

Luckin Coffee: A Study of the Reasons for Committing Financial Fraud and Solutions for Getting Out of a Financial Crisis

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Abstract: Luckin Coffee grew rapidly in the past few years and it was the fastest *Chinese Concept* company go public in NASDAQ. However, its stock price plunged in 2020 due to financial fraud. It is crucial for Luckin Coffee to think about how to recover from the financial fraud and become a business representative of the “new retail” under the Internet model again. To recover from the financial crisis caused and gain profit, Luckin could improve its existing business model by improving product development, strengthening capital management in both marketing and expansion. The internal structure can also be adjusted by diversifying equity and replacing the manager team. Taking Luckin Coffee as an example, this paper analyzes the causes of financial fraud, propose solutions to recover from it, and evaluate the effectiveness of solutions in the context of reality.

Keywords: Luckin Coffee; Financial crisis; Financial fraud; Business model

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1. Introduction

Financial fraud is the act of violating regulations, altering accounting items and covering up the true financial situation of an enterprise ^[1]. Its impact is enormous, as it not only causes the company’s share price to plummet, exposing a large number of investors to financial losses, but also plunges the company itself into financial difficulties and a credibility crisis. One famous example is the financial fraud of Luckin Coffee (hereinafter referred to as Luckin), which was revealed in 2020, caused an upheaval in US and Chinese capital markets. The situation escalated quickly, in half a year: in January, Muddy Waters issued a short-selling report stating that Luckin had falsified its financial data; in April, Luckin admitted to RMB 2.2 billion in fraudulent transactions and its share price plummeted 80%, shrinking its market capitalization by US\$35.4 billion; in June, it was forced to delist from NASDAQ. Luckin received lots of negative attention in this half-year. Luckin Coffee has a brand vision of “making it easy for every customer to enjoy a good cup of coffee that is worth drinking” and a brand mission of “creating a world-class coffee brand from China,” and people are concerned about its future development. Therefore, this essay explores a variety of countermeasures in hopes that these solutions could enable Luckin to take the first step towards being the leader of the industry.

2. Reasons for financial fraud

The causes of financial fraud should be defined in order to propose more targeted solutions. Lister describes

the motivation for financial fraud as the “source of the fire” and the opportunity as the “fuel that keeps the flame burning” [2]. When the pressure of performance and the need for financing, which was the source, met the opportunity for subjective manipulation of income under concentrated equity, which was the fuel, the fire of fraud occurred. Thus, the causes of financial fraud can be explored in both aspects of motivation and opportunity.

Firstly, in terms of the motivation for the financial fraud, the flawed business model created a persistent loss-making financial position. This led to difficulties in achieving the target of initial public offering (IPO) and these pressures prompted the falsification of finances. Specifically, Luckin’s business model’s defects emerged in the failure of finding the proper direction of product development and the adoption of the expansionary business strategy. In terms of product, Luckin’s selection is not mature enough. The choice of coffee which is not a mainstream beverage in China decided the limited market. Moreover, the Chinese freshly ground coffee market has already been dominated by Starbucks with a 36% market share. Based on these facts, it had no clear advantage in a competitive market. As a result, Luckin could not form the core brand effect and had an unstable stream of customers and its operating income was not promising [3]. To enhance brand awareness, Luckin wasted large amounts of money on low utility expenditure items. These funds were manifested in marketing, by issuing large coupons to capture the market at low prices and in operational expansion, by frantically increasing the number of shops to expand sales. By the end of 2019, there were 4507 shops established after it was established in 2017. These shops gave away more than 30.03 million cups of coffee for free or at low prices every month which caused a net loss of RMB\$3.16 billion. Except for the deficits, Luckin also did not have satisfying customer loyalty and customers were highly sensitive to price, the retention rate of new customers dropped to 35% or lower in the second month. The vicious cycle of operations has resulted in a continuous loss-making financial position. This made it more difficult to achieve the goal of meeting the financial requirements for a Nasdaq listing. Overall, the financial losses caused by the flaws in the business model affected not only the daily operations but also the achievement of the company’s strategic objectives. These pressures acted as the motivation for financial fraud.

