

Cost of the Accounting Scandal of Luckin Coffee to Multiple Aspects and the Influence Under Current Economy and Pandemic Time

Qiyao Wang

Beijing National Day School, Haidian District, Beijing 100039, China,
Email: wqy120356@163.com

ABSTRACT

Luckin Coffee, as one of the most successful marketing cases in China or even the world, break the fastest IPO record in China in 2019. However, the recent fraud has led to the great attention, fear of the reliability and value of Chinese stock market. This paper analyzes the fraud of Luckin Coffee, faking process and the general public's reaction. It illustrates the cost of assets and confidence through comparison analysis with the foreign investment and the domestic capital, the following influence toward the Chinese stock market. Evidence showed that the damage to the stock market is significant, especially in this pandemic time as the spread of COVID-19 with the economy crisis. In conclusion, the accounting scandal of Luckin Coffee informs a widespread damage to investors, the stock markets, and other Chinese firms that plans to attract capitals in the United states. The financial reporting system including the accounting firms and the internal financial department are also facing criticisms and needs to redesign the supervising measurements, clamp down the illegal movements, forming a solid and strict system avoiding the internal scandal or any other loopholes in order to create a reliable stock market for investors during this special time.

Keywords: Luckin Coffee, accounting Scandal, business fraud, stock market, china concept stock, accounting firms, economy in pandemics

1. INTRODUCTION

Viewed by vast investors and the general public as the major competitor of Starbucks in China, Luckin Coffee rivalry grown its business and started over 2,000 stores in 2018, planed for more in 2019 [1]. It draws a wealth of discussions over the stock market not only in China, but also international wide. At the beginning of 2020, an 89 pages report from Muddy Water Research dragged Luckin to discussions again, but in a negative way. Stating that there is a 69% overstate in the third quarter and 88% overstate in the fourth quarter [2]. While after raising the enormous amount of capital from going public, the scandal could affect the investor's confidence, especially the foreign capital's confidence toward Chinese firms. After report and apologize from Luckin Coffee came out, the stock price fall by 85% comparing to the day before \$26.2 [3]. Under this condition, analysis of the managing system and the relationship between investments and variation and fraud could give us a detailed examination of the influence. Addressed the previous development that how could Luckin Coffee proposed IPO in two years with constant loss. Analyzed the scandal about the loopholes in the company's accounting system and following dispose of Luckin Coffee. Explained the influence of this incidents toward the market and confidence of investors including the similarity comparing to the previous business fraud;

defined the furthered damage in this bad economy and crisis situation.

Considering the rapid growth of Luckin Coffee, the new discussions toward this fresh Online-delivery management and large discount has never stopped. The query about profitability, operating difficulties, and debts became the major concerns on investment toward Luckin Coffee. Accordingly, the detailed information could offer some motivations and evaluations on the reason that the scandal happened. Similarly, this paper aims to identifies the specific impact and cost of economics due to this large-scale fraud by emerging and fast-growing Internet-based food company. Since the Luckin Coffee serves as a new pattern of management that came out in recent years, comparing with other cases could appraise the influence on the future aspects. Ultimately, these dissects could help with our financial reporting system to clarify and redress the issues in order to attract investment and more capitals for the economy.

1.1. Literature Review

Individual or business accounting scandals and frauds are not rare around the world, especially in the most valuable American stock market, for instance, the report about accounting scandal of Steinhoff International, "a \$7.4 billion accounting fraud involving a small group of top executives and outsiders, according to an independent

