

Governance Reform after Financial Fraud and Its Efficacy on Luckin Coffee: A Comprehensive Analysis

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Abstract: Based on the revival of Luckin Coffee after the financial fraud scandal, it is essential to analyse the corporate governance reform and offer suggestions to firms that want to avoid the performance dilemma. This paper will focus on the post financial fraud reformation and its effectiveness on Luckin Coffee. A case study of Luckin Coffee will be used in this paper to evaluate the weaknesses of management before the financial fraud and analyse the governance reform after the scandal; Data analysis will be applied to assess the efficacy of the governance reform; A SWOT analysis of Luckin Coffee will be conducted to examine the competitive power in the coffee market. The research finds that the corporate governance reform concerning internal administration, the implementation of blockchain technology, and creative marketing strategies have a close connection with the rise in financial activities and transactions, expansion of retail outlets, and competition within the coffee industry. It also provides some suggestions: improving internal control is significant rather than just creating regulations; it is preferable to use associated technologies to monitor the functionality of control system; and the distinct orientation of market is necessary for firms to grab more market share.

1 INTRODUCTION

Established in the year of 2017 and launched in Xiamen, China, Luckin Coffee aims at including coffee into every individual's daily routine and constantly providing customers with the access to superior quality and high cost-performance coffee (Luckin Coffee, 2024). With the assistance of sophisticated retailing networks and upgraded AI algorithms, Luckin coffee surpassed Starbucks with 4,507 physical locations and became the swiftest firm from the foundation to IPO (Luckin Coffee, 2024; Li et al., 2022). Nonetheless, after the acknowledgement of financial fraud scandal in April 2020, Luckin Coffee rapidly fell into the quagmire of public criticism. There was over a 75% drop of Luckin Coffee's closing price following the proclamation of financial fraud (Wei, 2023). What was not anticipated was that after suffering substantial financial losses and losing investors' and consumers' confidence, Luckin Coffee has achieved a miraculous revival. By the end of 2021, Luckin Coffee announced that 868 new locations had been built and net revenue had increased by around 97.48% from 2020 – the year Luckin Coffee admitted financial fraud (Huang, 2021). Moreover, the number of Luckin Coffee stores

continued to grow sustainably and stably, rising approximately 19.4% from December 2021 to June 2022 (Luckin Coffee, 2022). The temporary success in expanding market scales and increasing net sales is inextricably linked with Luckin Coffee's effective governance reform and tactical marketing strategies. Meanwhile, the case might serve as some inspiration for certain struggling businesses. This paper will argue the effectiveness of corporate governance in terms of internal control management, the blockchain technology, and creative marketing strategies. It will first use the case study of Luckin Coffee to assess vulnerabilities that existed in the corporate governance prior to the financial fraud. Then it will analyse measures that Luckin Coffee has made on transforming corporate governance. Finally, it will use data analysis and SWOT analysis to evaluate the performance of governance reform, as evidenced by rising stock prices, expanding retail locations, and competitiveness in the coffee market.

2 LITERATURE REVIEW

From the 21st century, corporate governance reform

has drawn a lot of attention and progressed rapidly. Solomon et al. have mentioned the concept and framework of internal control and risk management (Solomon et al., 2000). Hochberg et al. have assessed how the Sarbanes-Oxley Act (SOX) affects shareholders (Hochberg, 2009). Reed has provided a framework of how to deal with the issue related to governance reform for developing countries (Reed, 2002). Enriques and Volpin have analysed the corporate governance reform in EU area, which are improving disclosure standards, enhancing internal control and enabling power to shareholders (Enriques and Volpin, 2007). After the incident of financial fraud scandal involving Luckin Coffee, Feng and Chen claim that the financial risks of Luckin Coffee may rise due to the loss of corporate reputation (Feng and Chen, 2021). Gu et al. indicate that Luckin Coffee needs to do a lot of work to restore its image and gain profits (Gu et al., 2021). Peng et al. use GONE theory to evaluate Luckin Coffee's financial fraud and offer suggestions to firms in a similar field (Peng et al., 2024).

