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Motivation and Countermeasures of Financial Fraud in Listed Companies

—A Case Study of Luckin Coffee

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Abstract: The prevalence of financial fraud within publicly traded corporations has emerged as a significant concern within the field of auditing. In recent years, there has been an exacerbation rather than a mitigation of instances of financial fraud. Luckin Coffee is a domestic coffee brand that has emerged in the market, established by Qian Zhiya, who previously served as the CEO of Shenzhou Youchuan Group. Established in the year 2017, the organization achieved a notable milestone by being successfully listed on the NASDAQ stock exchange in 2019. In the year 2020, the disclosure of financial wrongdoing occurred. The discreet and innovative financial fraudulent practices employed by Luckin Coffee can serve as a valuable point of reference for the future advancement of firms. This paper presents an introduction to the fundamental notion of financial fraud and its associated theories. It proceeds to investigate the specific financial fraud process employed by Luckin Coffee. Additionally, it proposes recommendations for mitigating the risk of financial fraud in listed businesses, utilizing the Gone theory.

Keywords: Luckin coffee, Gone theory, Financial fraud

1. Introduction

The prevalence of financial fraud within publicly traded corporations has emerged as a significant concern within the field of auditing. In recent years, there has been an exacerbation rather than a mitigation of instances of financial fraud. Within the global market, prominent publicly traded corporations such as Enron World Telecom, Lucent, and Global have been implicated in instances of financial fraud, consistently augmenting the documentation of financial misconduct through diverse means. China has had a notable frequency of domestic financial fraud occurrences, with notable cases including Zixin Pharmaceutical, China idea stocks, and Green land. Fraudulent activities not only significantly tarnish the reputation of the firm and diminish its market value, but also exert a substantial influence on China concept stocks, rendering their listing in both domestic and international markets more challenging. Furthermore, it is evident that in recent years, there has been a notable increase in the diversification of fraud tactics, as well as an escalation in the secrecy surrounding these methods. Additionally, there have been instances where foreign entities have been implicated in colluding with fraudulent activities. It is evident that despite the increasing robustness

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of financial laws and regulations worldwide, as well as the tightening scrutiny on enterprise listings, the methods employed by companies to commit financial fraud are continuously evolving and becoming more covert. Therefore, conducting case studies on financial fraud, providing theoretical insights, and developing effective strategies to prevent such fraudulent activities remain highly significant for enterprises.

Luckin Coffee opened in 2017 in Xiamen, Fujian. Luckin Coffee, China's "Starbucks", is famous due to its great taste and low prices. Luckin Coffee was listed on NASDAQ in the US in May 2019 after four rounds of financing: angel round, Round A, Round B, and Round B-1. In January 2020, well-known short seller Muddy Waters produced an 89-page study that employed rigorous data and 981 days of work records to demonstrate Luckin Coffee's financial wrongdoing. Luckin Coffee stated that its COO Liu Jian and his employees had fake trading behavior and 2.2 billion yuan in phony transaction volume in April 2020. Luckin Coffee ceased NASDAQ trading and prepared for delisting on June 27, the same year. The CSRC and CBRC condemned the incident and imposed suitable fines. This supplier, guarantor, and lender issue caused many personnel losses and had a major impact. Based on this, this paper will analyze the financial fraud case of Luckin Coffee. This paper introduces the basic concept of financial fraud and related theories, analyzes the specific financial fraud process of Luckin Coffee, and puts forward suggestions on the prevention of financial fraud risk of listed companies by using Gone theory.

