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# WHAT WAS LACKING AT LUCKIN? A CASE STUDY OF ETHICS AND FRAUD IN A U.S. LISTED FOREIGN COMPANY

Devon Baranek, Rider University
Nandini Chandar, Rider University
Sherry Li, Rider University

## CASE DESCRIPTION

*This case provides students an opportunity to analyze fraud and ethical issues in the context of global capital markets. Luckin Coffee, a China-based retail coffee chain, gained prominence with a record IPO in 2019 and fell into disrepute the next year as a major fraud was uncovered. An internal investigation revealed employees engaged in improper behaviors, including falsifying transactions data that led to gross overstatements in revenue for the first three quarters of 2019. Luckin was charged with issuing materially false registration statements and prospectuses for its IPO in 2019 and secondary offering in January 2020. The company was delisted and investigated by the SEC for the accounting fraud, settling for \$180 million in December 2020. This is a multi-purpose case with an abbreviated version (Question Set A) appropriate for an introductory financial accounting course, and an extended version (including Question Set A and Question Set B) appropriate for an upper-level or graduate course in financial accounting or fraud/forensics. Prior classroom instruction on the navigation of the SEC's Edgar database, the PCAOB and the U.S. regulatory framework, and Yahoo Finance or another stock price tracking website may be beneficial at the higher course levels. The case should be assigned as a group project due to its length and required level of analysis. Students at all levels should be given at least one full class period (60-90 minutes or more) to work on the case and an additional one to two weeks outside of class to complete the questions. Classroom discussion after the due date should be at least one hour.*

**JEL:** M40, M41

**KEYWORDS:** Accounting Fraud, Ethics, Enforcement Action, Luckin

## CASE INFORMATION

Luckin Coffee is a retail coffee chain founded in Beijing in 2017 by Jenny Qian. It sells coffee, tea and other food and beverage items to customers throughout China, operating a web-centric business model that allows customers to order and pay through apps and mobile wallets (Barrett, 2020). Specifically, the company utilized mobile apps and offered a 100% cash-less environment and network of pick-up stores located in areas with high demand for coffee, like office buildings, commercial areas, university campuses (Luckin 2019a). Additionally, Luckin aimed to gain market share quickly by offering deep discounts.

Luckin's major competitor is Starbucks, which operates more than 4,000 retail locations in China and has found success by offering a comfortable place for people to work, study, or hang out. Luckin's strategy is the opposite: the majority of its locations are kiosks with limited or no seating, and the orders have to be placed and paid for on its app. By January 2020, Luckin managed more than 4,500 retail locations (Bloomberg 2020). Luckin's mobile app was central to its growth strategy. The company used it to send vouchers and coupons for free or discounted coffee to its customers. The vouchers/coupons reduced the price of Luckin's beverages and caused the company to operate at a loss, but was part of a larger strategy to win market share, expand brand awareness, and increase customer base (Luckin 2019a).

Luckin grew rapidly in its first years of business. It opened its first store in 2017, followed by an additional 2,370 stores in the next 18 months (Luckin 2019a). This rapid growth attracted attention from investors in China and abroad. Luckin raised $150 million in April 2019 from private investors which increased its enterprise valuation to $2.9 billion (CNBC 2019).

In May 2019, Luckin made an initial public offering of American Depositary Receipts (ADRs) on the Nasdaq, raising approximately $600 million. At that time, the company reported operating 2,370 stores in 28 cities across China and claimed to be the "second largest and fastest growing coffee network" in China (SEC 2020a). In its prospectus, Luckin disclosed total revenues of $125 million for 2018, and $71.3 million for the quarter ending March 31, 2019. It repeated the goal of becoming the largest coffee chain in China, crediting its disruptive retail model, strong technology capabilities and superior customer value proposition of high quality, high affordability and high convenience (Luckin 2019a).

The pre-IPO valuation of the company continued its rapid climb, from $1 million in July 2018 to $2.9 billion in April 2019. The IPO in May 2019 was priced at $17 per ADR and considered a success, raising $651 million and valuing the company around $5 billion on its first trading day (Yang, 2020a).

## THE FRAUD SCHEME

After the IPO, analysts following Luckin focused on the revenue growth trajectory of the company, ignoring the fact that it wasn't profitable and didn't estimate when it would be (Bloomberg 2020). During this time, Luckin was unable to meet its own earnings guidance or the revenue and growth expectations of the market. Beginning in April 2019, Luckin artificially inflated its revenue and growth using fabricated coupon sale transactions through three fraudulent schemes, outlined below (SEC 2020b). See Appendix A for a more detailed explanation of each fraud scheme.

1. Luckin employees created fake customer accounts using their cell phone numbers and those of their family members, and fabricated coupon sales and redemptions by these fictitious customers. Sales of several millions of dollars were connected with this scheme.
2. Luckin created fake corporate accounts and used them to fulfill fictitious bulk orders. These transactions were recorded alongside bonafide voucher sales to regular corporate clients like airlines and banks. Tens of millions of dollars of sales were fabricated this way.
3. Luckin entered into sham coupon purchase agreements with third-party shell companies. Luckin recognized nearly $280 million dollars of fabricated sales this way.

Certain employees at Luckin were aware of the fraud and even maintained separate databases to track the fictitious and legitimate transactions. The "Business Operations Database" tracked legitimate coupon sales and redemptions, while the "Fabricated Database" included both legitimate and fabricated sales numbers. The same Luckin employees would switch the database used to generate reports, depending on what reporting was required. Luckin's Finance Department only had access to the Fabricated Database and therefore unknowingly incorporated fictitious transactions into Luckin's financial statements.

The total amount of sales transactions associated with these schemes was at least $311 million from April 2019 to January 2020. During this time, Luckin was able to keep perpetrating the fraud by recycling the money from fabricated coupon sales back to the funding companies (controlled by or associated with Luckin employees) and fictitious corporate customers, using bank transfers and fictional business-related expense payments to vendors (SEC 2020a).

