Investing in a Foreign Startup Company: Luckin Coffee Inc.

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Many foreign companies, particularly from emerging markets, have been listed on the US stock markets as a form of American depositary receipt or share (ADRs or ADS) in recent years. Although those US-listed foreign stocks provide a great opportunity for domestic investors to diversify their portfolios, they could also add additional risks to investors unfamiliar with those companies' business strategies, corporate governance, investor protection, and accounting or audit practices in their home countries. In this case, we introduce Luckin Coffee Inc., a Chinese startup coffeehouse chain that went public on the Nasdaq in 2019. This case aims to guide students in evaluating a foreign startup company's investment by examining its business strategies, operating performance, corporate governance, and auditing practices when limited company history and financial data are available. It also allows students to research companies' filings to identify useful information for investment decisions.

Keywords: emerging market, cross-border listing, ADR, financial reporting, corporate governance, international auditing, PCAOB

INTRODUCTION

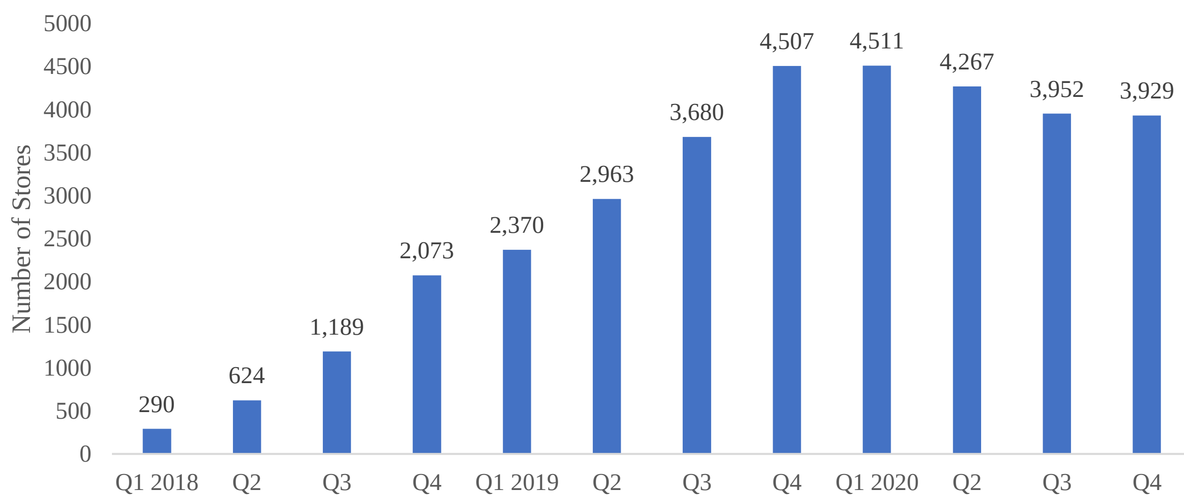
As a security analyst at Invesco Corporation, Andrew Hays, along with his colleagues, analyzed financial statements to identify investment opportunities and made recommendations on company stocks. In April 2019, he observed that a Chinese startup, Luckin Coffee, had filed an Initial Public Offering (IPO) with the Securities Exchange Commission (SEC) to list on the Nasdaq. He noted that, according to various reports and news sources, the company had been expanding rapidly since its inception and had the potential to surpass Starbucks as China's largest coffee chain. Moreover, investors seemed enthusiastic about investing in Chinese stocks in recent years, as evidenced by the market value of US-listed Chinese stocks reaching $1.2 trillion in 2019. However, regulators and institutional investors often expressed concerns about US-listed companies, citing issues such as lack of transparent disclosure and weak corporate governance, which could increase investment risks.

After discussing with his manager, Joseph Corey, Andrew was tasked with conducting a thorough analysis of Luckin Coffee. This analysis would include the company's strategies, operating performance, and potential issues and risks associated with investing in Luckin Coffee, to be detailed in a report.

COMPANY BACKGROUND

Luckin Coffee Inc. is a Chinese coffee company and coffeehouse chain. The name 'Luckin' *(ruixing* in Chinese) symbolizes 'happiness' and 'luck.' Established in 2017, the company rapidly expanded following the opening of its first trial store in October 2017. Within just 15 months, it opened more than 2,000 self-operated stores across 28 major cities, becoming the second-largest coffee chain in China. According to Luckin's registration filing, the company sold nearly 90 million cups of coffee and other products, attracting over 12.5 million transacting customers in 2018 alone. Its revenue saw a significant increase, soaring from RMB 250,000 ($36,000) in 2017 to RMB 840 million ($122.27 million) in 2018, compared to Starbucks, which operated 3,521 stores with revenue of $2,355.8 million in China in the same year.

FIGURE 1
NUMBER OF LUCKIN COFFEE STORES



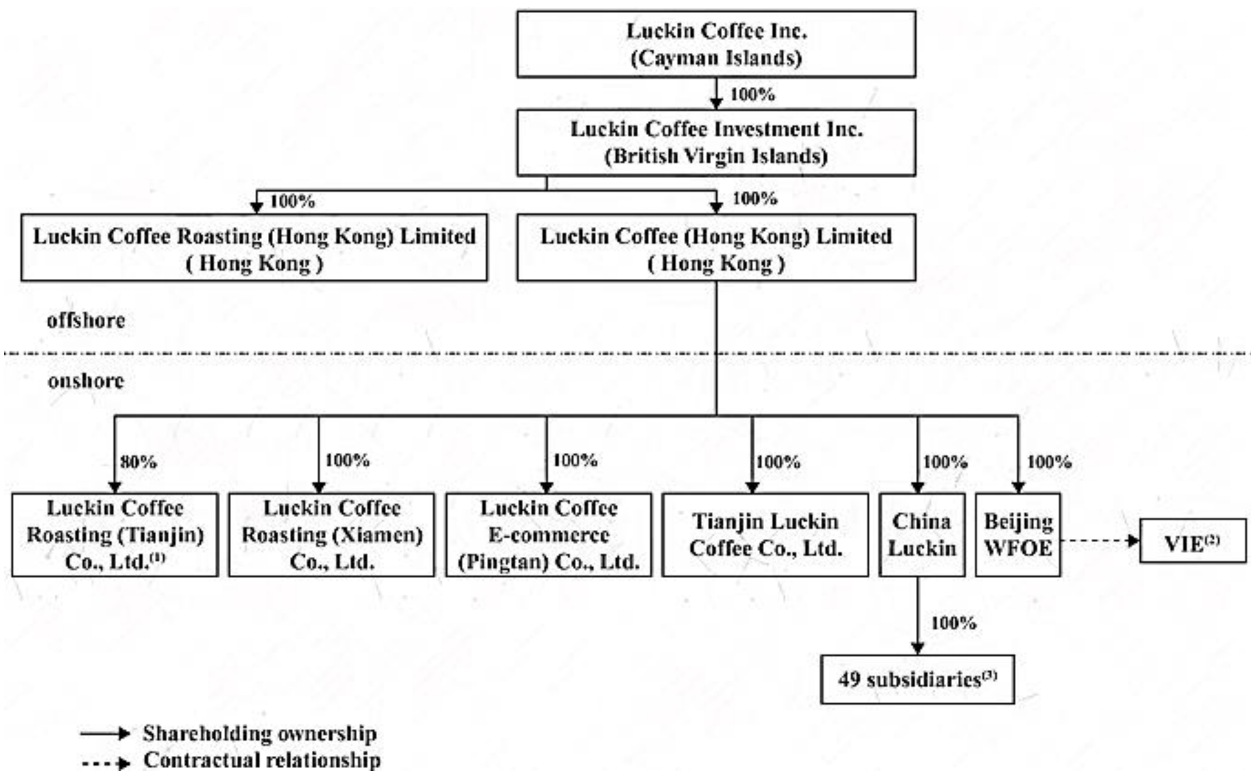
Source: Luckin's filling, 2019

In April 2019, the company filed with the SEC and announced its plan to list on the Nasdaq. The underwriters for Luckin's IPO included Credit Suisse, Morgan Stanley, China International Capital, and Haitong. On May 17th, Luckin completed its US initial public offering, priced at $17 per share in the form of American Depositary Shares (ADSs), and raised $645 million after fully exercising the greenshoe option, valuing the company at over $3 billion. To strengthen its market-leading position, Luckin ventured into the smart coffee and snack vending machine market. This expansion introduced 'Luckin Coffee EXPRESS' and 'Luckin Pop Mini', targeting locations such as office buildings, campuses, airports, bus terminals, gas stations, highway service stations, and communities. These new offerings are intended to complement Luckin's existing retail store network.

