

# **Analysis of Financial Fraud in Listed Companies based on Luckin Coffee**

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## **Abstract**

**During the vigorous development of the global capital market, financial fraud has been rampant. Both domestic and foreign enterprises have affected the market order. Taking Luckin Coffee as the research object, through case analysis, this paper explores the overview, causes and impacts of its financial fraud, and proposes corresponding countermeasures and suggestions. The data comes from Luckin Coffee's own financial statements, Humin's short-selling report, and relevant references. The study shows that the fraud has led to changes in Luckin Coffee's management, negatively impacted Chinese listed companies in the market, decreased trust, and promoted reforms in international capital market regulatory rules.**

## **Keywords**

**Lucky Coffee, Financial Fraud, Listed Company, Reasons for Fraud.**

## **1. Introduction**

With the rapid development of the global capital market, financial fraud has always had an impact on market order. In recent years, from domestic cases such as "Evergrande Real Estate" and "Zixin Pharmaceutical" to foreign cases such as "General Electric (GE)" and "eFishery", as well as the series of financial fraud incidents involving "Lucky Coffee Inc." (a popular online brand), these events have attracted widespread public attention. Especially the "internet sensation" Lucky Coffee Inc., on the trading day before April 2, 2020 (US time), the company disclosed to the US Securities and Exchange Commission (SEC) that it was suspected of financial fraud, with the involved amount reaching as high as 2.2 billion US dollars. This triggered a new round of trust crisis among Chinese-listed companies. The SEC promptly launched an investigation, and it was confirmed that the financial fraud allegations of Lucky Coffee Inc. were true. Based on this, this article takes Lucky Coffee Inc. as the research object and uses the case analysis method to analyze the rapidly rising and rapidly falling star companies in the listed companies, deeply exploring the general, causes and impacts of the company's financial fraud.

## **2. Summary of the Financial Fraud Case of Luckin Coffee**

### **2.1. Introduction to Luckin Coffee Company**

In 2017, Luckin Coffee was founded in Xiamen and its headquarters was established there. By the end of 2019, with 4,507 direct-operated stores, Luckin Coffee surpassed Starbucks' 20-year store layout in China and successfully became the largest chain coffee brand in China. On May 17, 2019, Luckin Coffee was listed on the Nasdaq Stock Exchange in the United States, raising \$695 million and becoming the fastest-growing company from establishment to IPO in the world [1].

From April to December 2019, Luckin Coffee inflated its revenue by 2.119 billion yuan through the fictitious commodity voucher business, accounting for 41.16% of the 5.15 billion yuan

revenue disclosed in its original external financial statements. Along with a 2.246 billion yuan increase in transaction volume, a 1.211 billion yuan increase in costs and expenses, and a 0.908 billion yuan increase in profits, this fraudulent behavior was traced by the company to the Chief Operating Officer (COO) Liu Jian and others, involving a transaction volume of approximately 2.2 billion yuan.

Not only did Luckin Coffee's financial fraud lead to its delisting from the Nasdaq on June 29, 2020, thus ending its 13-month listing journey, but it also triggered a trust crisis for Chinese-listed companies in the market. Eventually, on May 20, 2020, the United States pushed through the "Foreign Companies Accountability Act". The Act demands that a company be denied trading in the U.S. if the Public Company Accounting Oversight Board (PCAOB) cannot inspect the company's auditor for three consecutive years [2].

## 2.2. The Company's Fraudulent Financial Practices

### 2.2.1. Overstating Sales Revenue

**Data tampering system:** The Lululemon Coffee Company adopted the "skip order" method. Each cup of coffee had a unique three-digit pickup code. The pickup codes were generated in sequence and were manipulated by human means to skip certain digits, thereby increasing the actual sales volume compared to the fictitious order number method, and achieving a significant increase in transaction volume to inflate sales revenue. This method was deeply integrated with Lululemon Coffee's online operation model, forming a covert fraud cycle, and ultimately achieving the goal of beautifying the financial statements.

**False discounts and full reduction:** By taking advantage of consumers' attention to promotional activities, Lululemon made false records in its financial processing regarding discounts and full reduction activities. The actual discount offered to consumers might be relatively small, but the original price before the discount was exaggerated in the financial statements, while the actual received amount after the discount was recorded normally, that is, the net selling price per single item was falsified, thereby inflating sales revenue.

**Table 1.** Overstating sales figures

Methods	Trick	Examples	Result
Tampered data system	Skip the list	Change from consecutive increments (such as 381, 382, 383) to random number selection (such as 381, 383, 385)	In the third quarter of 2019, Luckin falsely increased its revenue by approximately 320 million yuan through unreported transactions, accounting for 15% of the disclosed revenue at that time. The sales volume in its stores was falsely inflated by 69%.
False discounts and "buy-one-get-one-free" offers	Does not match the price	A coffee that is actually priced at 10 yuan is recorded in the financial records as having an original price of 20 yuan. After applying the discount promotion, the payment received is 10 yuan, thereby artificially inflating the sales revenue by 10 yuan.	In the third quarter of 2019, the net selling price of a single product reached 11.2 yuan. The survey results indicated that the net selling price of a single product at Luckin was less than 10 yuan, with an inflated rate of up to 12%.

