

# Toshiba and Luckin Coffee: A Study of the Reasons for Committing Financial Fraud

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**Abstract:** Financial fraud, which has become a global issue, is a subject of discussion, surpassing time. Financial fraud significantly undermines investors' confidence and affects the health of capital markets. Hence, it is valuable to explore the reasons for committing financial fraud and propose solutions to this issue. This paper focuses on two financial fraud cases in recent years, Toshiba in 2015 and Luckin Coffee in 2020, analyzes and compares the reasons for the financial fraud in terms of pressure and opportunity factors, as well as proposes comprehensive suggestions for dealing with the corporate financial fraud issue.

**Keywords:** Financial fraud; Corporate case studies; Fraud triangle theory

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## 1. Introduction

With the progress of the 21st century, many public companies have become more aware and technically sophisticated in their fraudulent practices, and as a result, there is an intensification of financial fraud. Enron became the largest bankruptcy in American history after it was exposed to financial fraud. Subsequently, WorldCom and Vanke collapsed due to financial fraud. Prior to these cases, the founder of the Association of Certified Fraud Examiners (ACFE) Albrecht proposed that financial fraud is created by the three elements based on the fraud triangle theory: pressure, opportunity, and rationalization<sup>[1]</sup>. Pressure comes from operational performance and the need to raise capital for initial public offering (IPO), which is also the motivation for a company to act; opportunity comes from the lack of internal control, auditing, and regulatory institutions, which are the conditions for financial fraud to materialize; rationalization, which is subjective, is beyond the scope of this paper.

## 2. A brief overview of Toshiba and Luckin financial fraud cases

On July 20, 2015, the investigation report released by the investigation committee revealed that Toshiba's financial fraud lasted for seven years, with a false profit of about 151.8 billion yen, accounting for nearly one-third of Toshiba's pre-tax profit. Toshiba achieved the goal of falsely increasing profits and covering up its losses by arbitrarily estimating the percentage of project completion, delaying the recognition of costs and losses, exaggerating inventory value, as well as falsely increasing accounting revenue and other items. All three presidents successively participated in the fraud, which covered a wide range of businesses, involving almost all businesses of the company. Following Toshiba, which falsified its finances in 2015, the case of Luckin, an emerging company that falsified its finances in 2020, is more dramatic. On January 31, 2020, a well-known agency, Muddy Water, claimed that it had received an 89-page anonymous short

report, pointing out the fraud of Luckin Coffee. Then, on April 2, 2020, its share price plummeted by 80% after Luckin coffee admitted a false transaction of RMB 2.2 billion. On June 29, 2020, Luckin was delisted from NASDAQ under pressure.

### **3. Pressure perspective**

When analyzing the financial fraud cases from the perspective of pressure factors, the common denominator is that both companies were under pressure to deliver operational results in a market filled with competition. The market downturn and industry systemic risks have led Toshiba to take desperate measures to whitewash its financial reports. The global personal computer (PC) industry has experienced sluggish growth in recent years, with its market nearly saturated and consumer demand declining. The external environment has seen a significant change. However, Toshiba's management did not fully consider these changes and continue to set high profit targets, putting the top management of each division under massive pressure. Coupled with the 2011 nuclear leak that hit Toshiba's nuclear energy business hard, Toshiba's management failed to make timely adjustments to achieve these targets. In order to meet the unrealistic profit targets, the divisions had to find ways to falsify financial reports. For instance, Toshiba's PC division attempted to gain temporary revenue at the end of the quarter by "plugging distribution channels" <sup>[2]</sup>. Due to market competition, Toshiba's core competencies have declined. Toshiba was known for its production of white goods and electronic products. However, as technology has become more advanced and competitors in the industry are pushing the boundaries, Toshiba had not been able to hold on to its position as the industry leader in its areas of strength. In 2012, Lenovo had a 29% market share, overtaking Toshiba at 12% and becoming the top PC brand in Japan. At the same time, due to Toshiba's blind business expansion, significant resources were consumed in non-core areas, such as sensors and white light-emitting diodes (LEDs). Its core competencies could no longer support the company's growth, thus further contributing to Toshiba's whitewashing of its financial statements. Toshiba did not consider the adaptation of its internal decision-making to the external environment when setting its strategic objectives and specific business objectives, resulting in poor business outcomes and the use of an illegal measure – financial fraud.