Before Luckin's first earnings release as a public company (in the second quarter of 2019), analysts were predicting quarterly revenues of around $130 million. Luckin's 2019 Form 6-K filed with the SEC in August reported total net revenues in the second quarter of $132 million, with net revenues from products at $126 million, a 698% increase compared to Q2 of 2018 (Luckin 2019b). Approximately $36 million of these sales were fabricated. At the same time, Luckin's expenses were also overstated because of the fraudulent expense transactions necessary to return money used in the scheme back to the funding companies, although not proportionately. Luckin thus materially misstated its net loss, reporting a net loss of $99 million, which was understated by about $14 million (SEC 2020a).

By the third quarter of 2019, analysts were predicting around $190 million in earnings for Luckin. In its third quarter 6-K filing, Luckin reported net revenues of $216 million, a year-over-year increase of nearly 540%. The company also projected a nearly 400% rise for the upcoming fourth quarter (Luckin 2019c). These revenues included approximately $103 million in fabricated coupon sales and redemptions, as well as about $76 million in overstated expenses. Overall, the company materially understated its Q3 2019 net loss by $26 million (SEC 2020a).

Luckin continued to fabricate coupon sales and redemptions as well as inflate and fabricate related expenses through the fourth quarter of 2019. During this same time, Luckin's stock price continued to increase. About two months after the third quarter results were reported, the stock price had more than doubled from its IPO level and Luckin announced it had opened more retail locations than Starbucks (Sebastian, 2019).

On January 14, 2020, Luckin raised an additional $418 million through a follow-on equity offering and $447 million through a convertible bond issuance. These offering filings included the materially misstated financials previously released in 2019 (SEC 2020a). The stock price hit an all-time high of $50.02 per ADR in mid-January, nearly tripling its original offer price. Two weeks later the short-selling firm Muddy Waters released an unattributed 89-page document accusing Luckin of inflating its sales (Bloomberg 2019). The report included the investigative work of more than 1,500 individuals who visited about 15% of Luckin's retail locations across China. They counted customers in Luckin's stores, recorded thousands of hours of video and collected receipts from customers. The sales observed at these locations were far lower than what was reported by Luckin and after analyzing all the data, the authors of the report concluded Luckin must be inflating its own sales numbers (Yang et al. 2020).

Around this same time, Luckin's fraud was discovered by Ernst & Young (EY) through the annual external audit. The accounting firm reported that it found, "management personnel engaged in fabricated transactions which led to the inflation of the Company's income, costs and expenses" from Q2 to Q4 of 2019 (Webb and Chiu, 2020). EY reported its findings to the Audit Committee and an internal investigation was started.

On April 2, 2020, Luckin announced the formation of "… a special committee to oversee an internal investigation into certain issues raised to the Board's attention during the audit of the consolidated financial statements for the fiscal year ended December 6, 2019" (Luckin 2020a). The company disclosed that beginning in the second quarter of 2019, the chief operating officer and several employees had engaged in misconduct which included fabricating certain transactions. Luckin disclosed that $310 million of its 2019 revenue had been fabricated, and warned investors that they could not rely on the 2019 reports or earnings guidance (SEC 2020a).

Investors lost billions of dollars following the fraud disclosure, with the stock price rapidly declining in response to the news. On April 6, 2020 Nasdaq ordered to halt the trading of Luckin shares for pending news. The stock had plummeted to a closing price of $6.40 by that time, more than an 80% decrease from its all-time high (Lucas 2020).

## AFTERMATH

After the misconduct was discovered, Luckin self-reported the fictitious sales and expenses to the SEC and cooperated with the investigation. The company "… promptly undertook significant remedial efforts", including additional internal investigations, terminating certain personnel and relationships with third parties and adding additional internal accounting controls (SEC 2020a).

On December 16, 2020, the SEC charged Luckin with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. The SEC Complaint alleged that Luckin intentionally and materially overstated its reported revenue and expenses, and materially understated its net loss in publicly disclosed financial statements in 2019, in order to give the impression of rapid growth and to meet/exceed analyst expectations of revenues and earnings (SEC 2020a). Luckin also violated the reporting, books and records and internal control provisions of the Exchange Act (SEC 2020b).

Luckin did not admit or deny the charges, but agreed to pay a $180 million fine to settle with the SEC. According to the current CEO, "This settlement reflects our cooperation and remediation efforts and enables the company to continue with the execution of its business strategy. The Company's Board of Directors and management are committed to a system of strong internal financial controls and adhering to best practices for compliance and corporate governance" (Luckin 2020b).

On February 5, 2021 Luckin filed for Chapter 15 bankruptcy in New York. Since then, it has slowly begun to recover its business operations. Most recently, Luckin filed its annual report of 2020 with the SEC and continued to show signs of improvement, in the aftermath of the fraud and despite the pandemic (Luckin 2021). It currently trades on the Over-the-Counter (OTC) market under the ticker LKNCY. Appendix B provides a more detailed explanation of the charges, remediation efforts and aftermath of the Luckin fraud, suitable for an upper-level or advanced course.

## QUESTIONS

### Question Set A: Introductory Level

1. What are the key allegations of fraud in this case?

2. Who are the parties to the fraud? Were the actions of these individuals unethical, illegal or both?

3. Who are the stakeholders in this case – i.e., who are all directly or indirectly affected by this fraud? How are these parties affected by fake financial information?
4. Discuss the importance of internal controls and explain how an effective internal control system could have prevented or mitigated fraudulent activities at Luckin (tone at the top, control environment, collusion, etc.) Do you think a strong internal control system can prevent ALL fraud?

5. The fraud triangle is a model that explains why an individual commits fraud. It outlines three factors that contribute to the risk of fraud and other unethical behaviors: opportunity, incentives/pressure and rationalization. Apply the fraud triangle to analyze the fraud at Luckin.

6. List 2-3 internal control activities that could have helped uncover the fraud.

7. Discuss the role of the company management and auditor in ensuring that financial statements are accurately presented. Who is primarily responsible for providing accounting information and preparing financial statements? What is the role of the external auditor?