In addition, in terms of opportunity for financial fraud, flawed internal structures make it difficult to circumvent errors in decision-making and execution. This risk condoned the falsification of accounting information. Specifically, Luckin’s internal structure was deficient because of the concentration of equity and the high correlation between the shareholders’ and the senior management’s interests. The top two shareholders of Luckin were all executives of the company, holding most of the shares of the company and more than 50% of the voting rights. That is to say, the overall decision-making and execution rights of the company were all in the hands of the two senior executives, with a strong link between ownership and control. The centralized authority made the company vulnerable to individualism in strategic planning, decision making, and execution [4]. In the meantime, because executives have the advantage of withholding information [5], Luckin’s faithless chief operating officer acted as an important role in financial fraud. Overall, there was a significant increase in internal risks caused by internal structural weaknesses, which not only increased the tendency of wrong decisions and executions, but also increased the possibility of subjective and deliberate manipulation of revenue. The presence of these risks gave the opportunity for financial fraud.

3. Financial fraud solutions

3.1. Business model

Having identified the motivation and opportunity for financial fraud, Luckin could choose to make improvements to the business model and adjustments to the internal structure prevent financial fraud. Firstly, in terms of the business model, the company team could adapt the business model and develop a robust

business strategy to improve the company's performance. Teece argued that the distortion of accounting information is closely related to the business model adopted by the firm ^[6]. Amit and Zott also considered that the business model is the highlight and breakthrough of corporate innovation and there is a correlation between its design and enterprise performance ^[7]. That is to say, the business model has a direct impact on the actual value of the company. Therefore, the accounting information can be more comprehensive by improving the business model. This solution could enable Luckin to recover from the effects of financial fraud and obtain effective cash flow.

Luckin's business model can be improved by enhancing product research and development (R&D) and strengthening capital management. In terms of product development, Luckin could increase its investment in R&D projects to develop core products. Salim and Smyth found that companies that invest heavily in R&D gain more sales revenue and profits ^[8]. If the R&D directions fit the characteristics of the company and the market, it will have a positive effect on the output performance of the company. Thus, Luckin could choose to shift its product direction and create products with core competencies by combining coffee and ingredients according to the traditional Chinese food culture. For instance, Luckin could try combining tea, flowers, cereals and coffee, which would not only be more distinctive, but also integrates local culture. If the new product can be developed successfully, lost customers due to reputational damage can be restored and significant improvements in sales margins and performance will be made. However, Chambers and Jennings found that there is a lagged effect of R&D investment on firm performance ^[9]. On one hand, the market acceptance of innovative products is uncertain and volatile. It means that only a few products will be retained while other less successful products become sunk costs. On the other hand, the launch of similar products by other companies can undermine the impact of product development on business performance. Under these circumstances, some customers who are not invested in the brand will be lost. Nevertheless, the lag is only a partial reduction in utility and could not negate the positive effect of the investment in product development on improving the business model ^[10]. Therefore, improving product development is one of the viable solutions in terms of the business model to get out of financial difficulties for Luckin.

In addition to product R&D, capital management also can improve the business model. An efficient capital chain is essential to survive in the market ^[11], which in turn is linked to capital management, so it is important to improve the financial allocation and strengthen the capital management system. Financial management is a kind of a design of a business model and the allocation of funds can be optimized through a sound financial management system ^[12]. For Luckin, capital management can be discussed from marketing and expansion. Firstly, in terms of marketing, it can reduce price subsidies. Monica found that long-term corporate performance indicators are not affected by pre-IPO marketing expenditures ^[13]. Therefore, as a company returning to pre-IPO, reducing marketing expenditure is an effective way to achieve long-term performance indicators in combination with the current operating reality. In the past, Luckin's marketing expenditure was on using significant discounts to activate marginal consumers while the number of core customers declined. This could reduce discounting efforts and use communities to stabilize consumers for increasing consumer retention rate. However, Blattberg and Eppen found that consumers with coupons tend to accelerate their purchases over time ^[14], so the reduced marketing investment could undermine some of the "sales accelerator" effect. Thus, for Luckin, which is not completely out of financial trouble, reducing the amount of money spent on marketing is a trade-off that needs to be made. In addition, in terms of operational expansion, Luckin could change from an aggressive expansion strategy to a conservative one. Hamman and Smit argued that blind expansion is not the main route to success, instead, the company should focus on cash flow and non-cash working capital management ^[15]. Therefore, with the tightening of cash flow after the financial fraud, Luckin should conduct a comprehensive analysis of working capital liquidity and profitability. Branches that are not doing well can