report by PwC” [4]. Therefore, the previous studies illustrated several ways to detect accounting scandal or business fraud from most abnormal review subsequent (MARSs) [5]; analysis of small groups of data [6-7]. As a result, Muddy Water Research published that paper specifically pointed out the accounting scandal of faking sales including advertisement expenditure and short the Luckin Coffee [2]. For the several decades, the researches maturely, integrally, implicate methods for identifying frauds through data and managements. Specifically, after the scandal of Luckin Coffee, researchers delve into the cause and triggers of this case, such as opportunity, pressure, rationalization analysis [8]. Moreover, previous paper clarified the internal and external compensation measures to prevent these deceptions, such as “improve the company’s internal control system; perfect the role of intermediary agencies” [9]. In addition to the protective methods, Yibo Zhang and Lu Xu also indicated the impacts toward companies going public in the United States, China Concept Stock [3]. In spite of the relatively complete interprets about the firms and markets, few papers focused on the specific influence under this pandemic situation and differences in an economy crisis condition, like the conflict relationship between countries. Meanwhile, quantifying the cost toward confidence and capital of investors could still be a less-concerning area.

1.2. Research Methods and Discussion

1.2.1. Development of Luckin Coffee

Established in 2017, Luckin Coffee started its first store at Beijing. From that point, this firm grown rapidly spreading over China, even at the Forbidden City, with 4,500 outlets at the end of 2019 which surpass Starbucks as the biggest Coffee chain in China. The incredible speed of development was benefited from its special management and “luring customers with cheap prices and savvy use of technology” [1]. Only cost two years for Initial Public Offering, Luckin Coffee became widely recognized as the fastest growing company raising about 695 million dollars from IPO. The manager and directors of Luckin Coffee are not fresh employees, on the contrary, they used to work at Shenzhou with plenty of experience. Luckin Coffee aims to bring a fresh interaction to customers that combined with mobile phone, internet, and data-based services to compete against other brands through relatively low prices, great discount, and delivery service [10]. These features quickly help Luckin Coffee to win the market and increase the sales. Freely obtained a cup of coffee, most of the new customers were willing to install its applications on their devices. A wealth of investors values the sales and future which helped it grown faster. Nevertheless, the giant cost of low prices and opening new stores prevented Luckin Coffee from profits. In the January 2020, Luckin Coffee reached the market value for \$12,950,000,000 and \$50.02 per share.

1.2.2. The accounting scandal detail

At Feb 01, 2020, the well-known investment company, Muddy Waters Research, astonished all the investors through an 89 pages analysis, indicated the fake data and advertisement expenditure. This short report included the monitoring toward 1,832 stores with more than 10,000 hours recording, directly accusing the accounting scandal from the third quarter [2]. The paper claimed that Luckin Coffee secretly increased the sales through changing the pick-up codes, “After upgrade, it will increase randomly (e.g. 271, 273, 274...)” [2]. This long, fact-based report attracted and raised investors awareness, which led the stock price drop later. With relatively complex charts and diagrams, Luckin Coffee made an announcement on Feb 04, 2020, which denied all the accused from Muddy Water Research. Even so, the statement could not persuade anyone, especially under the fact that Luckin Coffee were facing constantly loss and incredible cost of development and settlement of new stores. Meanwhile, the report clarified that Luckin Coffee increased the advertisement consumption in order to make up the revenue and fake the actual revenue from receipts. These factors pushed other investment institutions and commitments to set up investigation toward Luckin Coffee. Shockingly, on April 02, 2020, it published an apology and committed the fraud, which cost a 75.5% drop from \$26.20 on the previous day to \$6.40 after the announcement. The corresponding capital was around 220 million RMB and causing the market value decreased by 354 million RMB [11]. The fail of Luckin Coffee pointed out the unreliable of fast-growing pattern that consume money for a larger share of market.

1.2.3. Caution and cost to the market

As described, the cost of this fraud is inevitable, tremendous, and broad. All the investors were suffered from the fraud. Increasing the customers through discount and consuming money to reserve the compete in the market could not make profits which might lead to the scandal and illegal actions. This large-scaled fraud brought the issues of financial reporting systems and regulator institutions in front of the general public.