8. The fraud scheme at Luckin was widespread and many employees knew of the fraud and either helped perpetuate it or failed to report it. What are some of the options available to employees who observe unethical or illegal behavior and wish to report it?

**Question Set B: Advanced Questions**

1. Locate Luckin's Press Release made on July 1, 2020 regarding the completion of its internal investigation (you can find press releases on its website under News & Events). What did the company find regarding the fraud and what remedial actions did they take or plan to take?

2. Using YahooFinance, find the closing stock price of Luckin (ticker: LKNCY) for the dates below. Explain how Luckin's exaggerated earnings and subsequent fraud disclosure affected its stock price. Is this type of market manipulation unethical, illegal or both?

   *May 17, 2019* (IPO date):
   *November 20, 2019* (Q3 financial results announced):
   *January 14, 2020* (Secondary offering):
   *January 17, 2020* (High price):
   *April 2, 2020* (Day of fraud disclosure):
   *June 26, 2020* (Last day of trading on Nasdaq):
   *Today:*

3. Find Luckin's registration statement (Form F-1) filed with the SEC in 2019.
   A. What are the ownership percentages reported for the individuals that were terminated after the fraud was revealed (the Chairman, CEO and COO)?
   B. When the fraud was first revealed, the COO was blamed and terminated. Founder and CEO Jenny Qian and Board Chairman of the Board Charles Zhengyao Lu denied any knowledge of the scheme. Given the above ownership information, do you think this is likely?

4. Public companies incur additional costs for regulatory compliance to enter the marketplace (for example the costs associated with disclosure and governance requirements of SOX or compliance with PCAOB audits).
   A. Describe some of the benefits of the increased regulation for public companies.
   B. Explain why SOX or the PCAOB did not play a larger role in the Luckin case.

5. Research the recently passed Holding Foreign Companies Accountable Act (HFCAA) and explain how this Act is related to the Luckin case.

6. Discuss the role of the company management and the external auditor in fraud prevention and detection, including the limitations of each party. Explain in the context of the Luckin case.

7. EY claimed that it had discovered Luckin's fraudulent activities during the annual audit of the 2019 financial statements, but instead of issuing an adverse opinion report, it chose to withdraw as Luckin's independent auditor. What do you think might be the reason?

8. After being delisted from Nasdaq, Luckin's stock continues to trade on the Over-the-Counter (OTC) market under a new ticker. Research the OTC market. Explain the advantages and disadvantages of OTC trading for Luckin and for investors.

9. It appears that the regulatory structure in the US did not prevent this fraud. Why do foreign companies seek to list on NASDAQ? Discuss broadly NASDAQ listing requirements and why these failed to

detect the fraud at Luckin prior to its IPO listing? What types of new controls should NASDAQ and other exchanges put in place to prevent these types of fraudulent activities and shore up investor confidence in its listings? What action should FINRA and the SEC take in this regard?

10. Do you think that employees and others held responsible in the fraud should be personally held liable?

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# WHAT WAS LACKING AT LUCKIN? A CASE STUDY OF ETHICS AND FRAUD IN A U.S. LISTED FOREIGN COMPANY

## TEACHING NOTES

Devon Baranek, Rider University
Nandini Chandar, Rider University
Sherry Li, Rider University

## CASE DESCRIPTION

*This case provides students an opportunity to analyze fraud and ethical issues in the context of global capital markets. Luckin Coffee, a China-based retail coffee chain, gained prominence with a record Nasdaq-listed IPO in 2019 and fell into disrepute in 2020 as a major fraud was uncovered. An internal investigation revealed employees engaged in improper behaviors, including falsifying transactions data that led to gross overstatements in revenue for the first three quarters of 2019. Luckin was charged with issuing materially false registration statements and prospectuses for its IPO in 2019 and secondary offering in January 2020. The company was delisted from Nasdaq and investigated by the SEC for the accounting fraud. Luckin settled with the SEC in December 2020 for $180 million and has been working to regain investor confidence under new management. This is a multi-purpose case with an abbreviated version (Question Set A) appropriate for an introductory financial accounting course, and an extended version (including Question Set A and Question Set B) appropriate for an upper-level or graduate course in financial accounting or fraud/forensics. Prior classroom instruction on the navigation of the SEC's Edgar database, the PCAOB and the U.S. regulatory framework, and Yahoo Finance or another stock price tracking website may be beneficial at the higher course levels. Due to the length of the case and the required level of analysis, this case should be assigned as a group project. Students at all levels should be given at least one full class period (60-90 minutes or more) to work on the case and an additional one to two weeks outside of class to complete the case questions. Classroom discussion after the due date should be at least one hour.*

## GENERAL COMMENTS

There are ten learning objectives in the case. At the introductory level, there are six learning objectives which are applicable to all students (Question Set A). At the advanced level, there are an additional four learning objective that may be utilized in an upper-level or masters-level course (Question Set B). Table 1 maps the learning objectives to the case questions.

The Luckin fraud is one of the most high-profile public accounting scandals in recent years in both the US and China. It took the company less than two years to go from startup to IPO, setting a speed record for a Chinese company seeking capital in the US market. Then it quickly fell into disgrace by fabricating hundreds of millions of dollars in revenues. The Luckin fraud has facilitated the passage of the Holding Foreign Companies Accountable Act (HFCAA), which mandates that if the PCAOB is unable to inspect a foreign company's audit work papers, the company's stock can be prohibited from trading in the US. Thus, we believe this is a timely and relevant case for not only the accounting students but also the other business major students.