3 CASE STUDY OF LUCKIN COFFEE

3.1 Background Information of Luckin Coffee's Financial Fraud

Having opened its initial shop for only around 17 months, Luckin Coffee made an achievement of the fastest-listing firm on NASDAQ (Chen, 2022). However, in January 2020, Luckin Coffee was accused of counterfeiting earnings by Muddy Waters Research, which instantly brought Luckin Coffee to public attention (Chen, 2022). Three months after the accusation, Luckin Coffee admitted to falsifying transactions and June 2020 witnessed Luckin Coffee's delisting from NASDAQ as a result of financial fraud (Chen, 2022).

3.2 The Revival of Luckin Coffee

In July 2020, a large portion of Luckin Coffee's internal investigation was complete, involving the review of around 55,000 documents and the interrogation of over 60 people (Luckin Coffee, 2022). Luckin Coffee found new investments from Joy Capital and Centurium Capital in April 2021 (Luckin Coffee, 2022). By December 2021, Luckin Coffee claimed that Centurium Capital's investment had been finished, with an equity

investment which was valued at US\$240 million (Luckin Coffee, 2022). A month later, Luckin Coffee accomplished the debt restructuring, and in August 2022, the company reported more than 72% year-over-year growth in proceeds (Luckin Coffee, 2022).

3.3 Weaknesses in the Former Management Structure of Luckin Coffee

3.3.1 Loss of Internal Control

One of the reasons for the existence of financial fraud at Luckin Coffee is the lack of internal control and supervision. Luckin Coffee used to publish an article in April 2019 which was themed at corporate governance charter (Luckin Coffee, 2019). It was evident that the charter did not constrain the act of financial fraud or the blurry distribution of power and responsibilities made it difficult for overseers to execute supervisory powers. In addition, regulators did not fully fulfil the obligation to prevent potential risks such as financial fraud.

3.3.2 Loss of Supervision in Auditing Field

Chen indicates that firms conducting financial frauds may fabricate the sales volumes by exaggerating the number of goods sold. For instance, coffee labels can be randomly assigned (Chen, 2022). Furthermore, consumers' unwillingness to request receipts makes it difficult for auditors to obtain adequate and typical samples, thereby reducing the accuracy of audits (Chen, 2022). The lack of audit samples and supervision provides opportunities for financial frauds to exploit vulnerabilities. In addition to the insufficient samples, the carelessness of Ernst & Young – Luckin Coffee's external auditor, was one of the reasons why the financial fraud was not found in time (He, 2024).

3.3.3 The Erroneous Motivation

In order to attract greater interest from investors and general public, Luckin Coffee exaggerated a significant amount of income and expenses by using fake transactions, which was an unrealistic pursuit of short-term performance (He, 2024).

4 THE CORPORATE GOVERNANCE REFORM AFTER THE FINANCIAL FRAUD

4.1 Enhance the Internal Control and Transparent Communication

Luckin Coffee takes immediate action to create a corporate image of integrity by enhancing internal control, risk management control and facilitating transparent communication in order to stimulate the effective corporate internal management.

In terms of management issues, Luckin Coffee revamps the internal management structure and two mechanisms have been established (Luckin Coffee, 2022). The new supervision mechanism may prevent the power from centralization and balance rights from governance, management to execution. Additionally, the report mechanism may strengthen internal control and the new management structure would rebuild a clear allocation of rights and responsibilities.

In addition, the foundation of “Three Lines of Defence”, which contains each business department in the first line, four departments related to control in the second line and two independent regulators in the third line, reduces the risk of management (Luckin Coffee, 2022). Meanwhile, Luckin Coffee puts emphasis on the examination of actual implementation and hires qualified advisors to test internal controls and assist with the restoration of internal management. Luckin Coffee states that with the help of the evaluation in 2021, the test has found 64 risks at the enterprise level, 118 programs to be recognized and 567 control procedures to be built (Luckin Coffee, 2022). The ingenious design of three lines and inspection mechanism shows the effectiveness of preventing potential risks.

Furthermore, Luckin Coffee is committed to enhancing transparent communication and information disclosure to present the image of integrity. Luckin Coffee’s disclosure schedule became more regular after delivering the annual report for 2021 in accordance with related rules (Luckin Coffee, 2022). Additionally, a whistleblowing policy has been developed which aims to identify weaknesses of manage systems and report violations of policies or laws (Luckin Coffee, 2022). The regulated disclosure of management reports and multiple channels of communication and whistleblowing may increase the transparency of the management. It shows that Luckin Coffee puts effort into the corporate internal management, including

internal control, risk management control, tests of the performance of management, and transparency of information.

