

Analysis of Luckin's Financial Fraud

Kangtian Yang^{1,a,*}

¹Jimei University Xiamen, Fujian, 361000, China

a. 2121729189@qq.com

*corresponding author

Abstract: With the rapid development of market economy and Internet technology, the number of listed companies has steadily increased. Luckin Coffee, one of the famous local coffee brand in China, not only challenges Starbucks's monopoly in the Chinese coffee market but also pioneers new directions for China's coffee industry. However, financial fraud has become increasingly prominent, causing significant losses to the country, securities market, and investors. This paper examines relevant theories of financial fraud using Luckin Coffee as a case study, providing a detailed review of its fraudulent activities from start to finish. The analysis reveals that Luckin Coffee primarily engaged in financial fraud by inflating online orders, exaggerating main business income and costs, and conducting complex related transactions. Furthermore, this paper conducts an in-depth analysis of three factors contributing to Luckin Coffee's financial fraud: financing pressure, market competition and balance of payments. Concrete measures and suggestions are proposed to prevent and control both internal and external financial fraud within listed companies. By delving into the Luckin Coffee's financial fraud case, this research aims to support optimization efforts in financial management practices while enhancing the soundness of related enterprises' financial system. It also seeks to help these enterprises enhance their competitiveness in the market while offering inspiration for improvements within China's capital market system. Additionally, this paper also reveals the negative impact of financial fraud on investor confidence, market order and sustainable development of enterprises, and emphasizes the importance and urgency of combating financial fraud.

Keywords: Financial fraud, Luckin Coffee, Internal control, External pressure, Management.

1. Introduction

Luckin Coffee is a typical representative of the Internet + new retail marketing model in the current coffee industry in China. By combining Internet technology with the new retail model, Luckin Coffee has created a new business model of collaborative sales between online platforms and offline stores in the coffee industry [1]. Since its establishment in 2017, Luckin has swiftly captured the market through extensive store expansion, implementation of split-marketing strategies, and issuance of a large number of coupons. On May 17, 2019, Luckin was listed on Nasdaq in the United States, raising \$695 million and setting a record for the fastest IPO globally. However, in April 2020, Luckin faced exposure as being involved in financial fraud. Despite this setback, as of 2022, Luckin's annual total net income has increased, reaching 13.293 billion yuan, indicating that the company continues to maintain stable development momentum [2]. This phenomenon has sparked the author's research

interest. In order to gain further insights into why Luckin managed to sustain positive development following the fraud incident it encountered, this study adopts financial analysis method to thoroughly examine various financial indicators and explore both business motivations and means employed during the financial fraud at Luckin. Additionally, this study also analyzes differences and similarities between Luckin and other enterprises involved in financial fraud regarding their approaches. To address similar instances of financial fraud effectively, several policy recommendations will be proposed. This study are expected to provide important implications for preventing financial fraud and promoting the healthy development of the market.

2. Industry Background Analysis

As the coffee industry continues to expand on a large scale, numerous companies have rushed into the market, including globally recognized brands like Starbucks and local emerging forces such as Luckin and Lian Coffee. Consequently, this situation has intensified the competition for market share and brand recognition within the industry. To distinguish themselves in this highly competitive landscape, some enterprises may resort to informal strategies, such as misrepresenting financial data, in order to attract more attention from both investors and consumers.

2.1. Inflated Income

Luckin employed fraudulent tactics, such as manipulating transaction documents, to fabricate sales activities that never occurred, thus creating a false picture of revenue expansion. This deceptive conduct directly contributes to the artificial growth of income data in the company's financial report.

Additionally, Luckin Coffee engaged in covert intervention by artificially controlling the distribution of delivery codes, resulting in irregular gaps within what should have been a continuous sequence of numbers. Consequently, this unintentionally facilitated “order inflation,” wherein “an inflated volume of sales” is generated through the utilization of automatically generated system data during the revenue recognition process [3]. The nature of this practice poses challenges for auditors and investigators attempting to identify such fraud due to its jump order pattern. It falsified sales for three quarters, totaling 2.2 billion yuan, and overstated 2019 sales by nearly four times by fabricating the number of online orders. Luckin inflated its assets mainly by fabricating the profit of individual items and store sales, overstating the average store by 88% [4]. According to the investigation of the Muddy Waters research company, Luckin Coffee's profit per product is less than 10 yuan, which is far from the 11.2 yuan stated in its published report [5]. Luckin has artificially further inflated its revenue by raising the list price per unit of product and making up transaction numbers. According to the disclosure from Muddy Waters research agency, the actual selling price of goods in Luckin's operations only amounted to 46% of the published price, far lower than the claimed 55% ratio stated by company management [6]. At the same time, the company misrepresented its market size by fabricating higher sales figures.