Table 1: Learning Objectives Mapped to Case Questions

| **Learning Objectives (Question Set A)** | **Case Questions** |
|---|---|
| (1) Students will describe the fraud at Luckin and identify the parties to the fraud. | **QA1, QA2** |
| (2) Students will identify the stakeholders involved in the case and explain how they were affected by the fraud. | **QA3** |
| (3) Students will apply the fraud triangle to the Luckin case. | **QA5** |
| (4) Students will describe the role of management and the external auditor in financial reporting. | **QA7** |
| (5) Students will explain the importance of implementing and maintaining a system of internal controls in connection with the prevention and detection of fraud. | **QA4, QA6** |
| (6) Students will identify options for reporting unethical or fraudulent activities. | **QA8** |
| **Advanced Learning Objectives (Question Set B)** | |
| (7) Students will describe the remediation efforts taken by Luckin in order to promote compliance with regulatory agencies. | **QB1** |
| (8) Students will investigate how the allegation and disclosure of the fraud impacted Luckin's stock price and how it is traded. | **QB2, QB8, QB9** |
| (9) Students will research SOX and HFCAA in the context of the Luckin case. | **QB4, QB5** |
| (10) Students will discuss the role of auditors, management and corporate governance in the detection and prevention of fraud. | **QB3, QB6, QB7, QB10** |

*This table shows the learning objectives of the case mapped to case questions.*

This case can be used in either an introductory or upper-level financial accounting course as well as an upper-level fraud or forensics course. If used in the intro-level course, Question Set A focuses on the basic concepts of fraud, the fraud triangle, internal control system and internal control activities. If used in at the upper-level, Question Set B focuses on more research and analysis, including external auditing, corporate governance and how different regulatory regimes can help detect and prevent fraud.

Because this case goes beyond what would be included in a traditional textbook, there are many different aspects instructors may choose to focus on - the individuals who committed the fraud (who, why, how), the lack of oversight of blatantly illegal behavior, the illegal vs unethical components of the case, the timing of the fraud and how it affected the stock price and IPO, the anonymous report alleging the fraud (who, why, how), the speed of the IPO, the effect of this fraud on the HFCAA, how Luckin is planning to come back from the controversy, etc. The case is designed to provide flexibility to the instructor, so different discussion questions or topics can be emphasized depending on areas of student interest or engagement.

## QUESTIONS:

### Question Set A: Introductory Level

Note: Exhibit 1 maps the case questions to specific learning objectives for instructors looking to emphasize (or omit) a specific topic or area.

**Question 1:** What are the key allegations of fraud in this case?

**Solution 1:** Students should be able to describe the following activities and their consequences:

A. Creating fictitious employees, entities and transactions with a view to artificially inflate revenue.

B. Making false financial statements and presenting a fraudulent picture of financial performance to support an IPO as well as subsequent stock and bond sales.
C. Filing false financial statements with the SEC.
D. Failure to maintain an effective or even adequate system of internal controls.
E. These actions constituted "fraud" – as the company had knowledge and intent of misleading investors and other stakeholders.

**Question 2:** Who are the parties to the fraud? Were the actions of these individuals unethical, illegal or both?

**Solution 2:**

A. *Top management:* Management sets the tone at the top and had a fiduciary responsibility towards shareholders as well as employees and third-party vendors with whom they did business. They encouraged fabricating transactions to meet unrealistic sales targets and did everything to boost short term performance [possibly to maximize their bonuses or the value of their stock options], encouraging and directing unethical and fraudulent behavior across the firm.
B. *Employees:* According to Luckin's internal investigation, more than 20 employees either participated in the fraud or had knowledge of it. Employees may have faced pressure to commit illegal or unethical acts as a condition of career security or advancement within the company.
C. *The Board of Directors and its Audit Committee:* Responsible for monitoring senior management, ensuring an effective system of internal controls, and supervising the external audit process to make sure that financial statements were accurately presented. The board of directors did not perform their functions effectively and it is not clear that they questioned the aggressive strategic plans set by top management which prioritized short term profits at all cost. The audit committee, required for SEC-listed firms in the US, also did not perform its functions in this case. The board failed in its fiduciary duties to ensure that management acted in the best interests of shareholders.
D. *External Auditors:* It appears that EY did not perform their role with due diligence. First, prior to the audit of the 2019 fiscal year end statements, EY sent a private letter to large investors stating that it did not have an issue with the financial information for the first three quarters of 2019. This was inappropriate as it was not based on a detailed audit, and was taken to represent a guarantee by investors that there were no problems with Luckin's financial statements. Such a statement also compromised the independence – both perceived and actual – of the audit firm. While a regular audit is not specifically designed to uncover fraud, EY in this instance did not act in the best interest of the public or the profession. It acted unethically as it failed in its duty to act with integrity and objectivity. It is possible that EY was motivated by obtaining other business from Luckin (like capital markets or consulting) and let this compromise its objectivity in this audit.
E. *External parties and entities with ties to Luckin's senior management*: These are "related parties" and they also had an ethical responsibility to come forward if they knew of irregularities at the firm. Any such external party that had a business relationship to Luckin had to also be disclosed in the notes to the financial statements. The fact that these ties were obscured points to the fraudulent intent of management in this case.

**Question 3:** Who are the stakeholders in this case – i.e., who are all directly or indirectly affected by this fraud? How are these parties affected by fake financial information?

**Solution 3:**

A. *Shareholders:* both current and potential shareholders. Current shareholders who are unaware of the fraud being perpetrated as well as potential shareholders making buy, sell and hold decisions based on public information that is misleading.
B. *Employees*: faced pressure to act unethically, fearing for their livelihood.

C. *Analysts:* were misled by false financial statement information and made incorrect recommendations on the stock.
D. *External auditors:* EY, who faced potential monetary fines, lawsuits and reputational consequences as their function involves safeguarding public trust.
E. *Regulators:* including the SEC, Nasdaq and PCAOB.
F. *Creditors:* $447 million convertible bond issuance was based on false financial information.
G. *Current US-listed Chinese companies and Chinese companies seeking IPO opportunities in the U.S.*: This high-profile scandal is a wake-up call for U.S. regulators and investors regarding the risk of fraud that foreign companies pose to the U.S. capital market. Chinese companies may face tightened scrutiny which makes it more difficult for them to gain capital from the U.S. market.

**Question 4:** Discuss the importance of internal controls and explain how an effective internal control system could have prevented or mitigated fraudulent activities at Luckin (tone at the top, control environment, collusion, etc.) Do you think a strong internal control system can prevent ALL fraud?