CORPORATE STRUCTURE

Luckin was incorporated as an offshore holding company in the Cayman Islands in June 2017. Simultaneously, it established Lucin Coffee Investment under the laws of the British Virgin Islands as the wholly-owned subsidiary of Luckin Coffee Inc., serving as an intermediate holding company to facilitate financing. Additionally, a Hong Kong subsidiary, Luckin Coffee Limited (Hong Kong), was set up as a wholly-owned subsidiary of Luckin Coffee Investment. Later in the year, Luckin Hong Kong established Beijing Luckin Coffee Co., Ltd. (Beijing WFOE), Tianjin Luckin Coffee Co., Ltd., and Luckin Coffee (China) Co., Ltd., or China Luckin, as its wholly-owned subsidiaries in China to commence the operation of a retail coffee business.

FIGURE 2
LUCKIN CORPORATE STRUCTURE



(1) Forever Growth Enterprise Ltd., one of our roasted coffee bean suppliers, held The remaining 20% equity interest in Luckin Coffee Roasting (Tianjin) Co., Ltd.
(2) Our director and chief executive officer, Ms. Jenny Zhiya Qian, and one of our employees, Mr. Min Chen, hold 83.33% and 16.67% of the equity interest in the VIE, respectively.
(3) As of the date of this prospectus, China Luckin has 49 direct and indirect wholly-owned subsidiaries, mainly operating as a coffee network.
Source: Luckin's filling, 2019

The structure of Luckin Coffee represents a typical Chinese Variable Interest Entity (VIE) business model. VIE originated from the Financial Accounting Standards Board's interpretation of Accounting Research Bulletin No. 51, which requires a parent company to consolidate a subsidiary if it has a controlling financial interest. Unlike the traditional approach based on ownership or legal authority control, the primary purpose of consolidating a VIE is to prevent corporate fraud, like the Enron scandal, which involved hiding debts and assets from financial disclosures through Special Purpose Entities (SPEs). In recent years, many China-based companies have adopted this structure to go public in the United States, circumventing the Chinese government's restrictions on foreign direct ownership and investment in certain industries.

In a typical Chinese VIE company, the founders of the Chinese operating company establish a shell company or SPE in the Cayman Islands or the British Virgin Islands as a financial vehicle to raise capital. This offshore company then establishes a wholly-owned Hong Kong subsidiary, which in turn sets up a Wholly Foreign-Owned Enterprise (WFOE) in China. Through a series of contractual arrangements between the WFOE and the Chinese operating company, the WFOE effectively controls the operating company by owning a major equity interest in the VIE. This contractual ownership allows the offshore holding company to consolidate the financials of the Chinese operating company into its statement, in compliance with GAAP regulations. Under this structure, the offshore company can provide capital to the Chinese operating company, and the profits can be transferred or paid back to the WFOE, and eventually to the offshore company, according to the signed contracts.

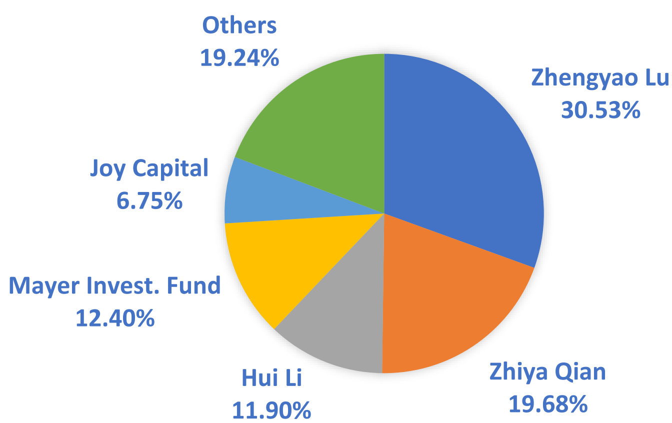
BOARD OF DIRECTORS AND STOCKHOLDER OWNERSHIP

Jenny Zhiya Qian and Charles Zhengyao Lu founded Luckin Coffee. Mrs. Qian served as the executive vice president and chief operating officer for CAR Inc. from 2014-2016 and as director and chief operating officer for UCAR Inc. from 2016-2017. Since Luckin's inception, she has been a director and became the CEO in November 2017.

Mr. Lu is a renowned Chinese businessman and entrepreneur. He founded several companies, including DITEL Technology, Beijing Huaxia, and UAA (a joint Automobile Club akin to AAA) in the early 2000s. He also founded CAR Inc., a publicly-listed Hong Kong company, in 2007 and served as its chairman and CEO. After CAR Inc.'s successful IPO in 2014, he established UCAR Inc. and served as its chairman and CEO before becoming Luckin's chairman in June 2018.

Before going public, Luckin's board consisted of eight members, including Jenny Qian Zhiya and Charles Zhengyao Lu, two executives, and two independent directors. The company's primary stockholders were Lu's family, owning 30.53%, Qian's family (Summer Fame Limited) with 19.68%, and Centurium Capital holding 11.90% of the shares.

FIGURE 3
LUCKIN PRINCIPAL SHAREHOLDERS' OWNERSHIP BEFORE IPOS

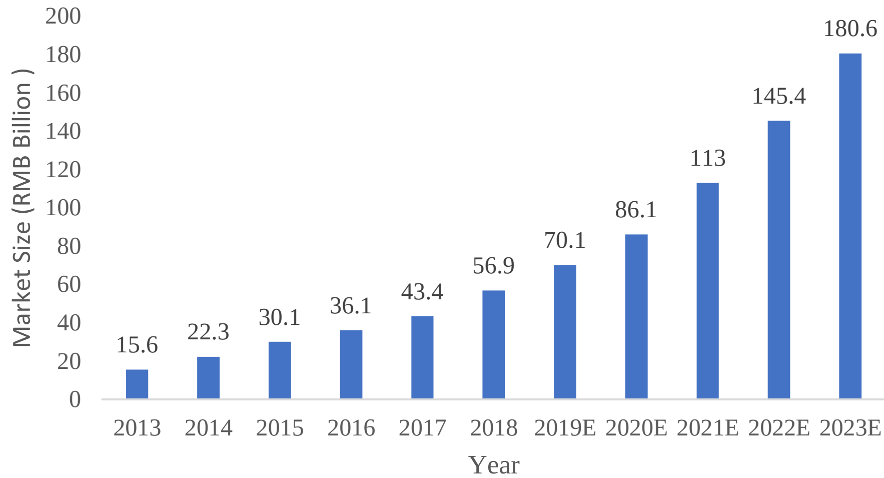


Source: Luckin's registration filling in 2019

Chinese Coffee Market

Coffee was first introduced to China in the late 19th century (IOC report, 2015), but coffee production and consumption remained limited for more than a century, overshadowed by China's profound tea-drinking culture. The coffee market began to emerge in the 1980s alongside the globalization of China's economy. According to a report by Frost & Sullivan, the retail size of the coffee market grew from RMB 15.6 billion in 2013 to RMB 56.9 billion in 2018. The market is projected to expand to RMB 180.6 billion by 2023, representing an annual growth rate of 26%. The report also indicates that coffee consumption increased from 4.4 billion cups in 2013 (approximately 3.2 cups per capita) to 8.7 billion cups in 2018 (about 6.2 cups per capita) and is expected to reach 15.5 billion cups (10.8 cups per capita) by 2023.