### 2.2.2. Overstated Cost and Revenue

The Luckin Coffee Company inflated its sales revenue, and therefore also had to simultaneously inflate its cost revenue to maintain the balance of the profit statement. When signing the coffee bean purchase contract, Luckin Coffee Company was in fact dealing with a fictitious "Ningbo Certain Food Supply Chain Company", and no goods were actually delivered. In the third quarter of 2019, the fictitious purchase amount was 120 million yuan. It also tampered with the purchase quantity and unit price. The actual coffee bean purchase volume of Luckinn Coffee

Company in 2019 was 1,800 tons, but the cost record in the financial statement showed 2,500 tons, resulting in an overstatement of costs of approximately 72 million yuan. Additionally, the purchase unit price of coffee beans was falsely raised from the actual 80 yuan per kilogram to 120 yuan per kilogram. At the same time, 20% of the total purchase volume was fictitiously increased. According to the short-selling report by Hunshui,[3] the total fictitious purchase cost for 2019 was approximately 350 million yuan.

### **3. Analysis of the Reasons for the Financial Fraud at Luckin Coffee**

#### **3.1. The Chaotic Internal Management of the Company**

As of 2019, the chairman of Luckin Coffee, Lu Zhengyao, held 23.9% of the shares, and the CEO, Qian Zhiya, held 15.4%. The combined shareholding ratio of the two would exceed 34%. In the equity design, if the two constitute a concerted action, this ratio means that they have the right to veto major matters of the company, that is, they have the direct veto power over specific resolutions of the shareholders' meeting. Chairman Lu Zhengyao's voting rights were 36.9%, and the CEO Qian Zhiya's voting rights were 23.8%. The combined voting rights of the two exceeded 60%, meaning they have absolute control over the company [4].

The board of directors of Luckin Coffee consists of 10 people, with a composition of 4 executive directors, 2 non-executive directors, and 4 independent directors. Apart from Chairman Lu Zhengyao and CEO Qian Zhiya, the key figure in this financial fraud, the COO, also serves as an executive director on the board. However, the COO has no company shares but can enter the board as an executive director. The independence of the Luckin board is insufficient, which is also an important reason why the responsibility chain of the financial fraud incident involves the board.

#### **3.2. Weak Legal Awareness of Employees**

When improper behaviors were carried out in Luckin Company, grassroots employees cooperated in carrying out actions such as fabricating purchase quantities and forging sales figures. Some employees were not aware that such behaviors violated laws and regulations such as the "Securities Law of the People's Republic of China" and the "Accounting Law of the People's Republic of China", and thus lacked sufficient understanding of the consequences of illegal and criminal acts. At the same time, Luckin Coffee Company did not establish a complete legal compliance training program, resulting in employees lacking the sense of responsibility to maintain market integrity and the thinking to defend the legal bottom line. Eventually, they became the executors in the fraud chain[1].

#### **3.3. Failure of Financial Audit**

On one hand, the internal audit department failed to function properly. The financial data was not thoroughly verified, and no checks were conducted on abnormal expenditures in abnormal transactions or large-scale fabricated orders. The internal accountants of the company failed to adhere to professional ethics and colluded with the company to commit fraud, resulting in discrepancies between the accounting information and the facts. Financial fraud has harmed the company's interests and had a negative impact on the development of the industry.

On the other hand, the external audit institution also failed in its functions. The auditing institution of Luckin Coffee was Ernst & Young Hua Ming Certified Public Accountants, one of the four global accounting firms. It failed to detect the signs of fraud through procedures, and the auditing process was not standardized. It failed to play its auditing role, allowing the fraudulent behavior to persist undetected and unexposed for a long time. The inaction of the auditing system led to financial fraud.

### **3.4. Loose Regulatory Constraints**

Internationally, there is a lack of coordination in the regulation of cross-border listed enterprises. The initial framework for ESG development in China is gradually taking shape, and the ESG concept is increasingly gaining popularity. However, compared to countries where ESG development is more mature, China started relatively late and the related supporting measures are not yet mature [5]. Domestic regulation has not formed effective supervision over the key aspects such as the essence of Ruiqing Coffee's business within the country and the flow of funds. The auditing supervision of US securities regulation for Chinese-listed companies has loopholes at the implementation level, with insufficient regulatory rules and strength, allowing Ruiqing to take advantage of regulatory loopholes to carry out fraud, reflecting the looseness and lag of regulatory constraints.

## **4. The Impact of Luckin Coffee's Financial Fraud**

### **4.1. Impact on the Company's Internal Affairs**

On June 27, 2020, the board of directors of Luckin Coffee Company resolved to request that Lu Zhengyao resign from his positions as director and chairman. On June 29, Luckin Coffee filed for delisting on the Nasdaq. After the fraud scandal was exposed, it not only seriously damaged its own brand image, but also lost the trust of consumers. The company was also held accountable by both China and the United States simultaneously. The State Administration for Market Regulation imposed a penalty on Luckin Coffee Company, totaling 61 million yuan. On December 17, 2020, the US Securities and Exchange Commission (SEC) stated that Luckin Coffee agreed to pay 180 million US dollars to reach a settlement.

