Strategic Repair After Corporate Financial Fraud: Path, Effectiveness and Implications

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Abstract. After financial fraud is exposed, companies usually take "self-rescue" measures positively to minimize economic losses and repair the reputation of companies. According to the financial fraud of Luckin Coffee, this article conducts a long-term tracking analysis of quarterly financial statements and analyzed the changing trend of Luckin Coffee's financial status by using the Z-score model. The article focused on two key financial measures Luckin Coffee took, exploring their long-term effectiveness and effects. The results show that the strategy of "opening up franchise to expand the market" measure adopted by Luckin Coffee can bring long-term sustainable and positive development to the company effectively. The "new product release" measure has been improving Luckin Coffee's financial position effectively and significantly in the short term, with limited impact in the long-term. Although post-crisis response measures can restore the financial structure and market confidence of companies to a certain extent, companies should firm to the bottom line of compliance, strengthen internal governance, and prevent the occurrence of financial fraud fundamentally.

Keywords: Financial Fraud, Luckin Coffee, Enlightenment and Results.

1 Introduction

Financial statement fraud involves the intentional presentation of financial data, often through the manipulation of revenue. Financial fraud can damage the rights and interests of stakeholders, disrupt market order, trigger legal accountability, threaten the survival of companies, and damage the market ecological environment [1]. Most of the existing research focused on methods and influencing factors of financial fraud, but research on methods to restore operations and rebuild the reputation of companies after financial fraud exposure is still relatively scarce. Luckin Coffee is one of the most representative cases of financial fraud in China in recent years. Luckin Coffee issued an announcement on April 2, 2020, admitting that it had committed financial fraud of 2.2 billion RMB, which had damaged investors' interests and undermined investors' confidence in the market [2]. However, after being forced to delist, Luckin Coffee took a series of commercial measures to recover its losses and regained positive profits in May 2021 successfully, continuing to develop positively after that [3]. A limited number of previous studies have focused on which strategic initiatives have played a key role in

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the recovery of firms that have "bailed themselves out" in the face of severe crises of confidence, capital runs, or even operational measures.

This article takes the case of financial fraud of Luckin Coffee as the starting point to analyze the financial situation of Luckin Coffee after the implementation of measures of "opening up franchises to expand the market" and "new product release"[4]. This article uses the numerical values calculated by the Z-score model to analyze the financial situation and trend of Luckin Coffee after taking "self-rescue" measures, and judges the effectiveness and characteristics of "self-help" measures taken by Luckin Coffee. This article fills the gap in previous research on the effectiveness analysis of financial fraud measures, tracks the effects of measures for a long period, and shows the long-term effects of "self-rescue" measures in a quantitative way.

2 Methodology

2.1 Introduction to the Z-score Model

This article uses the Altman Z-score model to process the public financial statements of Luckin Coffee. The Altman model was proposed in 1968 by Edward Altman, a professor at New York University's Stern School of Business, to assess the state of business operations and the possibility of bankruptcy in the next two years [5]. A Z-value of less than 1.8 is the bankruptcy zone, a Z-value greater than or equal to 1.8 and less than 2.99 is the gray zone, and a Z-value greater than 2.99 is the safe zone. The smaller the Z-value is, the likelier it is to go bankrupt.

The formula for the Altman Z-score model is:

$$Z = 0.012X_1 + 0.014X_2 + 0.033X_3 + 0.006X_4 + 0.999X_5 \quad (1)$$

2.2 Self-rescue Measures——Opening up Franchise to Expand the Market

After the company is opened to joining, it can achieve market expansion rapidly through the asset-light model, and at the same time integrate social resources to strengthen brand influence and popularity [6].

Luckin Coffee announced the opening of the franchise in January 2020 officially, of which Luckin Coffee stopped joining in the fourth quarter of 2023 and resumed joining in the first quarter of 2024. From March to September, 2020, Luckin closed 600 directly-operated stores and developed franchise measures vigorously. Franchise stores accounted for 17% of the company's revenue. In the last two quarters of 2024, the revenue of Luckin's franchised single stores increased by 60%, while the revenue of directly operated single stores increased by only 35% in the same period [7]. In order to study the effectiveness of the franchise strategy on financial recovery, this article collates the public financial statements from the fourth quarter of 2019 to the fourth quarter of 2024, calculates the Z-value separately, and observes the changing trend.