be closed down and the opening of new shops should be lessened. After reducing its investment, Luckin can also choose to open franchises if necessary. In this way, it could increase the number of shops indirectly through external capital investment to occupy the market. In general, Luckin could manage its capital by scaling down its marketing and expansion to implement fine-tuned operations. This means that it can reduce capital investment with relatively minor investment returns to meet prudent capital budgets during periods of unstable cash flow. Therefore, enhancing capital management is also one of the viable solutions for Luckin to get out of financial difficulties in terms of its business model.

3.2. Internal structure

As mentioned above, to compensate for the effects of financial fraud, adjustments need to be made on the business model. Besides, the changes in the internal structure of the company can also have a positive effect on getting out of the dilemma of financial fraud. Luckin could bring about an appropriate turnover in the board of directors. This would not only provide positive guidance for business model adjustments in the short term, but also take control of the company's future direction in the long term. This is because the ability of the executives to respond promptly to changes in the environment and to make clear decisions is a prerequisite for the growth of the company ^[16]. So, it is necessary to replace the faithless management team and choose someone with trustworthy and reliable experience to lead the whole company. Moreover, checks and balances are keys to preventing financial fraud ^[17]. Restructuring the board of directors, establishing a mechanism of balance and segregating functions could help Luckin get out of the financial crisis and it could also prevent this type of violation of the law from being committed again. Because organizations that are not pluralistic lack representation ^[18], for board restructuring, Luckin should consider board diversification. In terms of financial diversity, when the board members have a commercial banking background, the company has increased access to external financing and thus more funds, which could be a solution to the need for financing in the case of financial fraud ^[19]. However, board changes affected by sudden negative events are unconventional and often involve frequent conflicts of interest ^[20], Luckin need to replace the board members gradually. Luckin is currently facing a great deal of internal instability. A joint letter signed by executives requesting the removal of the current chairman exemplified the power struggle between the board of directors and put Luckin, whose goodwill had already been damaged by the financial fraud, at risk of falling back into the negative news frequently. Overall, Luckin can manage the company better by changing the leadership team and establishing a mechanism of balance to restructure the internal structure. If the adjustments work well and the company has a promising performance, the impact of power struggles can also be prevented. Therefore, restructuring the internal structure is one of the potential solutions to get out of financial difficulties.

4. Conclusion

On the whole, it is not all that easy for Luckin to turn the corner. In an environment of uncertainty, companies need to have the courage to face the future, and they also need a methodology to turn crises into opportunities ^[21]. When faced with an uncertain environment in terms of internal management, consumer market and industry trends, Luckin can adopt a new team to adjust its business model correctly and focus on the direction of innovative concepts in product development, making their products more widespread. Besides, the marketing of their products can be targeted towards a precise group of customers. Moreover, the operation of branches in expansion also needs to be optimized, the capital needs to be managed effectively, and finally completing the debt restructuring and overcoming the financial crisis. In fact, Luckin has made some efforts: coconut latte launched in 2021 has the potential to become a core product, branch expansion has slowed down and the company's management team has been partly restructured. These changes enabled Luckin to achieve an operating profit for the first time in 2022 first quarter, albeit only

RMB19.8 million. It indicates that the impact of financial fraud is being remedied and that it is now gradually emerging from the crisis, with some initial validation of some of the solutions proposed in this essay. In the future, there are still many challenges of negative effects of fraud that Luckin needs to face, such as regaining the trust of Wall Street and dealing with the competitive market. Some of the solutions mentioned in this paper may be helpful.

Disclosure statement

The author declares no conflict of interest.

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