2.2. Fictitious Costs

Luckin Coffee has exaggerated its advertising spending. According to Muddy Waters, in 2019, Luckin Coffee's reported advertising expenses were overestimated by at least 150% [6]. The operation is suspected of engaging in fictitious advertising transactions, wherein funds are paid to affiliated entities or unaffiliated third parties and then included as part of the company's revenue through exaggerated turnover figures. The second aspect pertains to cost and expense transfers: Luckin Coffee may have employed a financial maneuver whereby expenses incurred at the store level are shifted to the overall accounts of the group as a means to cover up inflated income. This strategy of transferring costs creates an illusion where individual stores appear profitable while the group as a whole seems

to be experiencing losses. The underlying logic of this strategy lies in shaping public perception regarding store-level profitability, thereby allowing for future improvements and enhanced earnings performance through expense reduction measures.

2.3. Related Party Transaction Fraud

Luckin Coffee is involved in a large number of transactions with related parties, strategically inflating its operating income and cost expenditure through artificial means. These related parties cover both the upstream and downstream sectors of the supply chain, including suppliers of raw materials and end consumers. By employing this interconnected transaction model, Luckin Coffee flexibly manipulates transaction prices and sizes so as to achieve false gains in operating income and cost data.

Secondly, Luckin Coffee carried out financial fraud through the practice of large-scale purchase of vouchers by related parties. The voucher, normally used as a promotional tool, was transformed by Luckin into a medium for fictitious transactions within this context. By improperly inflating its operating income and cost expenditure, the company purchased and exchanged coffee vouchers with the help of affiliated enterprises.

2.4. Data and Traffic Fraud

Luckin Coffee may falsify system data or tamper with system logs to glorify its business performance. Such manipulations rely purely on information technology without real business activities as support. Therefore, when reviewing the authenticity of data, it is crucial to employ logical verification methods that can effectively identify such false operations. Luckin Coffee may face inconsistencies during the integration of multi-dimensional data, which can be observed through logical differences between order volume, financial flow and logistics data. By meticulously aligning these cross-domain datasets and conducting in-depth analysis of anomalies, potential data forgery can be revealed.

3. Analysis of the Motivation of Financial Fraud

First, based on the balance of payments perspective analysis, for enterprises with unbalanced income and expenditure, the internal financing capacity is poor, and the company has no more funds for reinvestment or reproduction, so external financing is needed [7]. Financial institutions use a company's financial data to determine its solvency and then decide whether to lend. After the listing of Luckin Coffee, the original owners may want the stock price to remain high in order to reduce their holdings at high levels to cash out. In order to maintain a satisfactory stock price level, Luckin Coffee may use financial fraud to whitewash financial statements and send positive signals to the market.

Second, external financing pressure. As a rapidly expanding company, Luckin Coffee needs to constantly attract external investment to support its business development. In order to maintain high valuations and attract more investors, companies may exaggerate their performance and profitability through financial falsification. And in the initial stage of listing, Luckin Coffee attracted the attention of investors and financial institutions by falsely increasing revenue and profits so as to obtain more financing support. This financing demand prompts companies to use financial fraud to whitewash financial statements.

Third, market competition strategy. In the early days of its establishment, Luckin Coffee adopted a rapid market expansion strategy to attract consumers through a large number of subsidies and preferential activities. However, this strategy requires a lot of financial support, and financial fraud has become a means to ease the financial pressure in the short term. In the highly competitive coffee market, Luckin Coffee may exaggerate its market share and competitiveness through financial fraud to cope with the competitive pressure from other brands, such as Starbucks.

4. Analysis of the Impact of Financial Fraud

4.1. Consumers

As a prominent coffee chain, Luckin Coffee's financial data has been found to be inaccurate, significantly eroding consumer trust in the brand. In the process of product selection, consumers often evaluate a brand's integrity, reliability and stability. The revelation of Luckin's misconduct undoubtedly amplified consumer skepticism. Following the exposure of financial irregularities, Luckin's reputation suffered a severe setback. Consequently, consumers may develop a negative impression of the brand during their coffee brand selection process and lean towards more reputable alternatives. Worse, it may cause challenges in recovering pre-paid funds. In the case of Luckin Coffee, some consumers may have pre-deposited funds (such as recharge cards, membership cards, etc.). In the face of Ruixing's potential delisting crisis, insolvency and even the final bankruptcy liquidation process, the possibility of recovering these payments in advance is reduced, which directly leads to economic losses for consumers. Luckin Coffee's financial difficulties may adversely affect the stability of its store operations, leading to a decline in service quality and affecting customers' consumption experience.

