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Self-rescue for Financial Fraud Companies

-- Take Luckin Coffee as an Example

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Abstract

During the 2020 epidemic, Luckin Coffee revealed that it had forged a transaction volume of up to 2.2 billion yuan in the last three quarters of 2019, and also inflated its sales volume, expenses and costs. This caused an uproar and the stock was suspended multiple times during the session. , the market value shrank to US$1.6 billion in one day. Just when people thought that Ruixing was about to go bankrupt, Ruixing saved itself and achieved a turnaround. Its self-rescue methods and processes are worthy of reference by Chinese enterprises. This article takes Ruixing as an example, analyzes Ruixing's self-rescue process, and explores the company's self-rescue path.

Keywords

Financial Fraud; Risk Response; Corporate Governance.

1. Background

1.1. Luckin Coffee is Listed on the Market

Luckin was founded by Qian Zhiya, the former COO of UCAR. He discovered that coffee has a huge market in China, so he founded this coffee brand in Xiamen. Luckin Coffee opened its first internal test store on the first floor of its China headquarters in 2017, and opened its first external test store in Beijing Galaxy SOHO that same month. Since then, the company has expanded rapidly, and as of December 2019, the number of stores has reached nearly 5,000. After receiving investments from Dazheng Capital and Joy Capital, Luckin's market value has reached US$1 billion. By the end of 2018, Luckin Coffee's publicly disclosed annual report showed that the net loss reached 1.6192 billion yuan. Eighteen months later, Luckin was listed on NASDAQ in the United States, becoming the fastest Chinese startup to go public. One of the key factors behind this rapid listing is that Luckin Coffee has adopted the business model of a mobile Internet enterprise, emphasizing technology drive and data core, selling coffee through the Internet, adopting online and offline collaborative marketing strategies, and online through mobile applications. Make a reservation, and then the offline store will deliver it. In essence, Luckin Coffee belongs to a new type of O2O (online to offline) retail business model. After listing, Luckin Coffee's share price continued to rise in the capital market. This excellent capital market performance and rapid expansion attracted 64 new institutional investors in the fourth quarter of 2019, pushing the share price to more than 50 US dollars, and the market value was once reached $12.3 billion. In addition, in January 2020, Luckin Coffee conducted a round of additional financing of more than US$1.1 billion. This series of figures and growth rate are undoubtedly impressive. In terms of product market, it only took 2 years for Luckin Coffee to open more branches in China than Starbucks.

1.2. Financial Fraud

According to the data disclosed in the prospectus, in 2018, Ruixing Coffee's annual revenue was 841 million yuan, but its net loss was as high as 1.619 billion yuan, and the company's shareholders' net loss reached 3.19 billion yuan. If calculated according to this trend, Luckin

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Coffee’s average daily loss is about 4 million yuan. In the last three quarters of 2019, Luckin's operating conditions suddenly improved. At the end of January 2020, Muddy Waters released an 89-page short selling report, including the following aspects:

(1) False sales performance: Ruixing used various means to inflate its revenue, which may have been 69% in the third quarter of 2019 and 88% in the fourth quarter. This method of inflating sales revenue includes fictitious orders, exaggerating the actual selling price of each item, excessive publicity expenses in the third quarter of 2019, fictitious revenue from other products, etc. Of particular concern is that Luckin Coffee’s “orders per capita” fell from 1.38 in the first quarter to 1.14 in the fourth quarter.

(2) Complex related-party transactions: Luckin’s management’s high proportion of stock pledges means that company executives pledge a large number of shares as collateral to financial institutions to obtain funds, thus causing certain financial risks. In addition, Lu Zhengyao and a group of equity investors closely related to the company cashed out US$1.6 billion from China Car Rental, indicating the existence of potential equity transfer and cash outflow issues. On the other hand, through the acquisition of Borgward Auto, Ruixing transferred funds to entities related to the company, triggering scrutiny of related party transactions. Finally, absorbing a large amount of company cash in the name of "unmanned retail" indicates that the company may be at risk of funds being misappropriated. This is also one of the related-party transactions that requires careful review.