### **4.2. Impact on the Chinese Market**

The Luckin incident has caused a strong shock to the Chinese capital market, severely impacting the group of Chinese-listed companies. The decline in the value of these Chinese companies has continued to increase. After the incident was exposed, the trust in Chinese companies among American investors dropped significantly. They believed that Chinese enterprises had a relatively high risk of financial fraud. The Luckin fraud will lead to difficulties for all Chinese companies listed in the US in the future, and they will also face an unprecedented international trust crisis [6].

### **4.3. Impact on the World Market**

The transformation of international capital market regulatory rules was driven by the Robin hood incident. The "Foreign Companies Accountability Act" (HFCAA) passed by the US Congress in May 2020 clearly stipulates that if a foreign company listed in the US fails to pass the audit inspection of the US Public Company Accounting Oversight Board (PCAOB) for three consecutive years, it will face the penalty of mandatory delisting. This act regarding the auditing compliance issues of Chinese-funded companies has sparked extensive discussions on cross-border listed enterprises' regulatory supervision worldwide. The re-examination of their own capital market regulatory systems and the strengthening of requirements for financial information disclosure and audit supervision of listed companies in other countries and regions have, in the subsequent process, pushed the international capital market regulatory rules towards continuous improvement and towards unification. On the other hand, when a crisis of trust arose, Chinese companies wishing to go public in the United States might come at a greater cost [7].

## **5. Countermeasures and Suggestions**

### **5.1. Strengthen Enterprise Management**

Lucky Coffee should prioritize strengthening the management of its internal staff. The job responsibilities and authorities of the management team and the grassroots employees should be clearly defined. At the same time, an independent supervision position should be established to achieve effective checks and balances on the top-level decisions and the execution of business processes. The store management should use more digital systems. The regulatory authorities should strengthen the supervision of the stores. Through real-time data conversion, they can obtain operational data such as actual sales volume and material consumption, enabling the headquarters to implement dynamic monitoring of store operations, thereby reducing the possibility of data fraud. To address the problems caused by management chaos, it is necessary to simultaneously promote the improvement of the company's internal structure and the establishment of a cross-departmental cooperation platform to enhance information timeliness and strengthen management.

### **5.2. Improving Employee Quality**

When it comes to legal training for different positions, this is currently the top priority for LUCKIN COFFEE. Employees should be very clear about the legal consequences of fraud and be educated and reinforced on laws such as the "Securities Law of the People's Republic of China" and the "Accounting Law of the People's Republic of China". The cultivation of awareness of abiding by the law and the bottom line, as well as strengthening the corporate integrity culture and basic compliance standards, are necessary to achieve this. To prevent the recurrence of violations due to employees' lack of awareness, an employee quality assessment and improvement incentive mechanism can be established. Employees who actively learn and have outstanding compliance performance will be promoted and rewarded, thereby attracting and retaining high-quality talents.

### **5.3. Improving Financial Auditing**

Independent directors can form an internal audit committee to detect any anomalies. The internal audit department, which has an internal design committee that can directly report to the board's audit committee, ensures that the auditing work is not interfered with by the management. They are responsible for selecting and commissioning auditing institutions in accordance with external auditing requirements, choosing external auditing institutions with high qualifications and high reputation, and clearly defining auditing responsibilities and work standards, which can not only maintain the independence of internal audit, but also avoid the collusion between company management and accounting firms [8].

### **5.4. Strengthening Supervision and Constraints**

For a long time, there have been significant difficulties in solving cross-border accounting criminal cases. The difficulty and cost of supervision have further increased due to various factors in different countries and regions. To effectively prevent cross-border accounting violations, it is necessary for the securities regulatory agencies of various countries or regions to serve as a bridge and establish broader and more effective regulatory communication. Through such systematic cooperation measures, strengthening law enforcement cooperation can break through the geographical barriers of cross-border supervision and truly ensure the prevention of accounting criminal violations.

## 6. Conclusion

This article analyzes the financial fraud case of Luckin and clarifies its core fraudulent methods and underlying reasons. Regarding the reasons for corporate fraud, Luckin, in order to maintain its rapid expansion of the capital story, fabricated online performance and procurement costs, and also had internal governance flaws. As a result, it went from being listed to delisting in just 13 months. To prevent similar financial fraud incidents, it is necessary to strengthen enterprise management, improve employee quality, and improve financial auditing. The conclusion may be limited in its applicability when only focusing on Luckin as the research object, as it may not fully cover the financial fraud characteristics of enterprises in different industries and different listing locations. In the future, it can be conducted in-depth research on the compliance paths of Chinese-listed companies in the US regulatory game after the implementation of the Foreign Companies Accountability Act, as well as how multiple capital markets establish unified standards for punishing financial fraud.

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