1.3. Dereliction of organizations

Being the fastest firm going public around the world, Luckin Coffee’s scandal represents the dereliction of Ernst & Young company which helped the Luckin Coffee boosted their development but neglect the 220 million RMB accounting scandal. As one of the world-famous accounting firms, Ernst & Young could not identify the loopholes in the financial report. The accounting firms has the responsibility to correctly report the real evaluation to both the firms and the investors. Although there is no evidence implicated that Ernst & Young engaging in the

fraud, it still fails to illustrate or suggest the uncommon or abnormal data. Sometimes the accounting firms will reduce their employees and procedures in order to reduce cost and time considering the relative competitive market which might result in some incomplete investigations and negligence [9].

Meanwhile, the internal system of Luckin Coffee failed to limit the power of the directors which directly suggest the limitation of evaluating system [12]. It was pretty interesting that Luckin Coffee has vowed defended itself from the accusation in February but admitted the scandal in April which calls into questions. The internal management of this valuable company could not perform its role in this case. Proceeding this long-time, large-scale, influential accounting scandal, the ability of internal departments and officers should shoulder the responsibility. This instance indicated that the connection between different position and roles was weak. Preventing the risks and actions that might damaging the company's value or reputation should attach importance to the firms. Strangely, these directors were experienced and made a wealth of achievements before they start the business on Luckin Coffee, it could be pretty unusual that the cost of accounting scandal.

Beside the directly mistakes of directors and accounting firms, the management of Luckin Coffee draws into a question which aimed to rapidly seizing the market through free or discounted products and increasing number of outlets through extremely high cost. This kind of management could not avoid the giant financial and advertisement cost at the beginning of business that probably lead to the unbalanced of cost and profit. Investors would not willing to spend their money on this project. Consequently, this might be the reason that led to this scandal.

1.4. Damage to various aspects

After the strike of this incidents, another victim beside the investors, China Concept Stock, could be those Chinese firms that plans to go public in the United States. Luckin Coffee is not the first and only firm suffering the accusation of frauds, instead, some other firms like Alibaba Group, NetEase were also being accused in the United States which would further lead to distrust and lose confidence about China Concept Stock [11]. Giving the fact that over 50 China Concept Stock demonstrated a fall after the incident of Luckin Coffee which illustrate the dramatic impact on the reputation of Chinese firms to a great extent [8]. In addition to the loss of value, other process like evaluations and examine of Chinese companies which decide to go public in the United States will be much more complicated and stricter simultaneously [13].

Considering the economy crisis circumstances around the world, no doubting that the scandal of Luckin Coffee will hurt the stock market even worse.

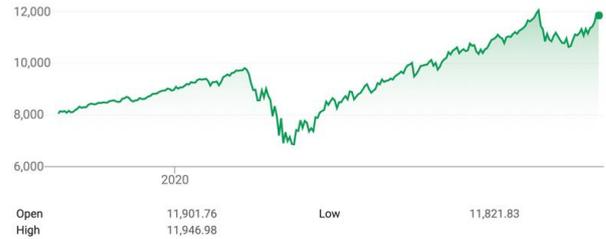


Figure 1 Nasdaq Composite

As the graph of figure 1 and 2 illustrated, the stock market suffered from February due to the spread of COVID-19. According to the Washington Post, due to the coronavirus pandemic, the breakers happened four times in March with three times only cost less than five minutes. [14].



Figure 2 SSE Composite Index

Likewise, the same trend exhibited in China's stock market which also have a decreasing pattern from the beginning of 2020. From the evidence and data illustrated, investors became conservative and less-confidence of the whole stock market since the spreading of COVID-19. While at the same time, the pandemic damage the economy including decreases of income and increases of products' prices. As the confidence of investors constantly decrease, preventing the case like Luckin Coffee should be the priority and valued.

2. CONCLUSION

Given the above, the accounting scandal of Luckin Coffee could be extrapolated that the fast-pace development of the scale and cost which also are the main attribution to their success, are the incentives for Luckin Coffee's directors to commit this fraud. Attracting customers and increasing the sales through large discount and great expenditure of advertisement for more investment from both domestic market and international market. This type of management could be high risky since the firm could not make profit at the first several years even though Luckin Coffee is the fastest firms going public. Easily step into a negative loop, Luckin Coffee has to keep the sales at a high statue to maintain its value toward the investors in order develop and compete for market. During this incident, the accounting firm of Luckin Coffee did not perform its role and correctly check the financial report and find the false. While this fraud demonstrates the significance of accounting firms in the business and

the internal report system which failed to signal the unusual data. Although the evidence of accounting firms and other department subjectively involving in scandal not founded, this incident still raises the awareness of the general public toward the authority of third-party auditors. Moreover, research on the reaction of financial reporting system and present the possible action for future.