Luckin's pressure also came from the need for considerable business data. Luckin was considerably under more pressure than Toshiba because it had to go public. In terms of its business model, it is inherently flawed. As a newly established company, Luckin chose to frantically increase the number of shops and occupy the market at low prices. According to Luckin's financial report, by the end of 2019, there were 5,200 shops within two years, giving away more than 30.03 million cups of coffee for free or at low prices every month. This consumed a large amount of capital, incurring a net loss of 3.16 billion. With the beverage market already in an oversaturated state, becoming an exclusive brand requires not only a lot of money, but also time to gain favor from customers. Unfortunately, before its financial fraud scandal, Luckin did not have good customer stickiness, and at that time, customers were highly price sensitive. Luckin's public reports showed that after becoming a trading customer, the retention rate of new customers dropped to 35% or lower in the second month, showing a low customer retention rate. This is due to Luckin's marketing approach, which entails offering significant discounts to draw in marginal customers without benefiting its core customers <sup>[3]</sup>. Over time, the number of core customers decline, the same customers are repeatedly stimulated over a certain period of time, and Luckin Coffee continues to operate in a mode where it needs to attract customers with discounts, making it difficult to get out of the rut. Therefore, its sales volume and earnings are unable to grow, which is a fatal flaw for sales. In terms of its strategic objectives, Luckin wanted more financing for working capital and needed to meet the conditions for NASDAQ listing at the expense of inflating revenue by skipping orders. From inception to IPO, it took only 17 months for Luckin Coffee to successfully go public with a market value of US\$4.25 billion, setting a record for the fastest IPO in the world. In terms of motivation, Luckin's flawed business model was under pressure to

grow under competitive market competition, resulting in insufficient cash flow. The pressure factor was the incentive for Luckin to falsify its finances to continue to operate and go public so as to receive more investment, resulting in the scandal and crisis.

#### **4. Opportunity perspective**

In addition to the pressure factor as the motivation, the common opportunity factor of the two financial fraud cases is defective internal control. Toshiba had always been regarded as a model of corporate governance in Japan <sup>[4]</sup>. Its corporate governance structure appeared to be sound and balanced, but the various bodies did not perform their respective roles; moreover, the internal supervisory system and independent outside directors were virtually non-existent. With centralized corporate decision-making and a lack of accountability in management, President Atsushi Nishida served as Toshiba's global president and the company's director. Furthermore, two of Toshiba's external supervisory members were former diplomats and lacked professionalism <sup>[5]</sup>. In other words, the supervisory committee was only a mere formality that provided the opportunity for committing financial fraud rather than performing the supervisory role. Toshiba's fraudulent internal controls were in fact weaknesses in corporate governance, including an inadequate governance structure and an insufficient segregation of incompatible duties of independent outside directors. These factors are critical components of fraud opportunity.

The lack of maturity in the internal control system at Luckin provided the opportunity for financial fraud. According to a report submitted by Luckin, the financial fraud was led by a team headed by Liu Jian, the company's chief operating officer (COO), and the activities of the operation were not known to the financial department. This reflects the lack of communication among departments, the poor risk perception of the internal control department, and the wrong motivation of the company's senior management. Therefore, it is impossible for Luckin to avoid risks in a timely manner. In addition, due to the lack of contingency plans, Luckin's public relations department failed to deal with and take prompt measures following the scandal. As a result, Luckin was very passive in the face of the scandal. Other than that, there are also problems in the control structure. Executives of listed companies usually have information advantage, thus having a good grasp of the company's growth. In possession of this advantage, executives tend to play a role in financial fraud. An important clue of financial fraud is the change in the lifestyles of these executives <sup>[6]</sup>. Based on the publicly disclosed information in the annual report, the two major shareholders of Luckin were the company's senior executives, 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 these two senior executives. The corporate governance problem was that ownership and control cannot be separated, thus making the company vulnerable to individualism in strategic planning, decision making, and execution, which can result in a significant increase in internal and external risks. The internal factors are reflected by the high relevance of shareholders' and executives' interests, the unreasonable control structure, the inability of internal controllers to perceive risks and control them promptly, as well as the lack of maturity of the public relations department. These factors have led to financial fraud problems, including false transactions and cost manipulation, the exposure of the company's unethical trading practices, and the worsening of the incident.