2. The concept and related theories of financial fraud

2.1. Basic concepts of financial fraud

The notion of financial fraud has been well-known to society since the 1990s. The definition of financial fraud varies significantly due to variations in accounting standards across countries and divergent academic opinions. According to the United States Anti-False Financial Reporting Committee, financial fraud refers to the intentional act of concealing or misrepresenting a company's operational circumstances, which can ultimately disrupt or deceive the decision-making process of statement users. According to the American Institute of Certified Public Accountants, financial fraud refers to the deliberate manipulation or fabrication of significant information that is required to be disclosed in financial reports. This deceptive practice, known as "management fraud," is aimed at misleading investors and other users of financial statements. As to the definition provided by the International Institute of Internal Auditors (IIA), fraud encompasses a sequence of illicit and deceitful actions perpetrated by individuals associated with a company, whether they be internal or external stakeholders. Within Chinese academic circles, there exists a diversity of perspectives and research foci pertaining to the phenomenon of financial fraud, resulting in a multitude of explanatory frameworks. As per Auditing Standards for Certified Public Accountants No. 1141, financial fraud pertains to the occurrence wherein an audited enterprise or company engages in the concealment or distortion of its financial report through deceptive methods. This is typically carried out by internal employees, managers, or by relying on a third party, with the intention of acquiring illicit profits or fulfilling specific objectives [1].

In general, while there may be variations in the conceptualization and theoretical frameworks of financial fraud across domestic and international contexts, scholars in the field of finance both domestically and internationally concur that financial fraud mostly pertains to deliberate fraudulent activities undertaken by corporate management with the aim of augmenting income. In the context of this activity, it is possible for management to deliberately present inaccurate financial statement information with the intention of deceiving both internal and external stakeholders, so leading them to make erroneous judgments.

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2.2. Financial frauds of listed companies and their causes

During the period from 2010 to 2019, the China Securities Regulatory Commission (CSRC) addressed a total of 113 instances of financial fraud within A-share listed businesses. Out of these cases, 50 were determined to have significant adverse consequences [2]. The detrimental effects of financial fraud on the growth of China's capitalist market have been significant, with subsequent instances of financial fraud exerting a negative influence on the smooth listing process of other well-functioning enterprises. Hence, it is imperative to succinctly outline the behavioral patterns exhibited by organizations implicated in fraudulent activities and thoroughly examine their underlying objectives. This resource serves as a point of reference for other publicly traded corporations seeking to discover instances of financial misconduct.

Upon reviewing the pertinent literature, the methods employed in financial fraud can be succinctly outlined as follows: the inflation of income, the inflation of cost expenses, and the utilization of related party transactions as a means of perpetrating fraudulent activities.

First, inflated income. Mainly refers to companies with listing or financing needs, such companies hope to use more perfect financial statements to attract more investors' capital investment. The common way of inflating income is to recognize income in advance in violation of accrual system; non-operating income business, etc.

Second, inflated cost expenses. The inflated cost refers to the cost fraud of confusing the cost accounting price in violation of the state regulations. The inflated cost includes the inflated material cost; Inflated labor costs; Inflated advertising costs; The inflated cost of production expenses, etc.

Third, concealing related party transactions [3]. The concealment of related party transactions mainly refers to the fraud that the management authorities use related party transactions to cover up losses and fictitious profits, or use special purpose entities to manipulate profits, so as to disassociate related party transactions, and fail to make appropriate provisions in the statements and appendices, and fully disclose the misleading users of the statements. The methods of concealing related party transactions include bank loans, equity transfers, etc

The transfer of funds to related parties on the basis of purchasing items for transactions, through virtual orders, the funds are returned to the business. This way increases the business revenue and profits of the enterpris [4].

3. Analysis of the Luckin coffee financial fraud

3.1. The case

Luckin Coffee was founded in the year 2017, specifically in Xiamen, which is located in the province of Fujian. Luckin Coffee is highly preferred by domestic white-collar clientele because to its extensive store network, competitive pricing, and exceptional convenience. Within a span of only 17 months, the aforementioned entity has successfully established itself as a prominent publicly traded corporation on the NASDAQ stock exchange in the United States. In the initial months of 2020, Muddy Waters, a prominent individual engaged in short selling, published a comprehensive 89-page report concerning Luckin. This report highlighted Muddy Waters' utilization of a workforce consisting of 92 full-time employees and 1,418 part-time employees to carry out on-site monitoring activities. The monitoring efforts encompassed the recording of 981 business days' worth of store traffic, encompassing the entirety of operational hours. Additionally, a total of 25,843 receipts were collected as part of this endeavor. The presented receipts provide evidence suggesting that Luckin has engaged in the manipulation of financial data since the third quarter of 2019, with the intention of creating a deceptive perception of profitability [5].