4.2 The Implementation of Blockchain Technology and Information Management System

The application of blockchain technology and security system are two cornerstones of Luckin Coffee’s reform, which guarantee the safety of financial systems and effectively reduce the possibility of financial fraud.

Blockchain technology, which trails the financial data by utilizing encryption theory and other tools, can provide supervisors with reliable information (Chen, 2022). After the adoption of blockchain technology, the possibility of the financial fraud may drop to a low level. According to Chen, different from the previous system, the way blockchain collects data makes it more costly for insiders to manipulate information than the potential profits because data is stored in a series of networked computers (Chen, 2022). The use of blockchain may prevent financial fraud and reduce the motivation of profiteers, while reducing the workload of auditors as well. In order to make up for the creditability that Luckin Coffee lost previously, blockchain technology has been implemented in the data management part. The data connection between Luckin Coffee and its partnerships was completed in September 2022 (Luckin Coffee, 2022). The introduction of blockchain technology can play a significant role in information transparency, as financial data, sales data and supply chain data can be traced and documented. Consequently, Luckin Coffee can regain reputation from investors and consumers. In addition, the comprehensive information security system has been established to safeguard proprietary information, which may reduce the risk of information leakage (Luckin Coffee, 2022).

Additionally, around 27,000 employees have been trained on information security protection and Luckin Coffee is committed to the development of information security (Luckin Coffee, 2022). Luckin Coffee has acquired several certifications related to the construction of information management systems (Luckin Coffee, 2022). The use of blockchain technology and the construction of information security systems are two major factors that enhance Luckin Coffee’s credibility and information clarity. The reform in the external control area is one of the factors why Luckin Coffee recovered within two years.

4.3 Well-Positioned and Tactical Marketing Strategies

Luckin Coffee enacts tactical marketing strategies by having precise orientation of the target market and cooperating with other brands to increase advantages in the competitive coffee market.

Luckin Coffee has a clear target of coffee market and customer base. In order to prevent overlap in the coffee market, Luckin Coffee focuses on offering high-quality and relatively cheap coffee to attract consumer groups (Cao, 2022). The clever market position effectively avoids directly competing with other superior coffee brands like Starbucks. According to Cao, through the method of providing coupons for customers, the price of a cup of Luckin Coffee is relatively cheaper than other competitors (Cao, 2022). However, due to the initially price of coffee, consumers may unconsciously associate Luckin Coffee and other noble coffee brands of the same caliber, which invisibly boosts the sales of Luckin Coffee and gains a large number of loyal consumers. The discount strategy captures the psychology of some consumers who prefer affordable coffee. Furthermore, the rapid introductions of new products and new flavours of coffee is another reason why Luckin Coffee can attract customers. Luckin Coffee indicates that from January 2022 to September 2022, as many as 92 new products were launched (Luckin Coffee, 2022). Coconut Milk Latte sold more than 100 million cups annually among these coffee types, while the Coconut Cloud Latte sold over 4.95 million cups in the first week after its launch (Luckin Coffee, 2022). The constant discounts, cost-effective coffee and continuous penetration have increased the market share of Luckin Coffee, which is an essential reason why Luckin Coffee recovered in a short time.

Additionally, Luckin Coffee vigorously searches for opportunities to collaborate with other renowned

brands to increase its reputation. For instance, Huang claims that an innovative coffee product, which combines Moutai wine and coffee, has been launched as a result of the partnership between Luckin Coffee and well-known Chinese liquor firm Moutai (Huang, 2024). The coffee, which is called “liquor-laced latte”, soon increased the performance of Luckin Coffee’s market sales. After the release of the new product, about 2,437 net stores were achieved along with 23.1% store profit (Huang, 2024). As the well-known liquor brand in China, Moutai has accumulated a reputation among consumers. The cooperation between Luckin and Moutai can attract customers due to the scarceness of co-branded goods, which may stimulate customers’ curiosity and motivate them to make an immediate purchase. As this is supported by Shin and Kim, who claim that unique and novel items tend to grab people’s interest more easily and humans are naturally fascinated by new and unknown things (Shin and Kim, 2019). The joint brand strategy captures the consumer’s curiosity and represents a tactically effective transformation in market strategy.