In terms of opportunity factors, there are differences between the two companies. Toshiba inherited a traditional Japanese corporate culture that makes its employees hesitant to defy their superiors. Additionally, it has been in a long-term partnership with an external accounting firm. Since Luckin is a Chinese company listed in the United States, cross-border regulation is more challenging. At Toshiba, the corporate culture was such that the employees must not question the authorities. Toshiba's internal auditors had identified the flaws in Toshiba's internal audit at the beginning of the period, but due to the extreme concentration of power at the top, there was a dysfunctional internal audit function <sup>[7]</sup>. Moreover, when Toshiba's top

management set unrealistic profit targets in pursuit of profit, the employees did not question the decision due to the corporate culture established in the company. In order to meet the unreasonable expectations, the corporate management adopted inappropriate accounting practices, which laid the groundwork for the company's operations. In addition, Toshiba's external auditing firm did not provide adequate oversight. As the auditor had been serving in partnership with Toshiba for a long period of time, it was possible for the accounting firm to condone the company's financial fraud for its benefit; the firm's appointment system was flawed<sup>[8]</sup>. The other opportunity factors include Toshiba's arbitrary leadership style due to the Japanese corporate culture and the failure of the external audit firm in performing its due diligence; the external audit firm condoned the financial fraud, rather than basing itself on public interest.

A poor regulatory system also provides opportunities for financial fraud. It is worth mentioning that Luckin, whose main business and assets are in China, chose to be listed on NASDAQ because its financing is in overseas capital markets and its investors are all over the world. Therefore, there are problems such as overlapping supervision and a lack of access to some cross-border regulatory information. In addition, an inadequate regulatory system for listed companies also exists. In the United States, only 7% of all financial frauds are detected by the Securities and Exchange Commission<sup>[9]</sup>. It can be seen that the flaws in the regulatory system and the difficulty of supervision due to cross-border listing had given Luckin the opportunity to commit financial fraud as a condition.

## **5. Conclusion**

After sorting out the pressure and opportunity factors of Toshiba and Luckin, the business needs under market competition and internal control are common factors of financial fraud. Given the fierce market competition, companies tend to commit financial fraud in violation of the law when the profits from legitimate operations do not satisfy their targets to ensure that their operating figures are substantial, specifically, Toshiba to retain its market position and Luckin to attract investment by going to IPO. The concentration of the company's control power reduces the opportunity to circumvent faulty decisions. The deficiencies in internal control weaken the risk prevention function, resulting in the company's insensitivity to the occurrence of financial fraud. Along with the company's financial fraud similarities, the decadent corporate culture has fostered an environment conducive to counterfeiting. The failure of external audits to remain impartial and objective as well as the inadequacy of the market regulatory system for listed companies lead to the collapse of the external defense line against fraud. When combined with the analysis of fraud data over the years, the average years of 2000–2004 and 2011–2014 are considered high incidence periods of financial fraud, indicating that corporations have a stronger motivation for fraud in the economic downturn<sup>[10]</sup>. With the impact of the new crown pneumonia and the generally sluggish economic performance of international markets, the number of corporate financial fraud cases will continue to trend upwards, thus warranting caution. In conclusion, enterprises should draw experience and lessons from financial scandals, clarify their strategic position, innovate development ideas, improve their corporate governance mechanisms, earnestly carry out internal supervision, strengthen the development of enterprise management culture, improve the external audit system, and actively prevent the occurrence of financial fraud. The market should continue to improve the relevant laws and regulations as well as the penalty system for financial fraud, increase the penalty for company violations, truly deter violation acts, protect the legitimate rights and interests of investors, improve investors' confidence, and ensure a more rational and healthy development of the securities and capital markets.

## **Disclosure statement**

The author declares no conflict of interest.

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