

Similar financial models: Are they free lunches?*

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Abstract: In recent years, the academic and practical circles have paid so much attention to similar financial models because they generated a miracle in GOME (Gome Electrical Appliances Holding Limited) and SUNING (Suning Appliance Co., Ltd.) respectively. But what's the influence of such a model on corporate profitability and risk? Are similar financial models free lunches? To seek for the answers to the above questions, in this paper, we take Gree (GREE Electric Appliances, Inc. of Zhuhai), Midea (Guangdong Midea Electric Appliances Co. Ltd. Stores) and GOME for examples to carry out a comprehensive and in depth financial analysis. The conclusions of this paper are: The company with similar financial characteristics has higher profitability and risk level; Only the companies which meet special requirements need or can implement such a model and the identification and control of hidden risk can guarantee its success.

Key words: profitability; similar financial model; supply chain; risk

1. Introduction

The business models of GOME (Gome Electrical Appliances Holding Limited) and SUNING (Suning Appliance Co., Ltd.) have gained much attention in the practical world since they succeeded in realizing a rapid and up to the limit growth in profits and sales revenue in a short period. Scholars called their operating ways similar financial models. In the year of 2004, Gree (GREE Electric Appliances, Inc. of Zhuhai) refused to offer products to GOME and started to establish its own distribution channels. Gree set a good example for other companies in home appliances manufacturing section by operating at the same model as GOME did. Since then, the operating way of Gree was also called a similar financial model. In the year of 2007, Midea (Guangdong Midea Electric Appliances Co. Ltd. Stores) followed the suit of Gree to implement its similar financial model. In recent years, similar financial models have been found it not only implemented in home appliances chain industry, but also in other sections such as home appliances manufacturing, real estate, hairdressing and so on. So many industries are interested in such a model, then, what's the driving force? If a company plans to implement a similar financial model, what requirement should it meet? Is such a model a free lunch? What's the hidden risk? In this paper, we take Gree, Midea and GOME for examples to carry out a profitability and risk analysis to search for the answers to the above questions.

2. The definition of similar financial models

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In a simplified way, business models can be defined as the ways in which companies earn money (Michael Rappa). Similar financial models originally refer to the operating ways of securities and insurance companies. Since the operating ways deriving from GOME and SUNING gained widespread concern, similar financial models have referred to the methods with which companies live on their suppliers. Namely (WU Hong-guang & LI Ling, 2003): In cash transactions with their consumers, an extension of 3-4 months to pay the upstream suppliers leads to substantial cash deposit on the book on the long-term and forms such a fund circle: Sales expansion—increase of cash deposit in the book because of sales expansion—occupation for suppliers' fund to expand scale or to do other things—further scale expansion to enhance the value of retailing channels and to bring more cash deposit on the book. It is an internal fund circulation system. Why have GOME and SUNING been able to do so? Nothing more than a law to grasp: to allow the downstream business enterprises to occupy the upstream suppliers' fund. But the problem is: It is a phenomenon abound that the downstream businesses occupy the upstream suppliers' fund as long as companies have more payables than receivables. Therefore, similar financial models no longer just refer to GOME's and SUNING's operating modes. In this article, all the ways are named similar financial models when the occupied suppliers' and consumers' fund is more than a company's fund occupied by their suppliers and consumers.

Based on financial structure theory, enterprises only have three ways to make money (Eugene F. Brigham, 2003): When total debt ratio is low, companies mainly rely on the stakeholders' capital to make money. Under such circumstances, companies are using their own money to make money for themselves; When total debt ratio and the cost of capital are higher, enterprises mainly rely on debt to operate. Under such circumstances, companies are using creditors' money to make money for creditors; When total debt ratio is higher and the cost of capital is lower, enterprises still rely on debt to operate. But now companies are using creditors' money to make money for themselves. It is clear that the third way is most sophisticated and cost-effective. Therefore, we can also regard similar financial models as ways in which companies use someone else's money to make money for their own. Obviously, a higher total debt ratio and lower capital cost or even no capital cost is the key to the third approach, because the financial leverage can play a beneficial role only by doing so.

3. How to make profits by similar financial models?

3.1 The contribution of other operating income

Assuming the average single-store sales for GOME is 90 million Yuan, GOME charges its suppliers various fees such as access fees, advertising fees, channel fees, renovation costs and so on. It is estimated that all kinds of fees account for 13% of total sales revenue, or 11.7 million Yuan ($90 \text{ million} \times 0.13$). It is clear that the contribution of other operating income to GOME's performance is great because it operates in a retail chain industry with very low gross margin.