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Prior to the commencement of trading on April 2, 2020, Luckin Coffee publicly disclosed the findings of its internal inquiry, which revealed that the Chief Operating Officer (COO) and certain subordinates were involved in inappropriate activities during the second quarter of 2019. Specifically, it was determined that sales generated from fraudulent transactions amounted to approximately 2.2 billion yuan. The financial fraud committed by Luckin Coffee Company was given significant attention by the China Securities Regulatory Commission on April 3, 2020, leading to a harsh condemnation of Luckin Coffee's fraudulent financial activities. On June 29, 2020, the trading of Luckin Coffee on the NASDAQ stock exchange was suspended and subsequently delisted due to the company's filing.

3.2. Luckin Coffee financial fraud means

3.2.1. Inflated sales revenue

According to the Muddy Waters report, Luckin Coffee's inflated revenue and profit are mainly reflected in two aspects, on the one hand, the number of goods sold is inflated, and on the other hand, the retail price of each single product is increased. In terms of the number of falsely sold goods, the official data released by Luckin Coffee is that in the third quarter of 2019, the number of daily sales of goods per store is 444, and it is expected that the fourth quarter can reach 483-506. Based on the findings presented in the Muddy Waters report, Luckin Coffee experienced a notable increase in daily sales per store during the third quarter of 2019, with each store averaging 263 units sold. Additionally, there was an observed surge in order volume, leading to an increase in the number of deliveries during the fourth quarter. Upon the acceptance of each order by the company through its online platform, the Luckin app software would create a three-digit number for the purpose of food pick-up. The food pick-up code is typically created in a sequential manner; however, Luckin Coffee managed to enhance its sales volume by leveraging this technique. During the third quarter of 2019, there was an observed average growth rate of 72% in the volume of Luckin coffee orders for the subsequent fourth quarter [6]. However, with regards to the augmentation of the sales value of individual commodities, as indicated by the Q3 2019 financial report data of Luckin, the average net sales price per item during the third quarter of 2019 stood at 11.2 yuan. Nevertheless, Muddy Waters conducted a comprehensive analysis by gathering a substantial sample size of 20,000 Luckin receipts. Through this examination, it was determined that the mean net selling price per product amounted to merely 9.97 yuan, indicating a notable surge of 12.3%. Based on the aforementioned two factors, it may be inferred that the reported revenue of Luckin Coffee to external stakeholders might exceed its true revenue.

3.2.2. Inflated advertising costs and Covert related-party transactions

According to the Q3 financial statement of Luckin Coffee, its advertising expenditure exceeded 382 million yuan. However, the difference of the actual expenditure of Focus media tracked by CTR was 336 million yuan, and the actual advertising expenditure was 46 million yuan. The difference of 336 million yuan was very close to the overstated store profit. And since the third quarter of 2019, this misstatement phenomenon has become very obvious, which is likely to be the formation of fraud in Luckin Coffee's overstatement of advertising expenditure transfer income and store profits [7].

According to Muddy Waters' findings, it was revealed that Lu Zhengyao, the chairman of Luckin Coffee and concurrently serving as its CEO, engaged in the transfer of internal funds from Luckin Coffee to Luckin. These funds were subsequently utilized to procure Luckin Coffee products, thereby generating fictitious revenue for Luckin Coffee and inflating its financial statements. According to the U.S. Securities and Exchange Commission, Luckin Coffee is accused of engaging in deceptive related-party transactions, resulting in the fabrication of sales figures exceeding $300 million between April 2019 and 2020 [8].