As the current circumstance of COVID-19 and economy crisis, the impact and damage to the whole stock market could be magnified on investors and firms. The giant loss of stock value, on the first hand, damage the stock market and the confidence of investors especially in this period of time which all the stocks exhibits a negative trend. On the second hand, the China Concept Stock, also losses its reputation and the value go down after the scandal happened.

ACKNOWLEDGMENT

During the process of writing this paper, I want to first show my deep gratitude to my professor and teachers who gave the detailed and precise instructions toward my essay. Their advices helped me to build up the construction and some immature aspects of the research. On the other hand, the encouragement of my parents and friends is also significant to my work which stimulated my passion on the development.

REFERENCES

- [1] "This coffee company thinks it can beat Starbucks in China <https://edition.cnn.com/2018/12/28/business/luckin-coffee-china-starbucks/index.html>
- [2] Luckin Coffee: Fraud + Fundamentally Broken Business, Muddy Water Research
- [3] Yibo Zhang & Lu Xu. (2020). The impact of accounting scandal and short to the Chinese firms on the international market from the perspective of Luckin Coffee instance. *Heilongjiang Science* (13),160-161. doi:.
- [4] 5 most scandalous fraud cases of 2019, <https://www.fraud-magazine.com/recap-article19.aspx?id=4295009428>
- [5] Z. Wang and Q. Chen, Monitoring online reviews for reputation fraud campaigns, *Knowledge-Based Systems* (2020) 105685, <https://doi.org/10.1016/j.knosys.2020.105685>.
- [6] H. Li, Z. Chen, B. Liu, X. Wei, J. Shao, Spotting fake reviews via collective positive-unlabeled learning, in: 2014 IEEE International Conference on Data Mining, ICDM 2014, Shenzhen, China, December 14–17, 2014, pp. 899–904.
- [7] S. Rayana, L. Akoglu, Collective opinion spam detection using active inference, in: *Proceedings of the 2016 SIAM International Conference on Data Mining*, Miami, Florida, USA, May 5–7, 2016, 2016, pp. 630–638.
- [8] Min Min. (2020). Could Luckin Coffee survive---the analysis of Luckin Coffee accounting scandal. *Hebei Qiye*(08),102-103. doi:.
- [9] Liping Zheng & Yang Zhao. (2020). Research on the reason of accounting scandal and solution about public companies---taking Luckin Coffee for example. *Finance Research* (04), 4-6. doi: 10.19634/j.cnki.11-1403/c.2020.04.001.
- [10] Menghao Wang, Research on Financial Analysis of Luckin Coffee, *Advances in Economics, Business and Management Research*, volume 116, <https://doi.org/10.2991/icesed-19.2020.4>.
- [11] Zejun Li. (2020). The risks and solutions of Chinese firms going public in the United States---take Luckin Coffee for example. *Tianshui Xingzheng Xueyuan Xuebao* (04),99-102. doi:.
- [12] Helin Li (2020-05-15). The accounting scandal of Luckin Coffee illustrates the disability of internal control system. *China Accounting News*,009.
- [13] "The economic crisis will expose a decade's worth of corporate fraud", <https://www.economist.com/business/2020/04/18/the-economic-crisis-will-expose-a-decades-worth-of-corporate-fraud>
- [14] "Do 'Circuit Breakers' Calm Markets or Panic Them?" https://www.washingtonpost.com/business/do-circuit-breakers-calm-markets-or-panic-them/2020/03/18/a20f7514-6956-11ea-b199-3a9799c54512_story.html