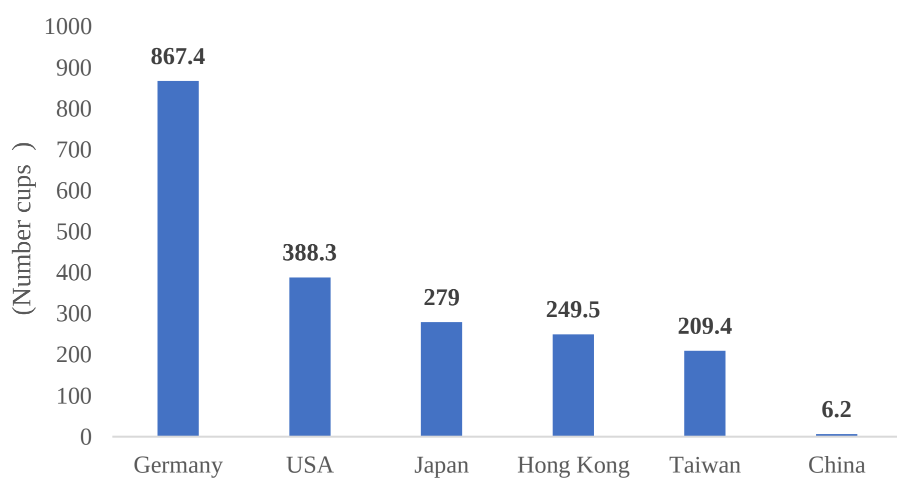
FIGURE 4
CHINESE COFFEE MARKET



Source: Frost & Sullivan Report from Luckin's registration filling in 2019

Although the coffee market is booming in China, coffee consumption there is still relatively low compared to other developed countries. In 2018, the average consumption in China was 6.2 cups per capita. This is in contrast to Taiwan with 209.4 cups, Hong Kong with 249.5 cups, Japan with 279 cups, the United States with 388.3 cups, and Germany with a high of 867.4 cups per capita.

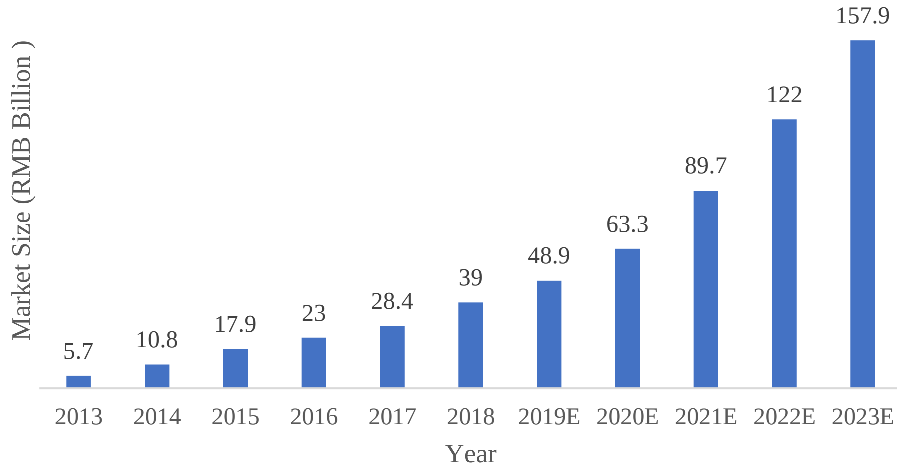
FIGURE 5
PER CAPITA COFFEE CONSUMPTION IN 2018



Source: Frost & Sullivan Report from Luckin's registration filling in 2019

While instant coffee continues to dominate the Chinese coffee market, the freshly brewed coffee segment has seen significant growth over the last 20 years, especially since Starbucks opened its first store in China in 1999. The retail sales of freshly brewed coffee have increased from RMB 5.7 million in 2013 (0.3 cups per capita) to RMB 39.0 million in 2018 (1.6 cups per capita). This figure is expected to rise to RMB 157.9 million by 2023, equating to approximately 5.5 cups per capita.

FIGURE 6
CHINA'S FRESHLY BREWED COFFEE MARKET

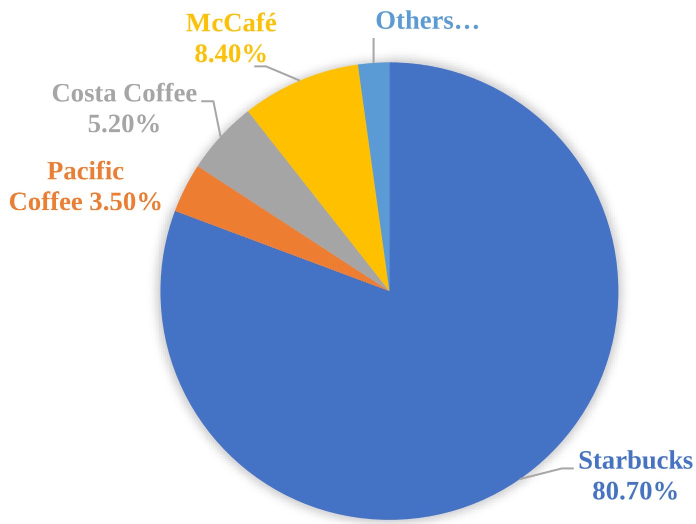


Source: Frost & Sullivan Report from Luckin's registration filling in 2019

Many analysts believe the Chinese freshly brewed coffee market has potential for further growth, driven by the explosive growth of the emerging middle class, particularly millennials, who make up a quarter of China's current population. This demographic has more disposable income and is more open to Western culture (Christina McInulty, 2021). Freshly brewed coffee is increasingly seen as a symbol of lifestyle. In contrast to Taiwan (83.3%), the United States (80.7%), and Japan (63.1%), where freshly brewed coffee constitutes a significant portion of total coffee consumption, the ratio in China was only 25.0% in 2018. Luckin attributed this low penetration rate to the 'inconsistent quality, high prices, and inconvenience' of freshly brewed coffee in China.

With this strong demand, competition in China's freshly brewed coffee market is intensifying. The number of coffee shops in China surged to over 100,000 in 2017, up from fewer than 16,000 in 2007 (Zhao, 2018). Starbucks, which entered China in 1999 at the World Trade Building in Beijing, is the largest coffee chain in the country. By 2018, it operated over 4,100 stores in 141 cities, making China its fastest-growing market. In an interview, CEO Kevin Johnson stated that Starbucks planned to have over 6,000 stores by 2022. Other major coffee chains in China include Taiwan's UBC Coffee, McDonald's McCafé, Britain's Costa Coffee, Hong Kong's Pacific Coffee, the Chinese chain C.straits Café, and South Korean brands Caffé Bene and Hollys Coffee. Additionally, global brands like Tim Hortons and Peet's Coffee have announced plans to expand their operations in China in 2017 and 2018.

FIGURE 7
MARKET SHARE OF CHINA'S FRESHLY BREWED COFFEE BY BRANDS IN 2017



Source: Finance Time "First Chinese coffee shop unicorn raises $200m to take on Starbucks" by Tom Hancock, July 11, 2018 https://www.ft.com/content/e0121820-84ca-11e8-96dd-fa565ec55929

COMPANY MISSION AND STRATEGY

Luckin Coffee's mission is to become a part of everyone's daily life, starting with coffee. The company aspires to establish a Chinese-based coffee chain that delivers high-quality, affordable, and convenient coffee and other products. In its roadshow document, Luckin positioned itself as a hybrid business model, combining elements of Starbucks, 7-Eleven, Costco, and Amazon. More specifically, Luckin aims to provide Starbucks-quality coffee and food, 7-Eleven's accessible channels, Costco's attractively priced product selection, and Amazon's technology-driven one-stop shopping experience (CKN, 2020). This strategy is designed to fulfill the large unmet demand for coffee and drive its mass-market consumption in China, achieving significant scale and growth in a short period.

Although customers often perceive Luckin as a coffee chain in the restaurant segment, Luckin identifies itself as a technology-driven, new retail business. As per Luckin's registration documents, its business model is anchored in mobile apps and store networks.