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4. The impact of Luckin Coffee's financial fraud

Following the disclosure of financial misconduct at Luckin Coffee, the stock price of the company had a significant decline of 80% before to the US stock market, subsequently leading to the suspension of trading on many occasions subsequent to the session. At the conclusion of the trading session, despite a marginal increase in the share price of the US stock market, it saw a substantial decline of 75.57%. Consequently, the market value dwindled to a mere 1.62 billion US dollars, resulting in a loss of almost 10 billion US dollars when compared to its peak value. Ultimately, Nasdaq compelled its removal from the market.

The financial fraud episode involving Luckin Coffee has had significant repercussions for the company, resulting in the severe penalty of delisting. Moreover, this scandal has also had a substantial impact on listed companies in the United States. The financial fraud case involving Luckin Coffee, amounting to 2.2 billion dollars, has resulted in a loss of trust in the Chinese global market. This has posed challenges for listed companies in terms of investment and fundraising, and has had a detrimental impact on the future growth and listing prospects of Chinese enterprises in the United States [3].

The occurrence of financial fraud has a significant impact on the stability of markets and the confidence of investors. Financial fraud leads to the deception of investors, resulting in heightened caution and potential avoidance of future investments in the stock market. This phenomenon adversely affects the overall well-being and long-term growth of the market. Simultaneously, the prevalence of financial fraud cases involving Luckin and other corporations will result in a dearth of dependable theoretical underpinnings and informational backing for the development of macroeconomic policies. Consequently, this will exert an adverse influence on the effective functioning of macroeconomic systems and overall economic stability.

5. Suggestions on prevention of financial fraud risk of listed companies by using Gone theory

5.1. In terms of greed theory and opportunity theory

The concept of greed has evolved to encompass a wider range of interpretations beyond its initial definition. One of the factors contributing to this issue is the presence of low moral standards. The individual engaging in fraudulent activities typically exhibits a deficient moral compass, wherein a prevailing set of values reflects a lack of ethical integrity. In light of this matter, the proposed resolution entails enhancing the ethical instruction provided to corporate executives. From a managerial standpoint, it is imperative to enhance the education on professional ethics and integrity, and to frequently conduct learning and educational initiatives for managers. These activities aim to cultivate an understanding among managers about the detrimental consequences and gravity associated with financial fraud. It is imperative to establish a cultural environment characterized by reciprocal oversight inside the corporate management structure, so enabling firm executives to uphold their moral and ideological commitment to combat financial fraud [6].

Opportunity theory is divided into internal and external theories, and external mainly refers to third-party auditors. The external audit firm is hired by the listed company, and its profit and contract term are decided by the listed company. The listed company and the external audit firm are stakeholders. Therefore, in this case, when the listed company has no particularly serious financial problems, the audit firm will issue financial reports according to the requirements of the listed company. The interests of external audit firms and listed companies are connected, which promotes the financial fraud and increases the probability of financial fraud. Therefore, the external audit

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company should play the role of independent supervision during the operation of the work, avoid interference, and strengthen the role of independent audit.

5.2. In term of need theory

The term “demand factor” is synonymous with the concept of “motivation factor.” Motivation plays a vital role in influencing accounting behavior. The adherence to acceptable and ethical accounting practices is likely to result in responsible and ethical conduct, but improper motivation may lead to unethical accounting activity in response to external factors, such as instances of financial fraud. From the standpoint of financial fraud, various criminal actors exhibit distinct motivations for engaging in fraudulent activities. Certain individuals may engage in financial fraud due to heightened performance pressure to achieve current period performance criteria, while others may conduct financial fraud primarily driven by personal avarice. The business model employed by Luckin Coffee is subject to significant performance-related pressures and necessitates a substantial infusion of capital to sustain regular operations. This, in turn, contributes to the emergence of financial crime. Hence, it is imperative for firms to develop rational business plans based on their specific company circumstances and client demands. They should strive to operate in a rational and efficient manner, while enhancing the competitiveness of their products. It is not advisable to indiscriminately pursue expansion and depend only on inexpensive prices as a means to foster organization growth.