**Solution 4:** Internal controls are the policies, methods and procedures implemented by a company to protect its assets, enhance the accuracy and reliability of its financial records, promote operational efficiency and ensure compliance with laws and regulations. Without good internal controls, companies put themselves at risk of theft, embezzlement, revenue loss, liabilities and public scandals. An effective internal control system can prevent fraudulent activities by minimizing the opportunity to commit fraud and increasing the perception of detection. It can also help detect and catch fraudulent activities sooner, and help management take remedial actions.

This case demonstrates clearly that no internal control system is perfect. Collusion (two or more individuals work together to overcome the prescribed controls) among management, employees and third parties can reduce the effectiveness of a well-designed system. Luckin's internal investigation found evidence that more than 20 employees had worked together to create fake sales orders and even maintained an entire Fabricated Database to produce financial reports. This level of collusion can be hard to be detected by any internal control system.

In addition, top management has the responsibility to support internal control and make it clear that unethical activities will not be tolerated. This is known as the "tone at the top"-one of five primary components of internal control systems. However, as per Luckin's internal investigation, several top executives including its former CEO and COO were directly involved in the fabricated transactions, making its own internal control system vulnerable and ineffective.

**Question 5:** The fraud triangle is a model that explains why an individual commits fraud. It outlines three factors that contribute to the risk of fraud and other unethical behaviors: opportunity, incentives/pressure and rationalization. Apply the fraud triangle to analyze the fraud at Luckin.

**Solution 5:**

*Opportunity*: There was a lack of effective internal controls at Luckin as well as large scale collusion among management and employees. The company directors failed to establish or enforce an ethical culture. Additionally, because Luckin is a foreign issuer, the submission and disclosure requirements existing at the time it went public allowed for less oversight than a similar domestic company would have faced (specifically the inability of the PCAOB to oversee the audits of public companies; and the exemption from SOX provisions for foreign issuers). This has since been addressed with the passage of the Holding Foreign Companies Accountable Act.

*Incentives/pressure*: Luckin faced pressure to meet its own unrealistic earnings targets as well as analyst and investor expectations. Management had personal incentives to profit from the increase in the stock price since the top executives received stock-based compensation (stock ownership and stock options).

*Rationalization*: The top management may have felt that they were helping the company meet various targets in order to grab market share from competitors like Starbucks as fast as possible. The attitude that "management is also doing it" or that "management was in the know" sets the tone to lower level employees who may have felt that management permitted or even instructed them to cook the books and they were just following orders.

**Question 6:** List 2-3 internal control activities that could have helped uncover the fraud.

**Solution 6:**

A. *Documentation procedures:* Documents provide evidence that certain transactions have occurred. Luckin inflated sales by creating fake customer orders. Good documentation procedures can help detect the orders that have never been actually placed and coupons that have never been redeemed.
B. *Segregation of duties:* Responsibility for receiving cash, checks, etc. from customers should be separate from the responsibility of employees to transfer funds for payment to the funding companies or the corporate accounts. Additionally the responsibility for bank reconciliations should be separate from the responsibility for authorizing or controlling transfers to funds from Luckin's bank accounts.
C. *Independent internal verification:* Internal auditors should continuously evaluate the effectiveness of Luckin's internal control procedures. Reconciliations and reviews of the business activities (sales, coupons, bank transfers, etc.) should be performed. Any discrepancies should be reported to a management level on a timely basis.
D. *Physical Controls:* Conducting timely and accurate physical inventory count/audit can help uncover the falsified transactions- the inflated number of fake orders will not be supported by the actual inventory turnover.
E. *Human resources controls*: Rotating employee duties and mandatory vacations will make it difficult to maintain the Fabricated Database; Conducting thorough background checks can help identify employees who were associated with those third-party entities involved in the fraud.

**Question 7:** Discuss the role of the company management and auditor in ensuring that financial statements are accurately presented. Who is primarily responsible for providing accounting information and preparing financial statements? What is the role of the external auditor?

**Solution 7:** Luckin's management is primarily responsible for providing accounting information and overseeing the preparation of various accounting reports including the financial statements. Company management has a responsibility to ensure the integrity and accuracy of the financial statements. The external auditor's job is to inspect and review the firm's financial statements and express an opinion on whether such statements are presented fairly in accordance with GAAP or IFRS. They also assess and evaluate the firm's internal control system.

**Question 8:** The fraud scheme at Luckin was widespread and many employees knew of the fraud and either helped perpetuate it or failed to report it. What are some of the options available to employees who observe unethical or illegal behavior and wish to report it?

**Solution 8:**

A. Several options for employees are outline in Luckin's Code of Business Conduct and Ethics (Luckin 2022), including an email account for whistleblowing: 1000@luckincoffee.com, reporting suspected loss, misuse of assets or theft to their manager and the Compliance Department or reporting fraud to the Director of Internal Audit or the Compliance Department. The Direct of Internal Audit is independent of management.

B. Report the suspected wronging directly to the Audit Committee of the Board of Directors. The chairman of the Audit Committee considers all allegations of fraud.
C. Report the suspected wrongdoing through the SEC's online Tips, Complaints and Referrals (TCR) system. Available at: https://www.sec.gov/tcr.

**Case Question Set B: Advanced Questions**

**Question 1:** Locate Luckin's Press Release made on July 1, 2020 regarding the completion of its internal investigation (you can find press releases on its website under News & Events). What did the company find regarding the fraud and what remedial actions did they take or plan to take?

**Solution 1:** Luckin found in its internal investigation that the fabrication of transactions began in April 2019. Both revenues and expenses were significantly inflated. It also disclosed that the former COO and CEO as well as certain employees participated in the fraud and that funds supporting the fraud were funneled to the company through related parties and third parties associated with Luckin's employees.