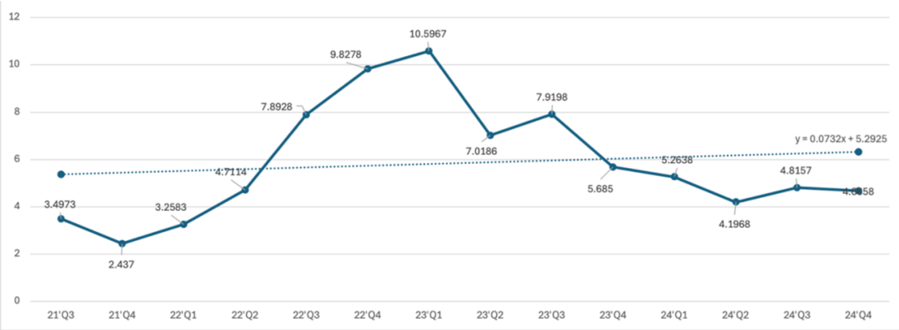

Fig. 1. Luckin Coffee Z value change chart and its trends during 2021-2024 Data from : Luckin Coffee chart during 2019-2024).

According to all quarterly financial statements of Luckin Coffee from the fourth quarter of 2019 to the fourth quarter of 2014, this article uses the Z-score model to calculate the Z-value, draws a line chart to show the financial status of Luckin Coffee, and analyzes the changing trend.

In Figure 1, the line chart of Luckin Coffee's financial status shows an upward trend generally, with a slope of 0.0732.

It is worth noting that the slope of the line chart decreased significantly from Q3 2023 to Q4 2023, from 0.912 between Q2 2023 and Q3 2023 to -2.2348 from Q3 2023 to Q4 2023. Subsequently, as shown in Figure 1, the Z-score line chart increased from -2.2348 from Q3 2023 to Q4 2023 to -0.4212 from Q4 2023 to Q1 2024.

Combined with the behavior of Luckin Coffee to stop franchising in the fourth quarter of 2023 [8], this article analyzes that the significant decline in the slope value of the line chart from the third quarter of 2023 to the fourth quarter of 2023 was caused by the cessation of franchising. Luckin Coffee announced the resumption of franchises in the first quarter of 2024 [9], and the downward trend of the slope from the fourth quarter of 2023 to the first quarter of 2024 eased slightly. The line chart after the first quarter of 2024 shows a slight downward trend or upward trend.

According to the analysis above, this article concludes that measures of opening up franchises to expand the market have shown indispensable results in the long term since their implementation has continued to bring positive effects to Luckin Coffee's financial situation, assisting Luckin Coffee to achieve "self-rescue" effectively.

2.3 Self-rescue Measures - New Product Release

Companies release new products regularly to improve market competitiveness, improve customer satisfaction and reduce costs

On April 21, 2021, Luckin Coffee released a new product, raw coconut latte, and put a considerable amount of effort into publicity. Luckin Coffee not only released a new product, but also invited celebrities, Lelouch and Gu Ailing, as spokespersons to return to the market in a short time [10]. It is estimated that most of Luckin's profits come from the contribution of sales of raw coconut lattes. This article collated all the publicly available quarterly financial statements of Luckin Coffee from the fourth quarter of

2019 to the fourth quarter of 2024, calculated Z-values separately, and created a line chart.

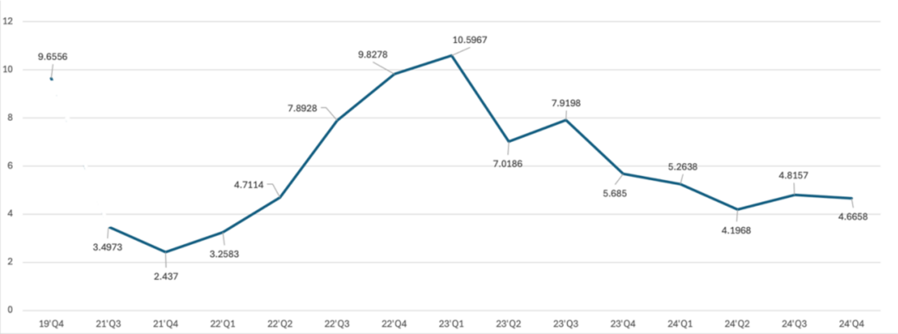

Fig. 2. Z-value change of financial statement Luckin Coffee chart during 2019-2024 (Data from: Luckin Coffee chart during 2019-2024).

