luckin Coffee spent 46 million yuan on its cooperative publicity target Focus Media, which accounted for 12% of Luckin Coffee's advertising expenditure, which is far lower than the proportion of Luckin Coffee in the previous few quarters. If Luckin Coffee's advertising expenditures caused by cooperation with other companies in the third quarter are the same as in the past, then it can be concluded that Luckin Coffee has inflated its advertising expenditures by nearly 158%.

### **4. Countermeasures and Audit Inspiration**

Anhua Yongming Accounting Firm is the audit agency responsible for Luckin. In May 2019, Luckin Coffee was listed on Nasdaq in the United States. From June 16, 2017 to the end of 2018, Anhua Yongming Accounting Firm was responsible for its audit. Conduct an IPO audit. During this period, Luckin raised a total of 695 million US dollars, and the audit fee was 779,100 US dollars, accounting for only 0.11% of the IPO financing. The proportion is extremely low. At the same time, the above financial analysis shows that Luckin lost 1.6 billion yuan in 2018 and Ernst & Young did not cheat. The motivation and willingness of the company have not been in the same boat as the enterprise.

To sum up, Luckin tried to use the management's personal financing ability to drive Luckin to go public in the United States. In order to maintain profitability, it inflated orders by skipping orders, falsely raised sales prices, falsely increased expenses with related parties, etc. The method fabricated financial data and carried out financial fraud, but finally delisted after 13 months of listing. In response to these means of financial fraud, the following countermeasures can be taken to prevent them.

#### **4.1 Focus on the Business Operation Model of the Audited Entity**

In the Luckin fraud case, as shown above, Luckin's business model is different from that of ordinary retail companies and does not rely on offline sales. During the audit process, one of the difficulties is that it is difficult to audit a large number of non-commercial transactions with non-related parties. If before the audit, industry experts are invited to audit the business operation model of the audited unit and analyze whether its profit model is reasonable, they will find that there are huge problems in Luckin Coffee's business profit model. Therefore, when conducting a CPA audit, the suspicious areas will be further excavated.

#### **4.2 Increase the Proportion of on-the-Spot Investigation Methods for the Retail Industry**

When Muddy Waters investigated Luckin Coffee's financial fraud case, its basic data came from field investigations conducted by mobilizing 92 full-time and 1,418 part-time personnel, which truly proved that Luckin's financial report was false. When Luckin Coffee was audited, generally because the on-site investigation was too time-consuming and labor-intensive, the audit agency would reduce the use of the on-site investigation method to a certain extent in order to reduce costs, which also prevented the auditors from grasping the audited company's performance to a certain extent. The production and operation situation has laid hidden dangers for the issuance of inappropriate audit reports. Inspired by the Luckin fraud case, when targeting special industries, such as the new retail industry, it is still necessary to increase the proportion of on-the-spot investigation methods to avoid being deceived by the company's non-data.

### **5. Event Impact and Enlightenment**

As China's fastest IPO company listed in the United States, Luckin Coffee has attracted the attention of investors all over the world since its listing, and is regarded by stock market investors as a stock with potential for future development. It is no exaggeration to say that Luckin Coffee even became the endorsement brand of China concept stocks at the beginning of its listing. Luckin's financial fraud was exposed, and it was not only Luckin and Shenzhou car rental that were damaged, but also other Chinese stocks that were preparing to be listed on the US market were pushed to the edge. It is more difficult to list in the United States, which affects the pace of listing of other Chinese concept stocks in China, exacerbates the difficulty of overseas financing and listing of Chinese concept stocks, reduces the development opportunities of Chinese concept stocks, and will also have a substantial adverse impact on China's economic development. In response to the financial fraud case of Luckin Coffee, Luckin and other companies in China concept stocks should learn the following lessons.

#### **5.1 Deliver Business Information with Integrity**

As an important medium for communication between listed companies and investors and other stakeholders, financial reports should ensure that the data is true and the information is comprehensive, and timely convey the real business and profit information of the company to all sectors of society, so as to be responsible to consumers and investors. In the face of business difficulties, what companies should do is to change their business thinking and adjust their business strategies, instead of fabricating sales data like Luckin Coffee to defraud investment trust, and delivering business information with integrity is the right way to gain customers and investors.

## 5.2 Improving the Internal Control System

The sound operation of a listed company is inseparable from a sound internal control system. Only by establishing a healthy and comprehensive internal control system can the company run smoothly. Luckin's ownership structure is too closely attached to the Shenzhou series, resulting in the non-independent internal control system, and it is difficult for the management to make decisions suitable for Luckin's development. Therefore, enterprise development should pay attention to the optimization of shareholding structure, balance the right to speak among shareholders, and avoid the occurrence of monotonous phenomena.

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