(3) The questionable nature of the business model: This part includes the following points: 1) China’s coffee consumption is dominated by tea, so China’s functional coffee product market is not large; 2) Luckin Coffee’s Customers are relatively price-sensitive, and it is not practical to increase revenue by reducing prices; 3) Luckin Coffee’s customers are not very loyal to the brand.

After Luckin announced its short-selling report in Muddy Waters, its stock plummeted, causing investors to worry about the market. However, Luckin refuted the rumors, causing the stock price to return to normal levels. However, Luckin publicly denied Muddy Waters’ accusations, causing the stock price to return to normal levels. However, a series of investigations later revealed Luckin Coffee’s fraud. Some law firms filed a class action lawsuit against Ruixing. At the same time, according to the SEC's request, Ruixing Coffee began a self-examination. Ernst & Young has taken important steps. Ernst & Young began an on-site review of Luckin's financial report for fiscal year 2019 a year ago. He noticed that Luckin has been providing it with large B-side customers since the second quarter of 2019. This huge shift from C-side users to B-side major customers has caused great concern and doubt among Ernst & Young's audit team. Ernst & Young immediately dispatched an anti-fraud legal and accounting team of more than ten people to conduct an in-depth investigation into Luckin and discovered that it had used large customers to purchase coffee coupons in large quantities on the B-side.

After Ernst & Young obtained evidence that the new B-side customer was related to Ruixing, it immediately reported the situation to Ruixing's audit committee. According to relevant regulations, if Ernst & Young informs the board of directors that there is major financial fraud in Ruiyuan, but the board of directors does not immediately initiate a fraud investigation process and report to the SEC, according to regulations, Ernst & Young will directly report the financial fraud it discovers to the SEC.

On April 2, 2020, Luckin Coffee issued an announcement indicating that it had falsely reported sales of approximately RMB 2.2 billion in the last three quarters of 2019, and indeed had financial fraud. This news directly led to Luckin’s delisting and ongoing Liquidation.

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2. Self-rescue

Just when people thought that Luckin Coffee would disappear from the scene, after two years of reform, Luckin Coffee not only did not declare bankruptcy, but bucked the trend and rose, changing its fate that was originally on the verge of bankruptcy. This successful self-rescue process is inseparable from the adjustment and firm determination of the company's internal management.

(1) Dual adjustments of the board of directors and management: After the financial fraud incident broke out, Luckin Coffee's internal management changed. In addition to Lu Zhengyao's series of investors, other shareholders including Dazheng Capital, Joy Capital and Legend Capital, especially Lu Zhengyao's senior executives, lost trust within the group and therefore conducted an important round of restructuring. Ruixing held its shareholders' meeting and board of directors respectively in July 2020. The board of directors voted that Guo Jin, the former administrative director and director of Ruixing Coffee, would serve as the company's chairman and CEO, replacing the former management. During this period, Dacheng Capital acquired The shares held by Lu Zhengyao and his management team made Dazheng Capital the company's controlling shareholder. At this time, Lu Zhengyao had completely withdrawn from the company's board of directors.

(2) Actively settle with the SEC: In December 2020, the US Securities and Exchange Commission stated that Ruixing had agreed to pay US$180 million in compensation to quell accusations of financial fraud. The next day, Luckin said it was actively promoting a $180 million settlement agreement with the U.S. Securities and Exchange Commission and was awaiting court approval. After Ruixing announced that it would pay US$180 million to the US Securities and Exchange Commission on February 5, 2022, the company reached a settlement with the US Securities and Exchange Commission on this issue. Although Luckin did not admit or deny the accusations made by the regulatory authorities in its solution, such results also show that it is willing to cooperate with the regulatory authorities and can continue to implement its business strategy with appropriate corrective measures.

