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Coffee Chain Fraud Spotlights Governance Issues Amid Crisis

By **Lisa Silverman Raymond Dookhie and Michael Bernstein** (May 15, 2020, 5:37 PM EDT)

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Financial fraud, like viruses, has been around for centuries, with one of the earliest recorded frauds dating back to 300 B.C., when a Greek merchant borrowed money, took out a large insurance policy on his ship, and then attempted to sink it.

Not only was the ship was destroyed, but the merchant's scam failed, as he was caught in the act — underscoring the fact that prevention is always has a better outcome than detection.

In these economic times, it is imperative for investors and lenders to undertake proactive measures to inoculate themselves against fraud and protect the value of their investments.

Although the nature of a fraud changes from century to century — even from fraud to fraud — the need to stay alert against all forms of deception remains constant.

Underscoring this point, on April 21, the U.S. Securities and Exchange Commission and the Public Company Accounting Oversight Board issued a joint statement warning investors of the risk of cross-border investing, stating that foreign jurisdictions are not maintaining "high-quality disclosure standards" and that there is a "substantially greater risk" that these disclosure statements will be "incomplete or misleading."

While financial disclosures for foreign companies may look similar to disclosures by a U.S.-listed company, foreign companies are often not subject to the same standards. The SEC and PCAOB further reinforced the fact that they have only limited ability to promote and enforce these standards in local jurisdictions, throwing into stark relief the risks associated with cross-border stock listings.

The warnings stem from a growing epidemic of financial fraud investigations at China-based companies listed on U.S. exchanges. On April 2, China-based Luckin Coffee Inc., which had high hopes of overtaking Starbucks Corp. as China's top coffee chain, disclosed in a U.S. filing that its chief operating officer, Jian Liu, along with other employees, fabricated 2.2 billion yuan, or $310 million, in sales from the second to fourth quarter in 2019.

The news sent Luckin's stock into a free fall; it dropped almost 90% — from $38 per share to $4.30 per share — before NASDAQ halted trading on April 7.

In the weeks since Luckin announced its fraud, China-based Tal Education disclosed "certain employee wrongdoing" in a "routine audit," and a report alleged that video-streaming site iQIYI (majority-owned by search giant Baidu Inc.) inflated revenue by $1 billion to $2 billion.

While iQIYI has denied the allegations, on April 22, Baidu's moral committee issued a statement that ex-Baidu vice president Wei Fang was arrested and is being investigated for fraud, and that his conduct "violated the company's culture of honesty."

As the investigation into Luckin's wrongdoing unfolds, there will be telling details and root-cause analyses that will make for sensational headlines, and more importantly raise serious questions about the efficacy of Luckin's governance and oversight. It will also underscore how important it is to conduct appropriate due diligence investigations when considering financial investments.

As Luckin grew, the company's financials provided warning signs of untoward activities. For example, in 2019, two years after its start, Luckin began to turn profitable, despite massive giveaways to attract new customers and reinvestments in store openings. High growth coupled with profits is an extraordinary result for a company in Luckin's life cycle stage.

One might ask, who was monitoring the company's books and records? Why were they not seeing the early warning signs? Were they asking the right questions? And, if issues were being raised, how did Luckin's management and the board respond? Were appropriate corporate stewards even in place?

For example, Luckin's chief marketing officer, Fei Yang, was previously convicted of fraud and served jail time. How did this go unnoticed? If the company were based in the United States, what disclosures would have been required? What was the level of pretransaction due diligence, or background investigation, on the company's executives? In short, what, if any, preventive measures were in place?

Given the downturn in the economy due to COVID-19, it is important to pay close attention on reported financial results versus analyst expectations. There may be added pressure on executives to show better than expected results in order to maintain market capitalization.

This can lead to the use of creative accounting to manage earnings (e.g., fraudulently pulling forward revenue from future periods in the current period or capitalization of expenditures which should be expended in the current period).

While the risk of fraud exists at most companies, it is especially prevalent in emerging market, cross-border listings, where U.S. agencies such as the SEC and PCAOB lack the tools or means for effective oversight.

In the case of Luckin, effective preacquisition due diligence would have uncovered questionable background information about its executives.

Periodic auditing and monitoring of the company's books and records and oversight controls could have revealed false sales and embezzlement. As corporate growth slides and employment falls, the number of reported frauds will likely increase and, as with the Luckin affair, will underscore the need for a robust series of processes and controls to prevent and detect frauds.

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