As remedial actions, the company:

A. Terminated former CEO and COO;
B. Required the Chairman of the Board to resign and be removed;
C. Would terminate 12 other employees who participated in, and/or had knowledge of, the fabricated transactions, including previously suspended employees;
D. An additional 15 employees were subject to other disciplinary actions;
E. Terminated relationships with all third parties involved in the fraud;
F. Implemented immediate enhancements to finance functions;
G. Engaged an internal control consultant to evaluate the existing controls and recommend enhancements to detect and prevent future misconducts;
H. Chartered an internal audit function to test and evaluate control functions;
I. Would strengthen ongoing compliance training to employees.

**Question 2:** Using YahooFinance, find the closing stock price of Luckin (ticker: LKNCY) for the dates below. Explain how Luckin's exaggerated earnings and subsequent fraud disclosure affected its stock price. Is this type of market manipulation unethical, illegal or both?

**Solution 2:**
*May 17, 2019* (IPO date): $20.38
*November 20, 2019* (Q3 financial results announced): $27.26
*January 14, 2020* (Secondary offering): $45.80
*January 17, 2020* (High price): $50.02
*April 2, 2020* (Day of fraud disclosure): $6.40
*June 26, 2020* (Last day of trading on Nasdaq): $1.38
*Today:* Answers will vary.

Luckin's exaggerated earnings inflated its stock price to a high of $50.02. By deceiving investors, Luckin was able to raise more money more quickly after its IPO through a follow-on equity offering and convertible bond issuance. Lucking knowingly and recklessly violated several securities laws and as well as professional and ethical standards.

**Question 3:** Find Luckin's registration statement (Form F-1) filed with the SEC in 2019.

A. What are the ownership percentages reported for the individuals that were terminated after the fraud was revealed (the Chairman, CEO and COO)?

**Solution 3:** Charles Zhengyao Lu (Chairman of the Board): 30%, Jenny Zhiya Qian (founder and CEO): 20% and Jian Liu (COO): options, no ownership.

B. When the fraud was first revealed, the COO was blamed and terminated. Founder and CEO Jenny Qian and Board Chairman of the Board Charles Zhengyao Lu denied any knowledge of the scheme. Given the above ownership information, do you think this is likely?

No, it is not likely. The Chairman and CEO owned 50% of the company and therefore had the most "skin in the game". It is unlikely such a large-scale fraud would have been committed without their knowledge. The COO Jian Liu had no ownership stake in the company, therefore he had less immediate financial motivation to commit fraud, although he could have benefited from the reputational effect of a successful company.

**Question 4:** Public companies incur additional costs for regulatory compliance to enter the marketplace (for example the costs associated with disclosure and governance requirements of SOX or compliance with PCAOB audits).

A. Describe some of the benefits of the increased regulation for public companies.
B. Explain why SOX or the PCAOB did not play a larger role in the Luckin case.

**Solution 4:**

A. Describe some of the benefits of the increased regulation for public companies:
    - Increased levels of investor confidence.
    - Less stock volatility, creating greater liquidity and improving a company's ability to raise capital.
    - Stronger internal controls, greater auditor understanding of those controls.
    - Fewer incentives and opportunities to commit fraud since companies are subject to greater fines/penalties. Company officers can be held personally responsible and face imprisonment if they fail to comply.

B. Explain why SOX or the PCAOB did not play a larger role in the Luckin case: SOX aims to prevent financial fraud and requires management to maintain an effective internal control system and certify accuracy of financial disclosures; Luckin's management would have been in violation of these provisions of SOX.

PCAOB oversees the external audit process by setting auditing standards and ensuring its compliance. During the time Luckin went public, U.S. regulators had difficulties monitoring financial reporting by foreign companies, due to fewer disclosure requirements for foreign issuers and a lack of access to necessary documentation. Due to political factors, Chinese issuers were exempt from compliance with SOX provisions. In addition, their audits did not come within the purview of the PCAOB. Investors in Luckin did not have the same level of protection that US issuers enjoy. These events contributed ultimately to the HFCAA.

**Question 5:** Research the recently passed Holding Foreign Companies Accountable Act (HFCAA) and explain how this Act is related to the Luckin case.

**Solution 5:** Sox requires the PCAOB to inspect the audits of all U.S. listed companies, including those located in foreign jurisdictions. However, for many years China has not been cooperative and has prohibited audit firms located in mainland China and Hong Kong from submitting audit work papers to the PCAOB because the local government believes that doing so would leak state secrets. Luckin's collapse led to renewed scrutiny of Chinese companies that sell shares on U.S. exchanges without adhering to the rules that require their audits be inspected by U.S. regulators, and facilitated the passage of the HFCAA. Under this new Act, the SEC can ban companies from trading and delist them if the PCAOB is unable to perform audit inspection for three consecutive years. The fallout associated with Luckin prompted fresh concerns about corporate governance in China.

**Question 6.** Discuss the role of the company management and the external auditor in fraud prevention and detection, including the limitations of each party. Explain in the context of the Luckin case.

**Solution 6:** Management and/or the governing body of the company are mainly responsible for preventing and detecting fraud. However, as per the U.S. auditing standards, auditors do have a responsibility to obtain reasonable assurance regarding whether the firm's financial statements are free from material misstatement, due to either error or fraud, and to appropriately identify, assess, and respond on fraud risks with due care and professional skepticism.

When performing audits, auditors first assess the internal control system of the firm and then rely on the information and documents produced and provided by the firm's accounting department and management. In Luckin's case, top managers were either directly involved in or had knowledge of the fraud, and even permitted/instructed certain employees to fabricate transactions. Some of the original accounting records were generated from a deliberately maintained Fabricated Database. This makes it difficult for auditors to identify evidence of fraud. In addition, auditors are generally not trained or paid to detect fraud. Thus, they may not have the incentives or ability within the scope of a regular audit to do so. In Luckin's case, it was Muddy Waters (a famous short-seller that would have profited from a drop of Luckin's stock price) who published the anonymous report that first triggered the questioning of Luckin's operations. This warning is what led to the fraud being uncovered by the auditor at that time.

**Question 7:** EY claimed that it had discovered Luckin's fraudulent activities during the annual audit of the 2019 financial statements, but instead of issuing an adverse opinion report, it chose to withdraw as Luckin's independent auditor. What do you think might be the reason?