Furthermore, in the dimension of moral emotion, Luckin Coffee's financial fraud not only violated legal norms but also seriously deviated from the basic principles of business ethics and integrity. This directly infringes on the basic trust of consumers, has a negative chain reaction on society, and damages the public's sense of trust. The financial fraud incident of Luckin Coffee, as an example of China Concept stock, may trigger the lack of trust in the entire China concept stock sector, affecting the overall confidence of the market. Although the direct impact is reflected at the investor level, it cannot be ignored that the decline in market confidence may also affect consumers' purchase intentions and decision-making process through a ripple effect.

4.2. Shareholders

After Luckin Coffee revealed that its financial data was untrue, its stock market performance suffered a major setback, and the value of assets held by shareholders was directly affected. For the investors who hold Luckin shares, they are faced with a sharp decline in the stock price, which directly leads to economic losses. In addition, large fines, such as the \$180 million settlement, will further erode the company's financial foundation and have adverse consequences for shareholders' future earnings expectations. Luckin's dishonest financial data may trigger shareholders to defend their rights through legal means, especially those shareholders whose property has shrunk due to the decline in stock price, and they may be inclined to explore judicial paths to protect their rights and interests. This may inevitably expose the relevant shareholders to the challenges of increased legal expenses and the uncertainty of future events.

The financial fraud incident has seriously affected the reputation and credit of Luckin Coffee, causing investors to have deep doubts about its future development prospects. That could cause shareholders to lose faith in the company, affecting its stock price and ability to raise capital.

4.3. Brand

As a well-known coffee chain brand, Luckin Coffee's financial fraud incident has caused a direct impact on its brand reputation and image. In the process of consumption decision-making, customers often weigh the credibility level and reliability of the brand; Luckin's actions have caused significant distrust among consumers. This lack of trust can drive consumers to choose coffee brands in favor of other competitors, which can adversely affect the company's market share and profit potential. Luckin Coffee's financial failure not only has a negative impact on its brand reputation, but also may trigger

the market's trust concerns in the overall Chinese general stock sector. In the short term, this incident may cause China Concept stocks to suffer from share price declines and financing bottlenecks. The decline of brand reputation may also restrict Luckin Coffee's progress in business expansion. Whether it is to open new markets or introduce new products, it may encounter more severe obstacles and tests due to the lack of consumer confidence.

With the exposure of fraud incidents, regulators have significantly improved the supervision of the capital market, especially for listed companies such as Luckin Coffee, imposing more stringent norms and standards. This suggests that companies may face more frequent regulatory scrutiny and higher compliance costs in their future operations.

4.4. Business Environment

Luckin Coffee's financial data fraud incident became a catalyst, prompting regulators to strengthen the authenticity of the financial statements of listed companies. The China Securities Regulatory Commission, the finance department and the General Administration of Market Regulation and other agencies coordinated in-depth investigations and gave severe measures to those responsible. In order to effectively prevent the recurrence of such incidents, the regulatory authorities may accelerate the optimization and improvement of the corresponding legal and regulatory system, improve the cost-benefit ratio of illegal acts, and strengthen the regulation of the disclosure of corporate financial information to ensure the fairness, fairness and high transparency of the market environment.

5. Suggestions for Preventing Financial Financial Fraud

5.1. Company

First, strengthen the construction of corporate governance system. The Luckin Coffee incident revealed the loopholes in the corporate governance structure, such as the internal control mechanism is not rigorous, and the authority of senior managers is excessively concentrated. To prevent the recurrence of similar crises, enterprises must improve the effectiveness of internal controls, adjust and optimize the governance structure to ensure the rationalization and transparency of the decision-making process. Enterprises should focus on improving professional ethics and enhance employees' integrity concepts and moral literacy. Through the implementation of systematic training and education programs, to guide employees to establish positive values and career concepts, to ensure that business activities and social ethics and legal norms in line.

Second, strengthen internal control. Build a comprehensive internal control mechanism: enterprises need to establish a complete internal control structure, covering the financial supervision system, accounting procedures and internal audit mechanism, etc., to ensure that all financial operations are standardized and comply with legal requirements. Strengthen the education and training of financial management personnel, improve their professional skills and professional ethics, and ensure that they can strictly implement financial regulations and professional codes of conduct.

Third, strengthen information disclosure and transparency. Enterprises need to build a systematic information disclosure mechanism to ensure that the disclosure of financial data and operating conditions is timely, accurate and comprehensive, so as to deepen the trust and confidence of investors and stakeholders. Encourage enterprises to actively disclose a wider range of non-financial information, involving social responsibility implementation, environmental protection measures, etc., to enhance the overall transparency of enterprises.