While other coffee shops like Starbucks focus on building customer experiences centered around social interactions in a café-style environment, Luckin cultivates its customer experience through self-ordering mobile apps with exclusively cashless transactions. All orders at Luckin must be placed through its mobile apps, whereas ordering via the app is optional and less common for Starbucks customers in China. Luckin believes that its 100% mobile order and cashless payment model simplifies operations, standardizes processes, and aids in engaging customers. It also enhances products and services and customizes sales and marketing efforts for each customer by leveraging big data and AI analytics.

FIGURE 8
LUCKIN COFFEE VISION AND MISSION

Source: Luckin Coffee roadshow slide from the book *Luckin Coffee Blitzkrieg* by Shuaibo Shen

Another strategic approach Luckin employs to expand its business rapidly is its diverse store network, which includes pick-up stores, relaxation stores, and delivery kitchens. The company initially built delivery kitchens, where customers can place orders via the mobile app and have coffee delivered directly to them for a 6 RMB (less than $1) fee with a 30-minute delivery guarantee. This business model offers two key advantages: significant reductions in rental and decoration costs, as these 'stores' can be set up quickly in small spaces inside office buildings or off the main streets, and the generation of mass transaction data from mobile orders, which assists the company in identifying demand hotspots. Once market demand is confirmed, Luckin tends to replace delivery kitchens with pick-up stores. These stores, measuring around 20-60 square meters (215-645 square feet), are strategically located within 500 meters of high-demand areas like office buildings, commercial zones, and college campuses. They provide limited seating primarily for online order pick-up and delivery services. Luckin also operates relaxation stores for a more casual, sit-down coffee experience as part of its branding strategy. With its mobile apps and store network, Luckin believes this new retail business model provides them with a competitive edge over rivals like Starbucks. In an interview, Eric Gui, Senior Vice President of Luckin, stated, 'The old way is people looking for coffee. With us, coffee finds them'.

FIGURE 9
LUCKIN COFFEE STORES BY TYPE

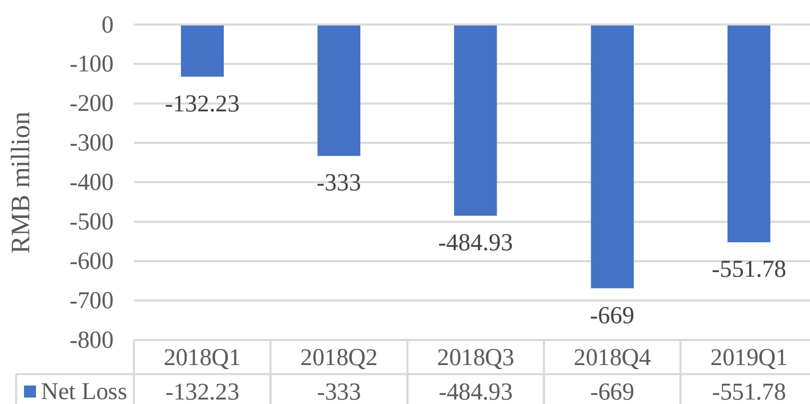
	Dec. 31, 2017		Mar. 31, 2018		Jun. 30, 2018		Sep. 30, 2018		Dec. 31, 2018	
	# of Stores	% of stores	# of Stores	% of stores	# of Stores	% of stores	# of Stores	% of stores	# of Stores	% of stores
Pick-up stores	4	44.4%	83	28.6%	356	57.1%	903	75.9%	1,811	87.4%
Relax stores	5	55.6%	15	5.2%	22	3.5%	45	3.8%	86	4.1%
Delivery Kitchen	0	0.0%	192	66.2%	246	39.4%	241	20.3%	176	8.5%
Total stores	9	100.0%	290	100.0%	624	100.0%	1,189	100.0%	2,073	100.0%

Source: Luckin's registration filling in 2019

Luckin implemented several marketing strategies to accelerate its growth. First, Luckin emphasized its use of premium Arabica coffee beans from renowned suppliers, with its coffee receiving numerous accolades, including a Gold Medal in the 2018 IIAC International Coffee Tasting competition. To build customer trust, Luckin allows customers to watch the coffee-making process in real-time through its mobile app. Second, Luckin focuses on competitive pricing. Although the demand for coffee is increasing in China, less than 25% of customers are willing to pay more than 30 RMB ($4.47) for a cup of freshly brewed coffee. Therefore, Luckin aims to meet this demand with comparative pricing; the average price of a cup at Luckin is about RMB 23.5 ($3.5), compared to RMB 32.2 ($4.80) at Starbucks and other global brands. Additionally, Luckin engages in aggressive promotions, such as offering free coffee to first-time customers, buy-two-get-one-free deals, and weekly 50% discount coupons to existing customers. Referrers also receive freebies when their referees sign up for the Luckin app. The company leverages social media platforms like WeChat for periodic giveaway campaigns to build its community. The mobile apps and extensive store network mentioned earlier facilitate easy access for customers in various scenarios at 'any moment'.

While Luckin's strategies have rapidly increased its market share, there are concerns about the sustainability of such aggressive tactics. For instance, to ensure timely coffee delivery, Luckin heavily subsidized its delivery service partner, SF Express, to maintain a 30-minute delivery standard. However, as Luckin shifted from delivery kitchens to pick-up stores to reduce delivery subsidies, the steep promotions and discounts began eroding its cash flows and profitability. These deep discounts brought the average coffee price down to RMB 12 ($1.67) (Yang 2020, WSJ). In 2018, the company expended over RMB 746 million ($111 million), or 88.7% of its total revenue for the same period, on sales and marketing. This led to a net loss of RMB 1.62 billion, or $241 million, in 2018.

FIGURE 10
LUCKIN COFFEE NET INCOME BY QUARTER



Source: Luckin's registration filling in 2019

Mr. Lu and Mrs. Qian, the founders of Luckin, have made substantial investments in the company to support its short-term financial needs. Moreover, Luckin has raised capital through several funding rounds to sustain its business strategy. In April 2018, Luckin secured $200 million in Series A financing, valuing the company at $1 billion and elevating it to 'unicorn' status. In November 2018, the company raised another $200 million in its Series B funding round, increasing its valuation to $2.2 billion. Prior to the IPO, Luckin completed an additional funding round of $150 million from investors, including Blackrock, bringing the company's valuation to $2.9 billion. By January 2020, the company's market capitalization had reached $12 billion, following a follow-on share sale and the issuance of convertible bonds.

TABLE 1
LUCKIN COFFEE INC. FUNDING HISTORY BEFORE IPO

Time	Amount	Type	Funding Source
2017	RMB 60 million	1 yr term loan	Jenny Zhiya Qian and Min Chen
2017	RMB 1.8 million	1 yr term loan	Charles Zhengyao Lu
2017	RMB 92.9 million	1 yr term loan	Primus Investments Fund (affiliated with Charles Zhengyao Lu)
2017	RMB 227.5 million	1 yr term loan	Star Grove Global Limited
2018	RMB 147.6 million	6m term loan	Haode Investment (affiliated with Charles Zhengyao Lu)
2018	RMB 350 million	Capital leasing	Everbright Financial Leasing
2018	RMB 300 million	2yr term loan	TTCO Trust Corporation Limited
2018/6	USD 189 million	Angel-1 share	Primus Investments Fund
2018/6	USD 200 million	Series A convertible redeemable preferred shares	Lucky Cup Holdings Limited, Joy Capital II, L.P., Joy Luck Management Limited, Galaxy Shine Limited, Haode Investment Inc., and Carob Investment Pte Ltd
2018/11	USD 200 million	Series B convertible redeemable preferred shares	Fortunate Cup Holdings Limited, Joy Capital II, L.P., Honour Ample Limited, Joy Luck Management Limited, Carob Investment Pte Ltd, and Blue Fortune Limited
2019/3	RMB 45 million	Capital Leasing	Zhongguancun Science-Tech Leasing Company Limited
2019/3	RMB 60 million	S-T Revolving loan	SPD Bank
2019/4	USD 150 million	Series B-1 convertible redeemable preferred shares	BlackRock and several pritate funds
2019/4	USD 8.9 million	Series B-1 convertible redeemable preferred shares	Taide Investment Management Ltd

Source: Luckin's registration filling in 2019

DISCUSSION QUESTIONS

1. What business strategies/models did Luckin Coffee adopt to become one of the largest coffee shops in China in less than 2 ½ years?
2. Discuss why Luckin's rapid growth can be sustained or not.
3. Can you perform a financial statement analysis to evaluate Luckin's operating performance? Are there concerns in its financial reports? Please be specific.
4. Discuss the company's internal and external auditing structure and processes.