5 RESULT OF THE CORPORATE GOVERNANCE REFORM

5.1 The Increasing Stock Price after the Corporate Governance Reform

From Figure 1, after the decreasing stock price in 2020, there has been a stable increase in the price of Luckin Coffee’s stock, from 2.33 USD in Apr. 2020 to 24.44 USD in Jan. 2024 (closing price). The ascending stock prices prove that Luckin Coffee has recovered capital flows and active transactions, making it more competitive in the coffee market.

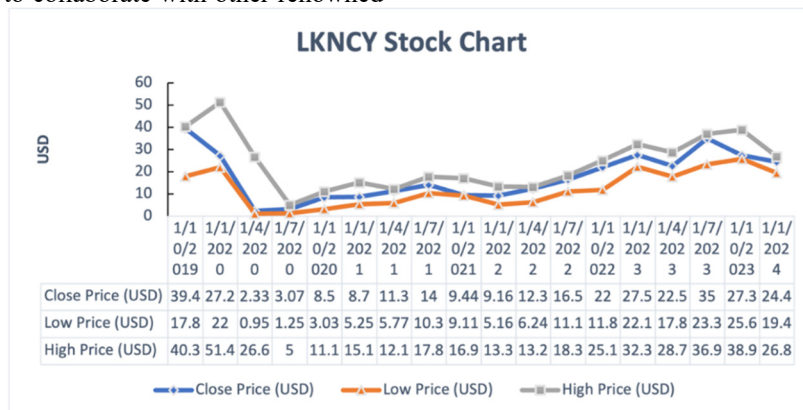


Figure 1: Luckin Coffee’s stock chart from Oct 2019 to Jan 2024.

Data source: <https://investor.lkcoffee.com/stock-quote-chart>

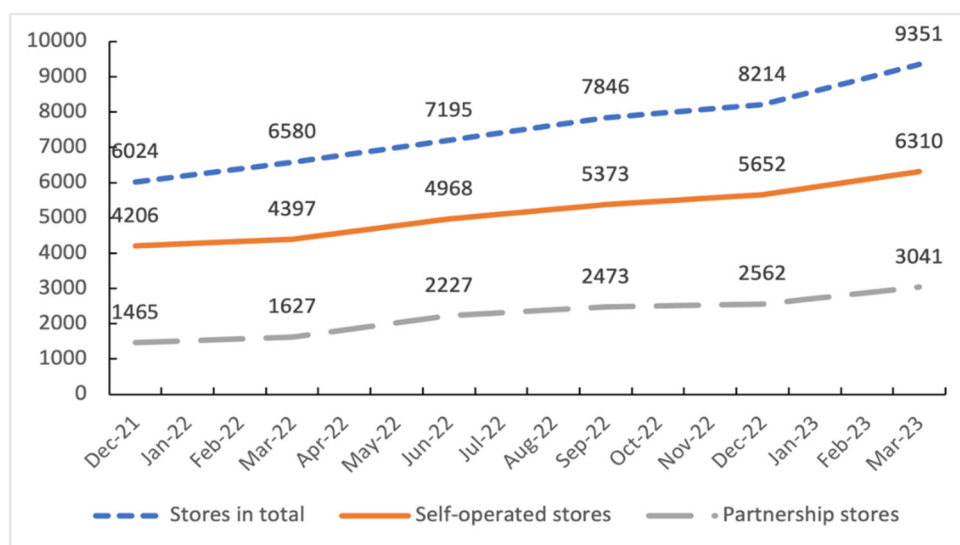


Figure 2: Luckin Coffee's Stores from Dec 2021 to Mar 2023.

Data source: <https://investor.lkcoffee.com/news-releases/news-release-details/luckin-coffee-inc-announces-first-quarter-2023-financial-results>

5.2 Constant Increase in Stores of Luckin Coffee

According to Figure 2, the steady rise in the number of self-operated stores and partnership stores reveals Luckin Coffee's expansion and close cooperation with other partners. By the end of March 2023, stores in total had reached 9,351. The growth reflects Luckin Coffee's commitment to expanding its customer base and the effective execution of market strategies.