From the third quarter of 2021 to the first quarter of 2023, the line chart as a whole showed a significant uptrend, with an average slope of about 1.183. Since the implementation of the "new product release" measure, Luckin Coffee's financial position has improved significantly, increasing its Z-value from 2.437 to 10.5967 during the fourth quarter of 2021 and the first quarter of 2023.

In consideration of the release of the new product, "Raw Coconut Latte", measures taken by Luckin Coffee on April 21, 2021, this article analyzed and reached the consequences that the "new product release" measure has a significant positive influence on Luckin Coffee's financial situation, which was able to alleviate the financial crisis in the short time [11]. However, by analyzing the trend of the line chart after the first quarter of 2023 in Figure 2, the article reached the conclusion that the "new product release" measure's influence was not strong enough to promote Luckin Coffee's financial improvement in the long term.

3 Enlightenment and Recommendations

3.1 Enlightenment

This article focuses on analyzing Luckin Coffee's "opening up franchise to expand the market" measure and "releasing new products" measure. Followings are the analyzed enlightenment. Firstly, two measures the article focused on influenced Luckin Coffee's financial position positively, which led to the conclusion that both the "opening up franchise to expand the market" measure and the "new products release" measure are crucial for Luckin Coffer to recover from its financial trauma.

Secondly, for the measures of "opening up the franchise to expand the market", the article analyzed the public financial statements during the relevant period and reached a conclusion. This article concludes that it is a critical and necessary measure for Luckin Coffee to achieve its goal of "self-rescue" in the condition of experiencing exposure to financial fraud and financial crisis, promoting stable development positively.

Thirdly, for the "new product release" measure, this article analyzed the financial statements at the relevant time period, and concluded that the "new product release" measure had a significant positive effect on the financial situation of Luckin Coffee in the short term. However, the long term effect of this measure is limited.

3.2 Suggestions

Based on the enlightenment of the analysis above, this article provided recommendations for companies and industries.

This article suggested that if the financial situation of a company is exposed due to financial fraud and falls into a crisis or trough, the company can use the strategy of "opening up the franchise to expand the market" measure or "releasing new products" measure to alleviate the financial pressure. For companies that lack a large amount of capital in the short term, this article recommends that the measure of "releasing new products" should be prioritized to solve the problem of a large number of financial vacancies in the short term. For companies that seek sustainable financial growth in the long term, this article recommended that the measure of "opening up franchises to expand the market" should be preferred.

This article made the following recommendations for the business industry

Legal operation and compliance management are the cornerstones of long term development and sustainable development of companies. Companies should keep the awareness of legal operation and any violation of the law and rules of the market will ultimately pay a heavy price [1].

4 Conclusion

In the context of the contemporary economy, this article aims to judge the effectiveness of the financial "self-rescue" measures adopted by firms commonly when facing major financial fraud. Taking the exposure of financial fraud of Luckin Coffee in 2020 as an example, this article selects two measures, "opening up franchises to expand the market" and "new product release", and explores the effectiveness of two measures in recovering the financial situation of Luckin Coffee. In this article, the AMPS model was used as the structure of the paper, and the Z-score model was used for data processing, exploring the effectiveness of two measures taken by Luckin Coffee in a quantitative form. The results of this article demonstrated the contribution and characteristics of two measures to the recovery of Luckin Coffee's financial situation in a quantitative form successfully. This article filled the gap of the lack of long-term tracking of the results of "self-rescue" measures and realized the long-term follow-up analysis of the "self-rescue" measures aims at recovering from Luckin Coffee's financial fraud.

Authors Contribution. All the authors contributed equally and their names were listed in alphabetical order.

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