5. What is corporate governance? Please analyze Lucken's corporate governance and discuss any potential concerns shareholders need to be aware of.
6. Based on your responses, why do you believe the auditors failed to disclose financial misconduct?

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APPENDIX 1: DIRECTORS AND EXECUTIVE OFFICERS OF LUCKIN COFFEE

Directors and Executive Officers	**Age**	**Position/Title**
Charles Zhengyao Lu	49	Chairman
Jenny Zhiya Qian	42	Director and Chief Executive Officer
Jian Liu	36	Director and Chief Operating Officer
Dr. Jinyi Guo	37	Director and Senior Vice President
Hui Li	50	Director
Erhai Liu	50	Director
Sean Shao	62	Independent Director
Thomas P. Meier	48	Independent Director
Reinout Hendrik Schakel	38	Chief Financial Officer and Chief Strategy Officer
Wenbao Cao	49	Senior Vice President

APPENDIX 2: PRINICPAL SHAREHOLDER OF LUCKIN COFFEE BEFORE AND AFTER IPO

	Ordinary Shares (as converted basis) Beneficially Owned Prior to this Offering and the Concurrent Private Placement		Ordinary Shares Beneficially Owned After This Offering and the Concurrent Private Placement				
			Class A		Class B		
	Number	%*	Number	Percentage of total ordinary shares on an as-converted basis	Number	Percentage of total ordinary shares on an as-converted basis	Percentage of aggregate voting power**
Directors and Executive Officers:							
Charles Zhengyao Lu	969,703	30.39%	—	—	484,851,500	26.06%	30.02%
Jenny Zhiya Qian	625,000	19.59%	—	—	312,500,000	16.80%	19.35%
Jian Liu	—	—	—	—	—	—	—
Dr. Jinyi Guo	—	—	—	—	—	—	—
Hui Li	377,877	11.84%	—	—	188,938,500	10.16%	11.70%
Erhai Liu	214,471	6.72%	—	—	107,235,500	5.76%	6.64%
Sean Shao	—	—	—	—	—	—	—
Thomas P. Meier	—	—	—	—	—	—	—
Reinout Hendrik Schakel	—	—	—	—	—	—	—
Wenbao Cao	—	—	—	—	—	—	—
Principal Shareholders:							
Lu's Family	969,703	30.39%	—	—	484,851,500	26.06%	30.02%
Summer Fame Limited	625,000	19.59%	—	—	312,500,000	16.80%	19.35%
Mayer Investments Fund, L.P.	393,750	12.34%	—	—	196,875,000	10.58%	12.19%
Centurium Capital	377,877	11.84%	—	—	188,938,500	10.16%	11.70%
Joy Capital	214,471	6.72%	—	—	107,235,500	5.76%	6.64%

Source: Luckin Coffee Inc. F1/A filings, 2019 https://investor.luckincoffee.com/static-files/84ace928-8850-46e2-a0ae-9c46b695dc7e

APPENDIX 3: INCOME STATEMENT OF LUCKIN COFFEE

		Currency RMB inthousands
	6/16-12/31/2017	**2018**
Net revenues:		
Revenues from product sales	250	840,695
Revenues from partnership stores — 15,344		
Total net revenues	250	840,695
Operating expenses:		
Cost of materials	(789)	(532,217)
Store rental and other operating costs	(1,559)	(576,244)
Depreciation and amortization expenses	(917)	(106,690)
Sales and marketing expenses	(25,464)	(746,018)
General and administrative expenses	(22,005)	(379,738)
Store preopening and other expenses	(5,723)	(97,794)
Impairment loss of long-lived assets		
Losses and expenses related to Fabricated Transactions and Restructuring		
Total operating expenses	(56,457)	(2,438,701)
Operating loss	(56,207)	(1,598,006)
Interest income	11	8,915
Interest and financing expenses		(16,121)
Foreign exchange gain/(loss), net	(175)	13,113
Other expenses, net		(7,777)
Change in the fair value of warrant liability		(19,276)
Provision for SEC settlement		
Provision for equity litigants settlement		
Impairment of trust investments		
Net loss before income taxes	(56,371)	(1,619,152)
Income tax (expense)/benefit		
Net loss	(56,371)	(1,619,152)

APPENDIX 4: CONSOLIDATED STATEMENT OF CASH FLOW OF LUCKIN COFFEE

		Currency RMB in thousands
	6/16-12/31/2017	**2018**
Net cash used in operating activities	(95,026)	(1,310,694)
Net cash used in investing activities	(72,922)	(1,283,218)
Net cash generated from financing activities	387,219	3,988,402
Effect of foreign exchange rate changes on cash and cash equivalents	(175)	17,397
Net increase / (decrease) in cash and cash equivalents and restricted cash	219,096	1,411,887
Cash and cash equivalents and restricted cash at beginning of year		219,096
Cash and cash equivalents and restricted cash at end of year	219,096	1,630,983

APPENDIX 5: CONSOLIDATED BALANCE SHEETOF LUCKIN COFFEE

		Currency RMB in thousands
	2017	2018
ASSETS		
Current assets:		
Cash and cash equivalents	219,096	1,630,983
Restricted cash		
Short-term investments		130,000
Accounts receivable		
Receivables from online payment platforms	12	4,609
Inventories	3,396	150,015
Prepaid expenses and other current assets	36,604	365,510
Amount due from a related party		147,559
Total current assets	259,108	2,428,676
Non-current assets:		
Property and equipment, net	39,118	904,992
Restricted cash		
Other non-current assets	38,730	151,408
Deferred tax assets, net		
Total non-current assets	77,848	1,056,400
Total assets	336,956	3,485,076

LIABILITIES, MEZZANINE EQUITY AND SHAREHOLDERS' DEFICITS		
Current liabilities:		
Short-term bank borrowing		8,000
Current portion of long-term borrowing		72,787
Capital lease obligation		108,664
Accounts payable		176,704
Notes payable		
Accrued expenses and other liabilities	6,076	371,017
Amounts due to related parties	382,219	24,198
Deferred revenues		
Warrant liability		19,520
Total current liabilities	388,295	780,890
Non-current liabilities:		
Long-term borrowing		226,969
Other non-current liabilities		
Deferred revenues	32	126,469
Total non-current liabilities	32	353,438
Total liabilities	388,327	1,134,328
Mezzanine equity:		
Series A convertible redeemable preferred shares		2,113,347
Series B convertible redeemable preferred shares		2,164,994
Total mezzanine equity		4,278,341
Shareholders' equity:		
Class A ordinary shares		
Class B ordinary shares		
Ordinary shares		
Angel-1 shares		743,376
Angel-2 shares		512,812
Additional paid-in capital	5,000	65,000
Statutory reserves		
Accumulated deficits	(56,371)	3,246,705
Accumulated other comprehensive loss		2,076
Total Company's ordinary shareholders' equity	(51,371)	1,927,593
Non-controlling interests		
Total shareholders' equity	(51,371)	1,927,593
Total liabilities and shareholders' equity	336,956	3,485,076

APPENDIX 6: LUCKIN COFFEE SALES PERFORMANCE

	For the three months ended or as of					
	December 31, 2017	March 31, 2018	June 30, 2018	September 30, 2018	December 31, 2018	March 31, 2019
Total stores	**9**	**290**	**624**	**1,189**	**2,073**	**2,370**
Pick-up stores	4	83	356	903	1,811	2,163
Relax stores	5	15	22	45	86	109
Delivery kitchens	0	192	246	241	176	98
Cumulative number of transacting customers (in thousands)(1)	**11.1**	**485.0**	**2,917.8**	**5,984.3**	**12,529.5**	**16,872.3**
Average monthly transacting customers (in thousands)(2)	**4.0**	**179.5**	**1,207.6**	**1,877.4**	**4,325.9**	**4,402.0**
Average monthly total items sold (in thousands)(3)	**8.6**	**487.5**	**4,001.0**	**7,760.3**	**17,645.1**	**16,275.8**
Freshly brewed drinks	8.0	451.7	3,743.7	6,220.4	13,418.8	13,077.2
Other products	0.5	35.8	257.3	1,539.9	4,226.4	3,198.6