3.2 Interest-free financing

According to their semi-annual reports of 2008, the home appliances listed companies which hold large amount of accounts receivable from GOME are mainly Midea, Little Swan (Wuxi Little Swan Co., Ltd.) and Konka (Konka Group Co., Ltd.). Midea and Little Swan have more than 200 million of and Konka has about 75 million of receivables. GOME pays its suppliers after goods are sold. The general payment extension of 3-4 months is equivalent to obtaining a sum of interest-free funds in advance. These funds can be used for a further expansion of scale. According to the management of GOME, it needs about 40 million of funds to open a new

store. Assuming its suppliers' fund occupied by GOME accounts for 26% of the average single-store sales (YAN Xin, 2007), or 23.4 million Yuan ($90,000,000 \times 0.26$), it is estimated that GOME can generate about 35 million inflows of funds (23.4+11.7 million Yuan) from each newly opened store. Based on the above calculation, the net outflow of funds is five million Yuan ($40-35=5$). The above analysis shows that the key to GOME's similar financial model is: To obtain non-interest bearing short-term financing from its suppliers to achieve the rapid expansion of the scale.

3.3 Using financial leverage to maximize shareholders' value

If we list the profitability indicators of Gree and Midea from 2003 to 2007 in a panel, they can be shown in Table 1. As seen from Table 1: Two companies' net profit margins are very low except in 2007. They belong to the business category which can earn money slightly although this indicator of Gree is higher than that of Midea. The returns on assets of two companies are only higher than the corresponding interest rates of bank loans. However, return on equity and return on invested capital are very high. The highest ratio is 29.6% and 32.84% respectively. According to DuPont model, two companies must have very high financial leverage, i.e., high total debt ratio. Of course, in general, the profitability of Gree is stronger than that of Midea. The profitability indicators of the latter in 2007 are higher than those of the former, because Midea established the same distribution channels as Gree did in 2007. So Midea has gained the potential great catch up since 2007.

Table 1 Comparison of profitability between Gree and Midea from 2003 to 2007 (%)

Ratios	Firms	2003	2004	2005	2006	2007
Net profit margin (NPM)	Midea	1.22	1.70	1.79	2.50	5.03
	Gree	3.35	3.04	2.79	2.63	3.59
Return on total assets (ROA)	Midea	2.03	3.34	3.71	4.58	11.25
	Gree	4.37	4.00	4.01	4.38	6.10
Return on equity (ROE)	Midea	7.06	12.24	12.48	14.51	29.60
	Gree	15.53	17.24	18.72	20.18	27.36
Return on invested capital (ROIC)	Midea	16.49	24.15	22.04	24.01	32.84
	Gree	15.68	16.75	22.57	25.68	24.16

Notes: Return on invested capital (ROIC) = (Total income+interest revenue)/(short-term borrowings + long - term liabilities+shareholders' equity).

Data source: Indicators in Table 1 are calculated based on the annual reports of the above listed companies.

Table 2 Comparison of solvency between Gree and Midea from 2003 to 2007

Ratios	Firms	2003	2004	2005	2006	2007
Current ratio (CR, times)	Midea	1.09	0.99	1.12	1.03	1.07
	Gree	1.13	1.02	1.00	0.99	1.07
Ratio of payables to total liabilities (RPTL, %)	Midea	63.95	72.55	68.56	76.13	69.74
	Gree	74.23	67.60	67.68	65.70	54.82
Ratio of unearned revenues to total liabilities (RURTL, %)	Midea	25.00	18.82	13.23	4.18	10.92
	Gree	13.89	21.15	18.63	24.98	23.43
Total debt ratio (DR, %)	Midea	64.72	67.91	59.54	63.84	67.34
	Gree	73.53	80.28	77.84	80.33	77.06
Ratio of interest-bearing debt to total liabilities (IBDR, %)	Midea	4.01	4.59	12.31	6.82	6.90
	Gree	0.05	3.35	3.85	0.49	/

Notes: (1) Total liabilities of the above companies mainly consist of current liabilities; (2) Ratio of payables to total liabilities (RPTL, %)=(accounts payable+notes payable)/total liabilities; (3) Ratio of interest-bearing debt to total liabilities (IBDR, %) = (short-term borrowings+long-term liabilities)/Total liabilities.