5.3. In term of exposure factor

Exposure factors generally refer to the hidden matters revealed in the process of financial fraud, as well as the punishment obtained after such hidden matters are discovered, which is generally divided into two situations, one is the possibility of exposure to fraud, and the other is the scope and degree of punishment for fraud. Often before counterfeiters decide to act, they need to determine the extent to which their actions will be punished, and if the punishment is less than the amount to gain, then the financial cheat will act. In a nutshell the criminal liability of those engaging in financial fraud will diminish over time as the severity of legal and regulatory penalties intensifies. Currently, the penalties imposed by China for financial fraud are relatively lenient, encompassing two primary dimensions. Firstly, there exists administrative punishment, which includes fines, criticism, warnings, and similar measures. Secondly, criminal punishment is also applicable in cases where financial fraud results in severe circumstances. In such instances, individuals are typically sentenced to imprisonment for a duration exceeding three years but less than seven years. The relatively minor consequences associated with these two punishments pale in comparison to the substantial advantages of engaging in financial fraud, hence incentivizing a greater number of individuals to assume risks in perpetrating such illicit activities. Simultaneously, it can be argued that China’s current legal framework and regulatory measures pertaining to financial fraud are insufficient in terms of their robustness and effectiveness. The existing provisions in Company Law, Securities Law, and Accounting Law explicitly address the issue of financial fraud. However, the penalties imposed on listed businesses for such offenses are deemed inadequate. Listed firms commonly encounter instances of financial fraud, which typically result in monetary penalties ranging from 100,000 to 1 million yuan. In light of substantial earnings and few penalties, a considerable proportion of publicly traded corporations opt to engage in financial fraud. Hence, given the increasing secrecy and diversity of contemporary fraudulent practices, coupled with the growing profitability of financial crime, it is imperative to incorporate enhanced legislation and regulations, as well as heightened punishments, as integral measures to mitigate the incidence of corporate financial fraud instances.

6. Conclusion

With the deepening of China's reform and opening up and the development of China's capitalist market economy, there are more and more listed companies in China. At the same time, listed companies are exposed to a variety of problems, among which financial fraud is the most typical and brings the most serious consequences. After the discovery of financial fraud, the company not only suffered damage to its reputation, but also increased the difficulty of listing other domestic companies, and faced the risk of stock delisting. Taking Luckin Coffee as an example, this paper reveals the means and negative effects of financial fraud in listed companies and puts forward suggestions on financial fraud in listed companies by using Gone theory. This paper not only provides suggestions for listed companies to prevent financial fraud from the theoretical level, but also allows readers to have a more accurate understanding of the means of Luckin Coffee's financial fraud.

This study focuses on the analysis of the Luckin Coffee financial fraud case in 2020. The chosen case is of recent occurrence, rendering it very relevant and applicable for examination. The most recent techniques of financial fraud are presented. The report additionally presents several recommendations for mitigating financial fraud through the application of Game theory.

This paper is extensively theoretical and lacks an analysis of financial statements, thereby hindering readers from developing a more intuitive comprehension of Luckin Company's financial statements. Owing to my limited research proficiency, the examination of financial fraud in publicly traded companies was superficial, and I did not undertake a comprehensive investigation into Luckin Company's developmental strategy during that period. Furthermore, the analysis did not incorporate the contextual backdrop of the era in its entirety.

The survey findings indicate that corporate financial fraud may be attributed to two primary factors. The first factor involves the intention to attract investors by meeting their expectations, while the second one pertains to the desire to expedite the investment return time. Furthermore, it is important to consider the pertinent rules and regulations.

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