APPENDIX 7: STARBUCK-OPERATED STORES FOR YEAR-ENDED SEPTEMBER 30, 2018

	Stores Open as of Oct 1, 2017	Stores Open as of Sep 30, 2018
Americas:		
U.S.	8,222	8,575
Canada	1,083	1,109
Brazil	108	-
Total Americas	9,413	9,684
China/Asia Pacific		
China	1,540	3,521
Japan	1,218	1,286
Thailand	312	352
Total China/Asia Pacific	3,070	5,159
EMEA (Europe, Middle East and Africa)		
U.K.	345	335
All Other	157	155
Total EMEA	502	490
Corporate and Other:		
Teavana	288	-
Siren Retail	2	8
Total Corporate and Other	290	8
Total company-operated	13,275	15,341

APPENDIX 8: PERCENTAGE CHANGE IN CHINA/ASIA PACIFIC STORE SALES

Fiscal Year Ended	30-Sep-18	1-Oct-17	2-Oct-16	27-Sep-15	28-Sep-14
Sales growth	1%	3%	3%	9%	7%
Change in transactions	-1%	1%	1%	8%	6%
Change in ticket	2%	1%	2%	1%	0%

APPENDIX 9: STARBUCK'S CHINA/ASIA-PACIFTC SEGMENT DATA

USD in million

Fiscal Year Ended	Sep 30, 2018	Oct 1, 2017
Net revenues:		
Company-operated stores	$4,096.9	2,906.0
Licensed stores	365.7	327.4
Other	11.0	6.80
Total net revenues	**4,473.6**	**3,240.2**
Cost of sales including occupancy costs	1,898.3	1,396.2
Store operating expenses	1,148.7	845.5
Other operating expenses	22.9	21.2
Depreciation and amortization exp.	412.1	202.2
General and administrative expenses	241.6	207.1
Total operating expenses	3,723.6	2,672.2
Income from equity investees	117.4	197.0
Operating income	**$ 867.4**	**$ 765.0**

Source: Starbucks' 10K filings in 2018 and 2019

TEACHING NOTES
INVESTING IN A FOREIGN STARTUP COMPANY: LUCKIN COFFEE INC.

CASE SYNOPSIS

Luckin Coffee Inc. is a China-based coffee chain company. The company was initially incorporated in the Cayman Islands in 2017 by two founders, Jenny Qian Zhiya and Charles Zhengyao Lu. It adopts a VIE (variable interest entity) structure through contractual arrangements to operate in China. Since its first trial coffee shop opened in Beijing in early 2018, its exponential growth has made it a solid rival for Starbucks, the largest coffee shop in China. Within 18 months after it opened its first coffee shop, the company opened 2,370 stores in 28 cities in China, with 16.8 million cumulative transacting customers. As a security analyst, Andrew Hays was asked to provide his assessment regarding the company's business strategy, financial performance, and potential issues for the investment decision a month before the company went public on Nasdaq in May 2019.

DILEMMA

With the recent booming economy in emerging markets, many US investors are eager to invest in foreign stocks, believing that that investment would offer sustainable returns. US-listed foreign stocks, such as American depositary receipts (ADRs), allow U.S. investors to purchase shares in foreign companies in a way that's easier and more convenient than buying shares on foreign stock exchanges. Since the filing requirements for ADRs are regulated in a manner similar to U.S. securities, buying those US-listed foreign stocks would be a great opportunity to earn substantial returns by improving diversification. However, many US-listed companies' recent fraud or financial misconduct cases highlight the risks associated with investing in foreign companies due to different home countries' regulatory and investor protection that investors have often overlooked.

In this case, we first ask students to evaluate business strategies/models that Luckin Coffee adopted that make it one of the largest coffee shops in China in less than 2 ½ years and discuss whether this type of rapid growth can be sustained. We also ask students to analyze its corporate governance, ownership structure, and financing strategy to identify potential issues that companies would not act in the best interest of shareholders. In addition, we ask students to perform a comprehensive analysis to assess Luckin's operation performance when limited financial data and track records are available.

Since financial frauds in publicly listed companies often cost investors billions of dollars, it is important to examine whether the due diligence of auditing is performed to defer abusing financial reporting behaviors from management, particularly for companies from less investor protection countries listed in the U.S. Therefore, we ask students to discuss the Luckin's internal and external auditing structure and politics in an attempt to verify potential reasons that auditors failed to disclose financial misconduct committed by US-listed foreign companies.

COURSES AND LEVELS FOR WHICH CASE IS INTENDED

This case would be suitable for upper-level undergraduate or graduate classes in accounting, auditing, international finance, or capstone courses.

RESEARCH METHODS

Primary and secondary data sources were used to develop the case. Financial information was pulled from Luckin's website under the "Investor Relations"tab.

LEARNING OUTCOMES

Upon completing this assignment, students should be able to:

- Identify business strategies and models companies pursue for their success/failure
- Investigate companies' corporate government, ownership structure, and pre-IPO funding activities
- Discuss rapid growth consequences
- Perform financial statement analysis with limited information
- Discuss internal and external auditing structure and politics
- Detail risks when investing in foreign stocks

TEACHING PLAN AND CASE ANALYSIS

The following is a suggested teaching plan based on an 80-minute class, followed by suggested class discussion questions.
(15 minutes) Review the pros and cons of investing in foreign stocks
(15 minutes) Discuss types of ADRs and their filing requirements
(15 minutes) Review financial statement analysis and verify the potential problems and limitations in ratio analysis
(15 minutes) Review corporate governance and investment protection issues
(10 minutes) Discuss internal and external auditing duties and challenges
(5 minutes) Discuss how to find corporate filings and financial information
(5 minutes) Summarize the key points

ASSIGNMENT QUESTIONS:

1. **What business strategies/models did Luckin Coffee adopt to become one of the largest coffee shops in China in less than 2 ½ years?**

Luckin claimed that freshly brewed coffee is underpenetrated in China due to the higher price, inconsistent quality, inconvenience, and long waiting time. Therefore, its goal is to build a China-based coffee chain brand with big data and artificial intelligence analytics technology to develop niche marketing strategies. Luckin adopts a so-called "new retail mode" strategy that blends online and offline commerce by digitizing the entire retail value chain to benefit both merchants and consumers. In other words, Luckin tends to merge offline, online, and logistics businesses to create an integrated retail sector in coffee to serve customers.

Luckin relies on mobile apps and store networks to serve customers to achieve the new retail mode. All Luckin's orders need to be made through its mobile apps. The mobile order helps the company reduce operating costs and generates mass data to analyze customer behaviors to develop business plans, including production, operation, logistics, and customer services. Its store network contains three different styles of stores to maximize efficiency. Delivery kitchens serve delivery service orders only by offering lower-cost, 30-minute delivery guarantees to build Luckin's brand. Once it identifies the market demand and suitable locations, it sets up pick-up stores in those "hot zones" so customers can have the experience of combining online shopping and offline shopping. Relax stores offer space for customers to socialize.

To be able to grow rapidly, Luckin adopts aggressive marketing strategies. To provide a better coffee-drinking experience, Luckin used premium Arabica coffee beans from prominent suppliers. To earn customers' trust, they can watch the coffee-making process in real-time through Luckin's mobile app. Luckin also offers a competitive pricing strategy. The average price of coffee in Luckin is 20-30% lower than that of its competitors. In addition, its promotions were aggressive, including freebies for first-time customers, heavy discounts such as buy-two-get-one free, weekly 50% discount coupons, and reward referral programs. Luckin also heavily advertised on various social media channels such as WeChat and Weibo to launch periodic giveaway campaigns to build friend circles. The mobile apps and fast-growing store networks successfully targeted customers who don't have much time to drink coffee at stores by meeting its mission of having coffee at "any moment."