(3) Complete debt restructuring: On February 5, 2021, Ruixing submitted a bankruptcy application to New York, and later signed an agreement with its creditors to support debt restructuring. In addition, the company received financing from Dazheng Capital and Joy Capital for debt restructuring and SEC settlement. The company also signed a settlement agreement with the plaintiff, including a settlement amount of US$187.5 million. With the support of creditors, Luckin successfully completed debt restructuring and ended bankruptcy protection.

(4) Internal management disputes

On January 6, 2021, an anonymous user posted on Maimai that Ruixing's senior executives jointly signed a request to remove the current company chairman and CEO Guo Jinyi from his position. The open letter listed Guo Jinyi's many "crimes" such as abuse of power, layoffs, and layoffs. At the same time, it was pointed out that "Guo Jinyi has neither virtue nor ability, and the company has fallen into an existential crisis." Li Jun, vice president of Ruixing, was listed as one of the signatories of the joint letter. He claimed that he had strong evidence proving Guo Jinyi's corruption. Industry insiders analyzed that this joint letter was probably organized by Lu Zhengyao, Qian Zhiya and others, aiming to regain control of the company.

At noon on January 6, Guo Jinyi, chairman of Ruixing Company, issued an open letter in response to this and gave another explanation. He said that this report was organized and launched by Lu Zhengyao and Qian Zhiya on January 3, and some unknowing employees were forced to sign it. He immediately asked the board of directors to form an investigation team to conduct a comprehensive investigation of the entire incident, and promised not to interfere with the work of the investigation team. He claimed that everything he did while in office was justified. He also emphasized that the company's current business is stable and its revenue continues to grow.

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This is not what some people who have participated in corporate fraud want to see. He also asked the board to investigate the initiator of the whistleblower letter and the motives behind it. The board of directors of Luckin issued a statement on the evening of February 17, 2022, saying that its investigation team had interviewed more than 40 executives, including employees who signed the joint statement, and reviewed more than 50,000 transaction documents, but found no Guo Jinyi, who was mentioned in the joint letter, showed no signs of misconduct. The statement also mentioned that the investigative team had discovered that several former managers were involved in planning the joint letter. Guo Jinyi won the executive dispute, and the board of directors promised to continue to support Guo Jinyi and his team and continue to promote the company's long-term development strategy.

After the above reorganization, Luckin Coffee divided its structure into three layers: the front-end is the growth line and the operation line, the middle-end is the technology department, product line and business analysis department, and the back-end is the external cooperation line, finance line, and personnel , four lines of compliance. This personnel change also involves many executives who participated in the joint letter.

Ruixing issued a statement on the evening of December 13, 2021, saying that it voted on a number of resolutions at the shareholders' meeting, including modifications to the "Shareholders' Equity Plan", "Memorandum of Association" and "Articles of Association". The resolution will impose strict restrictions on the transfer of shares of former managers in bankruptcy as well as their voting rights. Once these resolutions take effect, Luckin Coffee shareholders will not be able to transfer company shares to restricted individuals, and restricted individuals will not be able to transfer company shares or exercise their voting rights on company shares. The resolution was seen as necessary to prevent the return of former management who had been involved in the company's fraud. On January 27, 2022, Dacheng Capital announced that the buyer led by it had successfully acquired some shares of Ruixing Coffee, and the former manager of Ruixing Company, Lu Zhengyao, and his associates had completely withdrawn from Ruixing Coffee. Withdraw.

(5) Result: Luckin’s financial performance improved

Luckin released its financial report for fiscal year 2021 on the evening of March 24, 2022. The performance in fiscal year 2021 can be said to be remarkable. For the whole year of 2021, Luckin Coffee achieved total revenue of 7.97 billion yuan, a year-on-year increase of 97%. The gross profit margin is 60%; Ruixing Coffee has not achieved profitability in 2021, but compared with the same period last year, operating losses have narrowed by 80%, which was 2.59 billion yuan in the same period last year.