5.2. Government

Strengthen the construction of the legal system related to financial fraud. Supplement and revise the relevant laws and regulations such as the Accounting Law and the Audit Law, clarify the specific definition, manifestation and legal consequences of financial fraud, increase the cost of violating the law, and enhance the deterrent power of the law. Enhance the enforcement effectiveness of regulators, adopt a 'zero tolerance' policy for financial fraud, and deal with it severely once it is verified, and publicize typical examples to build a strong psychological deterrent effect.

Improve regulatory mechanisms. For example, build a systematic regulatory mechanism: establish a multi-level and wide-ranging regulatory model that includes government-led supervision, industry self-regulation and public supervision to ensure that enterprises' financial behaviors are comprehensively involved and effectively controlled.

Besides, enhance the application of regulatory technology. Through the adoption of advanced information technology tools such as big data and artificial intelligence, promote the supervision work to a higher level of intelligence and precision, and ensure the timely identification and early warning of potential risks.

Strengthen cross-border regulatory coordination: Enhance communication and cooperation with international regulatory organizations to jointly curb cross-border financial fraud, so as to maintain the stability and promote the healthy development of global capital markets.

Exchange and absorb international leading governance theories and practices, and continue to improve and optimize China's corporate governance structure and regulatory system.

Establish reward and punishment mechanisms: To reward and recognize enterprises that strictly implement financial norms and legal provisions and operate in good faith, to establish a positive model. Financial fraud and other illegal acts must be resolutely investigated and punished, and ensure that all relevant personnel are held accountable.

6. Marketing Strategies after Fraud

Luckin Coffee continues to implement its digital strategy, leveraging big data and Internet technology innovation to enhance customer experience while reducing labor costs. Specifically, customers can complete orders through online platforms such as mobile apps or wechat mini programs, and the transaction information is then summarized to the cloud to provide data support for the fine adjustment of store operations and the efficient optimization of the supply chain background.

Luckin Coffee has enhanced the allocation of resources at all stages of the supply chain, including the establishment of its own roasting plant to enhance the quality and stability of its products. At the same time, the company uses big data technology to deeply analyze consumer behavior and preference trends, systematically introduce new ideas, and regularly plan special activities, in order to fully meet the diversified needs of consumers.

Luckin Coffee has adopted a fission marketing strategy to attract customers by distributing coupons and offering discounts and other incentives, and incentivizing customers to share it with more friends to get extra offers. In addition, the company works with Internet celebrities and industry opinion leaders to broaden the boundaries of brand awareness and influence. On this basis, Luckin launched an invitation mechanism to encourage users to invite new members to register, and implemented member-exclusive marketing programs, thereby building a network effect of spontaneous propagation in the user group.

Price and quality are key considerations in the consumer decision making process. After realizing the problem of a single product structure, Luckin Coffee began to optimize its product line and introduce more kinds of drinks and snacks to meet the needs of different consumers. This not only increases the choice of consumers, but also increases the customer price and re-purchase rate. For

example, its thick milk series has sold more than 30 million cups a year since its launch; The raw coconut latte sold 10 million cups in just a few months. Recently, the launch of raw cheese latte is also favored by the market. Luckin is committed to product innovation and quality improvement, to accurately match consumer preferences, and know that customer satisfaction is the cornerstone of the enterprise [8].

7. Conclusion

This paper mainly reviews the financial fraud incident of Luckin and believes that it falsifies data through inflated income, fictitious costs, connected transactions, data traffic, etc. At the same time, the paper also analyzes the motivation of the fraud from different angles and restores the incident more comprehensively from internal and external aspects. At the same time, the article also focuses on the analysis of this move on consumers, shareholders, and the company's brand, as well as the adverse impact of the business environment. Luckin Coffee's financial fraud incident has sounded the alarm for the entire coffee industry and even the capital market. Through the in-depth analysis of this incident, the author realizes the importance of strengthening internal control, improving governance structure, strengthening supervision and self-discipline, and paying attention to moral construction. In the future, enterprises, regulators, investors, and society should work together to build a fair, just, and transparent market environment to promote the healthy development of enterprises and industries. Through the study of Luckin Coffee's financial fraud incident, this paper not only enriched the academic research on financial fraud but also provided a valuable reference for related enterprises in financial management. At the same time, it also provides ideas for regulators to improve regulatory measures, which will help maintain the stability and healthy development of the capital market. In this paper, the mining of Luckin's financial fraud incident is not deep enough, and more data and tables need to be added for powerful demonstration and explanation.

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