2. **Discuss why Luckin's rapid growth can be sustained or not.**

Luckin's business model has been a concern for many analysts and investors. According to the case described, Luckin seems to be taking rapid growth as its strategy by applying massive marketing efforts to maximize its market share quickly. The company increased its market share by opening more than 2,000 stores in a year. However, its financial results didn't seem to increase shareholder wealth. For example, its revenue and cash flows from rapid expansion were insufficient to cover its operating costs due to deep price discounts, heavy marketing, and new store investment. It mainly relies on funding from several rounds of private investors to support its operations and expansion, but the average store's revenue is deteriorating.

Luckin's case is a typical scenario of the long-standing debate on the primary goal of a corporation. The possible financial goals could be to survive, beat the competition, rapid growth, maximize market share, revenue, or profitability, or minimize costs. However, those goals contain some problems that cause ambiguity to managers. For example, a company can increase market share or revenue and beat the competition by lowering the price and offering any incentives, but it might not be in the best interest of shareholders in the long run. The goal of maximizing profit is often cited, but it does not specify what type of profitability managers should focus on. Managers could chase short-term profitability but sacrifice long-term profitability or competition for the company or focus entirely on long-term profitability and ignore short-term profits, which jeopardize the company's survival due to lack of cash flows. Many companies adopt growth as the goal of financial management but ignore the fact that growth is a tactic, not a goal. Therefore, corporations' more appropriate goal should maximize current stock value to avoid those ambiguities mentioned above.

It is common for managers to view growth as their primary goal, as Luckin did. For example, Krispy Kreme expanded quickly in early 2000 by increasing its number of stores from 218 to 357 in two years by heavily borrowing debt. Although Krispy Kreme reported nearly a 15% increase in second-quarter revenues from fiscal 2003 to fiscal 2004, the same-store sales were up just 0.1% during that time. Disappointing financial results caused the company to lose 75% of its market value. The company eventually closed unprofitable stores to avoid bankruptcy. Starbucks also made the same mistake. It opened more than 2,500 stores in 2006 to boost sales growth and shorten the long waiting lines. However, it found that its expansion cannibalized its existing sales and caused the quality to slip. Later, the company decided to close more than 500 unprofitable locations and focused on its core values. In an interview, CEO and founder Howard Schultz stated that "growth is not a strategy; it is a tactic. If growth becomes a strategy, I don't think it is enduring. I think growth covers up mistakes."

3. Can you perform an analysis to evaluate Luckin's operating performance? Are there concerns in its financial reports? Please be specific.

Luckin Coffee, once viewed by investors as an aggressively growing star in the Chinese coffee industry, was later revealed to be involved in corporate fraud, presenting a unique case study opportunity for conducting financial analysis with constraints. Founded in October 2017 and going public in May 2019, Luckin provided financial statements covering less than a two-year period at the time of its IPO. This scenario is particularly challenging for several reasons. First, only about one and a half years of financial data were available at the time of the IPO. It severely limits the application of financial ratio analysis across time, which typically requires a more extended timeframe to examine trends, as a ratio alone does not provide meaningful insights. Second, a direct comparison with its major competitor, Starbucks Coffee, is inadequate and impossible since Starbucks Coffee only published aggregated Asian market performance data, while Luckin Coffee's operations were entirely focused on the Chinese market. Furthermore, the absence of other publicly listed coffee stores in China eliminates the possibility of conducting a financial analysis within the same industry, as calculating an industry average without publicly available data is not feasible. Additionally, Luckin Coffee's rapid expansion business strategy has severely skewed most financial ratios, further eliminating the possibility of using traditional financial evaluation methods. Therefore, we need to creatively examine the financial numbers within the restricted dataset, especially focusing on growth and profitability measurements, to reveal critical insights into potential corporate manipulation and misreporting.

When a company exhibits rapid growth, especially at a rate that significantly outpaces its competitors or appears unsustainable given market conditions, suspicions of potential inaccuracies or even fraud in its financial statements may arise. In the case of Luckin Coffee, several analytical steps and considerations can be employed to detect fraud by analyzing growth numbers. First, in analyzing Luckin Coffee's rapid growth, it is crucial to compare its revenue generation capabilities against major competitors like Starbucks. Luckin's store count soared from 9 to 2,073 in just one year, approximately doubling every three months from January 2018 to December 2018. It is reasonable to expect a dilution in per-store revenue performance metrics due to the strategy of initially targeting the best locations before expanding to less optimal ones. Thus, it is expected the average monthly number of transacting customers and the average monthly total items sold per store to decrease as more stores are opened in less optimal locations within a short period. We calculated the average number of stores for each three-month period and then determined the average monthly transacting customer per store and the average monthly total items sold per store. The results are reported in table 1.

TABLE 1
LUCKIN COFFEE KEY REVENUE MEASUREMENT PER STORE

Three Months Period Ended as of	**3/31/ 2018**	**6/30/2018**	**9/30 /2018**	**12/31/2018**
Total Stores	290	624	1,189	2,073
Average Monthly Transacting Customers per Store	179,500/((9+290) /2)=**1,201**	1,207,600/((290+ 624)/2) = **2,642**	1,877,400/((624+ 1189)/2) =**2,071**	4,325,900/((1189 +2073)/2) =**2,652**
Average Monthly Total Items Sold per Store	487,500/((9+290) /2)=**3,261**	4,001,000/((290+ 624)/2)=**8,755**	7,760,300/((624+ 1189)/2)=**8,561**	17,645,100/((118 9+2073)/2)=**10,8 19**

Contrary to this expectation, the results in table 1 show that Luckin reported significant increases in both transaction volumes and sales per store during this aggressive expansion phase. This anomaly becomes more pronounced when compared to Starbucks' performance in the China/Asia-Pacific segment, which experienced a modest decline in net revenue per store with its expansion. Starbucks stores in China/Asia-Pacific grew from 3,070 to 5,159 from October 1, 2017, to September 30, 2018. The net revenue per store decreased as more stores opened, from approximately 1.0554 million USD per store in the fiscal year 2017 (3240.2/3070) to about 0.8671 million USD per store in the fiscal year 2018 (4473.6/5159).

With such rapid growth, one would expect Luckin Coffee's per-store revenue performance to decline. However, Luckin's story significantly differs from that of its primary competitor. Such disparities raise legitimate concerns about the sustainability and authenticity of Luckin's revenue and growth figures, necessitating further investigation to unearth potential manipulative practices in revenue reporting. In fact, Muddy Waters Research, upon receiving an anonymous report regarding fraudulent activities within Luckin Coffee, mainly concerning its revenue, conducted on-site verification of Luckin's sales activities, which led to the revelation of significant fraudulent activity.

4. Discuss Luckin's internal and external auditing structure and politics.

Overall, Lukin Coffee, Inc. had a poor business model and was a Variable Interest Entity (VIE), which led to a focus on stock price rather than on product and integrity and ethics in the business model. VIE-structured Chinese businesses do not fall under the same regulations as U.S. companies, nor are the Chinese-based audits available for U.S. Regulatory review. It was the perfect storm for management to quickly misrepresent financial statements and bring in capital on the U.S. stock exchange before fraud was discovered. The external auditors also found background issues with management's ethics related party transactions with companies and individuals with past fraudulent activity. Overall, it appears the Luckin was more interested in taking U.S. investors money than brewing a good cup of coffee and being able to sell it in China where coffee consumption was very low.

Senior management - Senior management has a fiduciary duty to certify and ensure financial statements are accurate and to maintain strong internal controls. The ultimate responsibility lies here. Senior management should implement strong internal controls and establish a corporate culture of ethical behavior. Chief Executive Officers (CEOs), Chief Financial Officers (CFOs) and Chief Operating Officers (COOs) of public companies are required to certify the accuracy of financial statements.

The Chief Executive Officer (CEO) and Chief Operating Officer (COO) were terminated based on findings of an internal Special Committee who found the CEO and COO participated in fabricated transactions. Co-founder and Chief Marketing Officer (CMO) was once in prison for illegal business operations.