As of the end of 2021, Luckin Coffee has a total of 6,024 stores nationwide. In the fourth quarter of 2021, the growth rate of Luckin's self-operated stores slowed down slightly, and the sinking market became the main source of Luckin Coffee's new stores. In the first half of 2021, the third quarter of 2021 and the fourth quarter of 2021, each Luckin Coffee franchisee brought an average income of 59,000 yuan, 95,000 yuan and 92,000 yuan to the headquarters. These revenues mainly come from sales of raw materials, equipment sales and profit sharing. Although profit sharing accounts for only a small portion, sales of raw materials remain the main source of revenue. According to previous estimates, all Luckin Coffee franchise stores are basically in a state of slight profit, so the current profit sharing is relatively small. From the first quarter to the third quarter of 2022, this number has maintained a continuous growth trend.

3. Enlightenment

The financial fraud incident of Luckin Coffee exposed the problems in the listing review and supervision of Chinese overseas listed companies. Luckin Coffee’s financial irregularities became the trigger for the crisis. Without these financial fraud loopholes, Muddy Waters would

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not have the opportunity to short Luckin. However, Luckin Coffee is not the first company in China to be shorted, which reflects that the listing process of companies listed outside China may have many flaws and non-compliances. In order to solve these problems, this article believes that it is necessary to carry out reforms from the following aspects:

3.1. Strengthen Sino-US Joint Supervision

In response to Luckin's fraud, the China Securities Regulatory Commission, the Ministry of Finance and the State Administration for Market Regulation have launched a series of investigations into Luckin Coffee's domestic operating entities, affiliated companies and related third-party companies. At the same time, under the cross-border supervision mechanism of international financial regulatory agencies, we actively cooperate with US regulatory agencies to carry out cross-border supervision. At the same time, we will strengthen exchanges and cooperation with international securities regulatory commissions such as PCAOB and SEC, and explore cross-border regulatory cooperation mechanisms to deal with regulatory risks in different countries and regions.

3.2. Improve Internal Management Structure and Implement Risk Management

Luckin Coffee actively carried out internal rectification after the financial fraud incident and established a "three lines of defense" risk management structure, which has achieved remarkable results, which is worth learning from other Chinese companies. The first line of defense is Luckin's business departments, which are responsible for implementing specific company goals; the second line of defense is composed of Luckin's legal department, quality management department, information security department, internal control and compliance department and other departments; the third line of defense includes Luckin's internal audit includes the Internal Audit Department and Compliance Supervision Department. Governance and senior management supervise each other, divide risk management responsibilities according to the division of responsibilities of each department, and ensure that each line of defense works around risk management objectives, and the responsibilities of each level are clear and mutually coordinated.

3.3. Promote Registration System Reform

In 2018, Chinese President Xi Jinping announced the establishment of the Science and Technology Innovation Board and promoted the point-based registration system reform. This reform will help accelerate the construction of the capital market system, improve the efficiency of the supply system, promote the advancement of pilot projects, improve relevant policies and regulations, protect the vital interests of small and medium-sized shareholders and other investors, ensure that the reform is forward-looking, and do a good job in both new and old projects. System connection to prevent problems when switching systems.

3.4. Strengthen Supervision of Financing Entities

The problem of financial fraud is not uncommon. This phenomenon has not only been common in the past, but may also be difficult to eradicate in the future. The fundamental reason is that the cost of financial fraud is relatively low, and the profits are far greater than the possible penalties. At the same time, the counterfeiters have a certain sense of luck. Taking the United States as an example, the penalties for securities fraud crimes are relatively severe. Natural person criminals may be sentenced to up to 20 years in prison, or fined not to exceed $5 million, or both; non-natural persons may face fines of up to $25 million. In contrast, China's penalties are relatively low. In the future, it will be necessary to strengthen the supervision of financial fraud, establish a sound criminal penalty system, and lower the threshold of punishment to prevent companies from intentionally committing financial fraud, thereby fundamentally eliminating the occurrence of fraud. In addition, the combination of civil and criminal penalties

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should be strengthened, and the introduction of third-party supervision mechanisms should be actively explored to enrich the regulatory tools of the capital market.

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