5.3 Enhanced Competitiveness of Luckin Coffee Through SWOT Analysis

Conducting a SWOT analysis can evaluate the internal conditions and external environment of Luckin Coffee. In terms of strengths, Luckin Coffee has a stable supply of coffee beans from different continents, including Ethiopia, Yunnan province in China and Brazil (Luckin Coffee, 2022). More than 15,000 tons beans were imported in 2021 and this figure doubled in the next year (Yu, 2024). Furthermore, the wide variety of coffee types can satisfy different consumer needs and attract many loyal consumers. The co-branding strategies can enhance the popularity of Luckin Coffee, while effective internal management ensures the smooth operation of the firm. Additionally, the implantation of blockchain technology can supervise the

transparency of information. The strengths of Luckin Coffee can be summarized as follows: three stable suppliers from different continents, the implementation of blockchain technology, various of flavours and types of coffee, effective internal control and risk management, a good orientation of coffee market and successful collaboration with famous brand Moutai.

Regarding the weaknesses of Luckin Coffee, the previous instance of financial fraud may negatively influence potential investors and consumers (Huang, 2021). Furthermore, new products may not satisfy the tastes of all consumers. For instance, a survey on whether liquor latte is enjoyable to drink received 4,234 votes in support and 4,517 votes in opposition (Huang, 2024). Therefore, the weaknesses of Luckin Coffee include the past financial fraud scandal and the possibility that new products may not suit every consumer's taste.

For opportunities, the vast coffee market in China presents all coffee firms with chances to make profits. The purchasing power of Chinese consumers enables firms to explore a variety of products, offering Luckin Coffee the opportunity to provide a range of options for consumers (Huang, 2021). In addition, the implementation of blockchain technology and corporate governance reforms in internal control and management may inject vitality in the operation of the firm.

For threats, the development of the tea market may pose competition to the coffee market. Milk tea culture was quite popular in the previous year and

plenty of milk tea brands may compete with Luckin Coffee for the limited market share (Huang, 2021). Furthermore, competition within the coffee market is another threat for Luckin Coffee. For example, Starbucks has also implemented several reform actions to increase its advantage (Huang, 2021). Therefore, a table of SWOT analysis can be created below (see Table 1).

Table 1: SWOT Analysis of Luckin Coffee

Strengths Three stable suppliers from different continents The implementation of blockchain technology Various types of coffee Effective corporate internal control and risk management A good orientation of coffee market and successful collaboration with famous brand Moutai.	Weakness The formal financial fraud scandal New products may not suit every consumer's taste
Opportunity The vast coffee market in China Effective corporate governance reform	Threat Competition with tea market Competition within coffee market

Although some drawbacks and threats exist for Luckin Coffee, the corporate governance reform brings more financial transactions to the coffee market, expands the number of stores, and increases competitiveness in the coffee market.

6 CONCLUSIONS

This paper has highlighted that the corporate governance focusing on internal controls, the utilization of blockchain technology and the implementation of related information security system, as well as approaches to marketing, are productive. These are evident in the growing number of active transactions, the expansion of retail presence, and competitive power in the coffee market. It first conducted a case study on Luckin Coffee and analysed deficiencies in the previous management structures. It then examined the changes in corporate governance reform at internal management, new technology and market strategy levels. Efficient internal control and risk management systems, the security systems and blockchain technology, the market focus and brand collaboration have enabled

Luckin Coffee to recover from its financial losses. Finally, it discussed the result of the corporate governance reform of Luckin Coffee. The rising financial activities and transactions, the increasing price of stocks, the expanding retail footprints and the competitiveness in the coffee market indicate that the strategies implemented by Luckin Coffee have had positive effects. The reform of Luckin Coffee can provide some approaches for other firms that are eager to reform their governance frameworks. Firms need to focus on enhancing internal controls rather than merely establishing regulations. If firms have adequate capital and technical support, it is advisable for firms to utilize relevant technologies to monitor and assess the effectiveness of control systems. Secondly, firms still need to maintain a relatively transparent environment not only in terms of regular information disclosure but also in communication, which could earn the trust of investors and consumers. In addition, establishing whistleblowing policies may assist firms to identify potential risks earlier. Thirdly, firms need to have a clear orientation of target customers. Releasing coupons and cooperating with other well-known brands may be two methods to enhance a firm's sales and popularity. It is important to note that retaining loyal customers is one of the reasons for the increasing number of retail outlets. Therefore, firms need to prioritize strategies aimed at retaining and expanding the base of loyal customers.

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