In the fraud triangle, the Luckin management team was given the opportunity and possibly pressure to sell stock and increase the stock price. The management team cashed out 49% of their stock holdings through stock pledges, which exposed investors. The management team appears to have more pressure to bring in investors than focus on risk.

Board of Directors - The Board of directors is responsible for overseeing management and ethical culture. The chairman of the board was required to resign based on findings by the Special Committee and on his degree of cooperation with the Special Committee. One of the Board members is/was on the board of other Chinese companies listed in the U.S. with significant losses to public investors.

Audit Committee - An Audit committee oversees the external auditors and ensures internal controls are sufficient to prevent fraud. At Luckin, the audit committee failed to conduct due diligence. They delegated responsibility to management.

Internal Auditors – Internal auditors should monitor and test the effectiveness of internal controls. The scope of their work results in how effective risk management systems support the organization's goals and objectives.

Revenue from the sale of coupons was calculated based on the number of redemptions, not actual coupons sold. Luckin Coffee fabricated coupon sales to inflate its revenue – employees were involved by selling coupons to individual, corporate, and third-party shell companies. Over 90% of the fraudulent money was recorded as revenue by selling coupons to third-party shell companies and then returning the money to the company as payment to a vendor for supplies. An increase in revenue ultimately resulted in a 200% increase in stock price.

The internal auditors not only failed to find the fraud, they also were part of covering up the fraud by supporting the management team and covering up the fabricated financial statements. They cooperated with the fraud and violated their code of ethics.

After the fraud was discovered, Luckin implemented enhancements based on internal controls consultations to detect and prevent misconduct in the future.

External Auditors External auditors should conduct an annual audit of financial statements to show reasonable assurance that the financial statements are free from material misstatement. Ernst & Young Hua Ming, LLP (EY), was the auditor to Luckin Coffee, Inc. The controversy here is that EY did not perform an audit, and therefore, they say they are not responsible. However, EY did issue a private "comfort" letter to several investment banks reporting it did not have an issue with the financial performance for the first three quarters of 2019.

Employees – Employees should have an anonymous reporting option to bring concerns to internal auditors. Twelve employees were fired after Luckin conducted an internal investigation. An additional fifteen employees were subject to other disciplinary actions. Luckin is moving forward with compliance training for its employees.

5. What is corporate governance? Please analyze Luckin's corporate governance and discuss any potential concerns of which shareholders need to be aware.

Corporate governance refers to the rules, practices, and processes by which a company is directed and controlled. It essentially involves balancing the interests of a company's many stakeholders, such as shareholders, management, employees, customers, government, and the community. Through governance, corporations set objectives, develop strategies to achieve them, monitor performance, and ensure accountability and transparency in their operations.

From Luckin's filings, students should be able to identify several concerns about Luckin's corporate governance structure and practices:

1. **The company's complex VIE structure:** From the corporate structure chart provided in the filing, Luckin is a holding company incorporated in the Cayman Islands. Then, it established a holding company (Luckin Coffee Hong Kong Limited) in Hong Kong to create a wholly foreign-owned enterprise (WFOE) inside China. The WFOE, Beijing WFOE, established service agreement relationships (See Exhibit 10.9 from the F1 filing) with Beijing Luckin Coffee Technology Ltd,the VIE, which is responsible for the

main operations in China. Under U.S. Generally Accepted Accounting Principles (GAAP), if a company has a controlling interest in a VIE, it must consolidate the VIE's financial statements with its own. This means the parent company, Luckin Coffee, includes the VIE's assets, liabilities, and operations in its balance sheet and income statement as if they were its own.

Although the VIE structure allows Chinese companies to get around the Chinese government regulation regarding foreign ownership restriction to access international capital markets, it comes with significant risks to investors. The reliance on contractual arrangements rather than direct ownership can create legal uncertainties. In case of a dispute or conflict, it may be difficult for foreign investors to enforce these agreements in Chinese courts. Because the parent company's value (Luckin Coffee) derives from its ability to consolidate its VIE on its financial statement, losing the VIE due to breached contracts would significantly devalue shareholders' investment. Furthermore, VIE structures can be complex and opaque, making it difficult for investors to understand the company's true financial health and risks. This can lead to issues with transparency and reliability of financial reporting.

2. **Fewer independent board of directors**: According to the F1 and F1/A filings in 2019, Luckin had six board members before the IPO and will add two independent directors when the SEC approves its registration statement (see Exhibit 1 of case study). Although the listing rule of NASDAQ generally requires that a majority of the board of directors be independent directors, Luckin decided to follow" home country practice" to structure its board, which is exempt by NASDAQ for foreign private issues in certain corporate governance requirements. Among those 8 directors, half of them, Charles Zhengyao Lu (chairman), Jenny Zhiya Qian (CEO), Jian Liu (COO), and Jiyi Guo (VP), are company executives. They were also the formal executive officers in UCAR Inc., a Chinese automobile electronic commerce platform service founded by Charles Zhengyao Lu in 2016. The weak internal control due to fewer independent directors potentially increases agency problems, especially for companies from weak corporate investor protection countries.
3. **Concentration of ownership and dual-class structure:** Another concern that might arise is the shareholding of the board members. Charles Zhengyao Lu (chairman) and his family member Sunying Wong (Mayer Investment Fund) will own 26.06% and 10.58% of the total shares after the IPO. Jenny Zhiya Qian and her family, Summer Fame Limited, will own 16.80% of the shares. Those three principal shareholders will own more than 60% of the shares, while the other two major shareholders own less than 20%. The concentration of ownership on two founders indicates that the executive team dominates the board, which would create potential conflicts of interest between management and outside shareholders.

The additional issue that makes Luckin's corporate governance less effective is the dual-class shares. Dual-class shares refer to a structure where there are two classes of shares, each with different voting rights. Luckin plans to adopt the dual-class structure following the IPO. The Class A shares, which are owned by pre-IPO shareholders, will carry 10 votes per share, and the Class B shares, which will be owned by post-IPO shareholders, will carry one vote per share. As a result, the three major shareholders mentioned above will have more than 70% of the voting rights.

Many small companies adopt dual-class shares to provide stability and allow companies to focus on long-term growth without the pressure of immediate shareholder demands. However, several challenges and controversies, particularly concerning corporate governance and shareholder rights, have been documented in the literature, especially for companies with less protection for minority shareholders. When a small group of shareholders has disproportionate control, there's a risk that decisions may only sometimes reflect the broader interests of all shareholders. The concentration of power can lead to decision-making that prioritizes the interests of controlling shareholders over the company's long-term health or the value of other shareholders' investments. The unequal voting rights can lead to a governance structure that lacks checks and balances. Moreover, since the managers have little change, they can be removed, and management can become entrenched, making it difficult for shareholders to influence management or hold them accountable for performance issues or strategic missteps.

6. **Based on your responses, why do you believe the auditors failed to disclose financial misconduct?**

Ernst & Young (EY) discovered the fraud and brought in an anti-fraud team to investigate. EY auditors found and reported suspicious related entity transactions and email exchanges where management approved fraudulent transactions. It appears that the fraud was timed so that stock prices could increase before auditors found the fraud.

US-listed Chinese companies have been seen as posing a risk to investors in the US stock markets. The SEC warned, ‘there is a substantially greater risk that disclosures will be incomplete or misleading and, in the event of investor harm, substantially less access to recourse, in comparison to US domestic companies’

The Holding Foreign Companies Accountability Act was passed by U.S. Senate and House and signed into law, giving US-listed Chinese companies three years to comply with the US audit requirements. As of January 2022, 200 Chinese companies may lose U.S. Stock exchange status because China-based auditors’ work cannot be inspected by U.S. Regulators. Auditors in China, based on research, have a “weak rule of law.” Combined with U.S. Regulators being blocked from inspecting audits, there is a higher likelihood of poor accounting controls.

Ernst & Young (EY) published audits from its formation in 2017 to the end of 2018. EY discovered fraudulent practices in 2019 in January and found that managers had inflated earnings between the second and fourth quarters. Luckin took this information and publicly announced fraud. EY did not issue an audit report on the 2019 financial statements and, therefore, was not liable.