**Solution 7:** EY's decision may have been driven by reputational and/or legal considerations – the angry investors may see it as Luckin's accomplice or at least blame the scandal on its inability to detect the fraud sooner, because EY was not only Luckin' auditor at the time of the fraud but also audited its 2017 and 2018 financial results which were included in the IPO Prospectus.

**Question 8:** After being delisted from Nasdaq, Luckin's stock continues to trade on the OTC market under a new ticker. Research the OTC market. Explain the advantages and disadvantages of OTC trading for Luckin and for investors.

**Solution 8:** OTC securities are securities that are traded directly between counterparts via a broker-dealer network instead of being listed on a formal exchange such as Nasdaq or NYSE. The OTC markets give smaller companies and companies that do not meet the requirements to be listed on a standard market exchange an opportunity to still trade their stocks. However, OTC trading is less regulated and requires less publicly available information.

For Luckin: Advantages: Less regulation, fewer filing requirements, less costly than major exchange.
Disadvantages: Less publicity and exposure, fewer potential investors, less liquidity, increased cost of capital.

For investors: Advantages: opportunity to invest in Luckin before it re-lists on a major exchange, lower costs to invest. Disadvantages: Less regulation, unaudited financial statements, lack of dependable publicly available information and transparency around company operations, growth, etc., increased risk of error and fraud.

**Question 9**: It appears that the regulatory structure in the US did not prevent this fraud. Why do foreign companies seek to list on NASDAQ? Discuss broadly NASDAQ listing requirements and why these failed to detect the fraud at Luckin prior to its IPO listing? What types of new controls should NASDAQ and other exchanges put in place to prevent these types of fraudulent activities and shore up investor confidence in its listings? What action should FINRA and the SEC take in this regard?

**Solution 9**: Students have the opportunity to critically explore NASDAQ listing requirements as well as the role of the SEC and other markets regulatory bodies like FINRA. Some key points include:

A. NASDAQ listings are much sought after by global companies as it facilitates superior liquidity, active trading and attractive valuations for growth companies.
B. In order to qualify for a NASDAQ listing, companies have to meet the threshold in at least one of the following areas (1) Income; (2) Market Capitalization and Cash Flow (3) Market Capitalization and Revenue; (4) Market Capitalization and Assets. [See https://listingcenter.nasdaq.com/assets/initialguide.pdf ]. NASDAQ listing requirements are primarily focused on liquidity and investor interest.
C. On NASDAQ listing requirements - these were originally developed in the context of U.S companies and markets. As such, its listing requirements complement the existing structure that regulates corporations and capital markets in the US. In 2020, following the Luckin Coffee experience, the NASDAQ filed a proposal with the SEC to tighten its listing standards for foreign issuers from a jurisdiction "that has secrecy laws, blocking statutes, national security laws, or other laws or regulations restricting access to information by regulators of U.S. listed companies." [See https://listingcenter.nasdaq.com/assets/rulebook/nasdaq/filings/SR-NASDAQ-2020-027.pdf ] The new proposals focus on greater liquidity requirements as well as higher accountability standards to qualify for listing. While this is a good step, it still may not have been sufficient to prevent the kind of fraud that the Luckin promoters perpetrated. NASDAQ governance rules like having a majority of independent directors on the board and an independent audit committee are not enforced for foreign companies, which are generally permitted to have their home country practice. From a business perspective, exchanges, as competitors for listings, have to adopt a cost-benefit perspective on listing controls. Most control systems unfortunately are not able to prevent all frauds.
D. On the role of the SEC - while the NASDAQ focuses on liquidity and the markets, the SEC monitors financial information and disclosure during the registration and review process. Foreign issuers have more leeway in this process – for instance, (1) they can use IFRS or US GAAP; (2) they only need to disclose aggregate rather than individual executive compensation. Thus, the SEC generally defers to the home country practice with regard to reporting requirements. Foreign issuers may have weaker corporate governance standards. Rules for US companies including SOX provisions are generally not required for foreign issuers. The SEC is responsible for overseeing the financial reporting and registration process. Any misstatements of financial information would come within the SEC's purview. In this case, the SEC investigated the company, charged Luckin with fraud and Luckin company had to ultimately pay a $180 million fine to settle the case.
E. FINRA oversees the broker-dealers involved in the IPO. It should investigate the brokers who served as underwriters for the Luckin IPO.

**Question 10**: Do you think that employees and others held responsible in the fraud should be personally held liable?

**Solution 10**: Luckin did fire the CEO and the COO, and suspended some key employees following the fraud being uncovered. But what about the rank-and-file employees who played along? This is a tougher call, and student responses may vary, so it should make for a good discussion. Key discussion points:

A. Organizational culture and tone at the top – employees may have felt compelled to go along and be a team player
B. For an employee, easy to rationalize with the "everyone around me is doing it" argument.
C. Employees may have perceived that their job success was correlated with putting up large revenue numbers.
D. Lack of governance and oversight made this easy.
E. The fraud appeared as a continuous loop – difficult to step off.
F. So, to an extent employees were a cog in the wheel. There must be a consequence for aiding in committing fraud. However, it is a difficult task for the US legal system to extend its reach to Chinese citizens.

**APPENDIX A: Advanced Level Explanation of Fraud Schemes**

**Luckin's Fraud Schemes:**

1. Luckin employees created fake customer accounts with their cell phone numbers and those of their family members and fabricated sales and coupon redemptions by these fictitious customers. Beginning in April 2019, certain Luckin employees transferred money from individual bank accounts to mobile accounts on WeChat and Alipay that were associated with the fake customer accounts. They used these transferred funds to make purchases on the Luckin app. The fake customer orders were placed in order to "redeem" coupons and fabricate sales, even though real orders were never placed and the coupons were never actually redeemed. Luckin recognized several million dollars of revenue from these fake customer transactions (SEC 2020a).

2. Starting in May 2019, Luckin created fake corporate accounts and used these accounts to fulfill fictitious bulk orders. All of the fictitious corporate accounts were controlled by or associated with Luckin employees or related entities. The corporate entities were all little-known, sham companies that transferred money directly to Luckin from a corporate Alipay account in order to purchase coupons on Luckin's app. Similar to the first scheme, the corporations placed fake retail orders, often in large amounts, to redeem coupons, which were recorded alongside bonafide voucher sales to regular corporate clients like airlines and banks (Yang, 2020a). Again, no real orders were placed for the companies, and the coupons were not redeemed. Luckin recognized tens of millions of dollars of sales this way, dwarfing legitimate purchases made during this period (SEC 2020a).

3. Beginning in 2019, Luckin entered into sham coupon purchase agreements with third-party shell companies. These shell companies were alleged to be intermediary agents that would resell coupons to individual customers. Certain Luckin employees were aware of the fraud and attempted to conceal the scheme by removing Luckin employees involved with the third parties (SEC 2020a). As part of the fraud, seven funding companies were utilized, including two of the fictitious corporate entities involved in the second scheme. These funding companies were controlled by (or associated with) Luckin employees and transferred money into Luckin's bank accounts. Luckin altered the bank statements to give the appearance that the funds were originating from the fictitious third party agents and not the funding companies. Following the transfer of funds, Luckin employees would generate fake coupons and fabricate coupon sales to the fictitious agents. Additionally, Luckin created more fake orders, to account for the individual customers who had supposedly purchased the coupons from the fictitious agents, in order to redeem the coupons. As above, real orders were never placed and the coupons were never redeemed. This scheme had the largest effect on Luckin's financial statements, fabricating more than $280 million dollars of sales.

Certain employees at Luckin were aware of the fraud and even maintained separate databases to track the fictitious and legitimate transactions. The "Business Operations Database" tracked legitimate coupon sales and redemptions, while the "Fabricated Database" included both legitimate and fabricated sales numbers. The same Luckin employees would switch the database used to generate reports, depending on what reporting was required. For example, Luckin's Finance Department only had access to the Fabricated Database and therefore unknowingly incorporated fictitious transactions into Luckin's financial statements.

The total amount of sales transactions associated with these schemes was at least $311 million from April 2019 to January 2020. During this time, Luckin was able to maintain the fraud scheme by recycling the funds from fabricated coupon sales back to the funding companies (controlled by or associated with Luckin employees) and fictitious corporate customers, using bank transfer and fabricated business-related expense payments to vendors (SEC 2020a).

**APPENDIX B: Advanced Summary of Aftermath**

After the misconduct was discovered, Luckin self-reported the fictitious sales and expenses to the SEC and cooperated with the investigation. The company "… promptly undertook significant remedial efforts", including additional internal investigations, terminating certain personnel and relationships with third parties and adding additional internal accounting controls (SEC 2020a).

Some of these efforts included terminating the Chief Executive Officer and Chief Operating Officer in May 2020, as well as overhauling the Board of Directors. The stock resumed trading on Nasdaq on May 20, but was shortly delisted due to "public interest concerns" as well as Luckin's failure to publicly disclose material information (Yang, 2020c). In July 2020, the Chairman of the Board was removed, and in September, Luckin was fined by China's top commerce regulator for its accounting misconduct (Yang, 2020b).

On December 16, 2020, the SEC charged Luckin with violating the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. The SEC Complaint alleges that Luckin intentionally and materially overstated its reported revenue and expenses, and materially understated its net loss in publicly disclosed financial statements in 2019, in order to give the impression of rapid growth and to meet/exceed analyst earnings expectations (SEC 2020a).

Luckin also violated the reporting, books and records and internal control provisions of the Exchange Act (SEC 2020b). Specifically, the company failed to make and keep books, records, and accounts which accurately and fairly reflected the transactions of the business. It also failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions were recorded as necessary to allow for preparation of financial statements in conformity with generally accepted accounting principles (GAAP) (SEC 2020a).

Luckin did not admit or deny the charges, but agreed to pay a $180 million fine to settle with the SEC. According to the current CEO, "This settlement reflects our cooperation and remediation efforts and enables the company to continue with the execution of its business strategy. The Company's Board of Directors and management are committed to a system of strong internal financial controls and adhering to best practices for compliance and corporate governance" (Luckin 2020b).

The impact of the scandal was widespread. Investors, including some extremely large and reputable institutional investors were stung by the financial loss. Luckin became another public failure for the Big Four - it had been audited by EY. The fraud also served as the trigger for political controversy around Chinese listed firms, leading to new legislation for all foreign-listed companies.

On February 5, 2021 Luckin filed for Chapter 15 bankruptcy in New York. Since then, it has slowly begun to recover its business operations. It has used the bankruptcy and reorganization to abandon some of its debt, shut down unprofitable and underperforming locations, and outsource the running of nearly 25% of its locations to third parties (Ghosh 2021). A $175 million class action settlement with shareholders was reached in October 2021 related to the fraud (Stempel, 2021). Luckin hired a new audit firm after EY resigned and recently filed its 2022 annual report with the SEC. The company continues to show signs of improvement and growth prospects, despite the fraud and pandemic (Luckin 2021). It currently trades on the OTC market under the ticker LKNCY and its market value has climbed back up to $3 billion.

## BIOGRAPHY

Devon Baranek is an Associate Professor of Accounting at Rider University. Her research appears in the *Journal of Accounting and Management*, *Journal of Forensic and Investigative Accounting*, *Managerial Auditing Journal* and *Current Issues in Auditing*. She is a CPA in Pennsylvania and teaches classes in financial and managerial accounting.

Nandini Chandar is Associate Professor of Accounting at Rider University. Her research appears in the *Journal of Accounting Research*, *Accounting Organizations and Society*, *Enterprise and Society*, *Accounting History*, *Review of Accounting and Finance* and *Global Perspectives on Accounting Education*.

Sherry F. Li is an Associate Professor of Accounting at Rider University. Her research appears in journals such as *Accounting & Taxation*, *International Journal of Auditing*, *Research in Accounting Regulation, International Journal of Business and Finance Research,* and *Review of Accounting and Finance.*