Data source: Indicators in Table 2 are calculated based on the annual reports of the above listed companies.

If we list the solvency indicators of Gree and Midea from 2003 to 2007 in a panel, they can be shown in

Table 2. As seen from Table 2: Two companies' total debt ratios are very high, but this figure of Gree is higher. The highest level reaches 80.33%. The current ratios of two companies approach 1, which shows they have made use of current liabilities to the limit. Two companies' ratios of payables to total liabilities are very high. It is clear that they are using a large amount of credits offered by their upstream suppliers. Gree's ratio of unearned revenues to total liabilities is not low, which shows it is using downstream consumers' credits on the other hand. Commercial credits are almost interest free funds except notes payables. While maximizing the financial leverages, two companies keep the ratios of interest-bearing debt to total liabilities at so low levels. Take Gree for example, it can even earn interest revenues in some years. Therefore, its return on equity (ROE) and return on invested capital (ROIC) can reach a very high level.

3.4 Further improving the profitability by supreme working capital management skills

As seen from Table 3: There is almost no difference in days working capital (DWC) between two companies during the whole period, except in the year of 2003 or 2007, Gree's days payables outstanding (DPO) are far longer than those of Midea. In the year of 2003, the greatest positive gap reaches 100 days, which shows Gree enjoys longer payment extension from its suppliers. Therefore, Gree's cash conversion cycle (CCC) is negative. It is clear that its suppliers' fund occupied by Gree can not only meet its ordinary operating requirement, but also can contribute to its long-term investment. For Midea, this phenomenon can not be discovered until the year of 2007. Both Gree and Midea have supreme working capital management skills. Midea operates at negative working capital in 2004, and Gree does so in 2005 and 2006. Two companies' net commercial credits are negative, which shows they operate by similar financial models. Ratios of working capital to total assets of two companies are so low, even negative, which shows the surplus working capital can be used to the projects that can generate more profits.

Table 3 Comparison of working capital management level between Gree and Midea from 2003 to 2007

Indicators	Firms	2003	2004	2005	2006	2007
Days working capital (DWC)	Midea	94.36	96.44	97.93	102.9	44.93
	Gree	67.24	99.88	106.5	95.18	86.25
Days payables outstanding (DPO)	Midea	93.20	88.06	48.48	96.23	69.53
	Gree	193.4	157.1	119.1	124.1	95.94
Cash conversion cycle (CCC)	Midea	1.16	8.38	49.45	6.63	-24.60
	Gree	-126.2	-57.18	-12.62	-28.94	-9.69
Net commercial credits (NCC, 0.1 billion)	Midea	-23.49	-40.97	-29.05	-38.49	-60.26
	Gree	-11.10	-29.36	-25.70	-54.79	-59.12
Ratio of working capital to total assets (WCR, %)	Midea	5.85	-0.83	7.24	2.03	4.61
	Gree	9.62	1.25	-0.14	-0.60	5.18

Notes: (1) $DWC = \text{Days Sales Outstanding (DSO)} + \text{Days Inventory on Hand (DIO)}$; (2) $\text{Cash conversion cycle (CCC)} = DWC - DPO$; (3) $\text{Net commercial credits (NCC, 0.1 billion)} = (\text{accounts receivable} + \text{notes receivables}) - (\text{accounts payables} + \text{notes payables})$.

Data source: Indicators in Table 3 are calculated based on the annual reports of the above listed companies.

3.5 Occupying the key nodes of supply chain to maximize profitability

From a financial management perspective, all supply chains are in fact financial supply chains or capital chains. The performance of financial supply chains depends on how an enterprise designs its supply chain or which key node of an enterprise plans to occupy. In electronic and electrical industry, many enterprises, such as Haier (Qingdao Haier Co., Ltd.), Konka, Sichuan Changhong (Sichuan Changhong Electric Co., Ltd.) and Midea supply their products to SUNING, GOME and other appliance chains via a regional marketing center just as the left route of Fig. 1 shows. Only Gree takes hold of sales section firmly. Therefore, Gree's supply chain follows the

route: raw materials, components suppliers–Gree–regional marketing companies–distributors–franchised stores and other channels, as the central route shows in Fig. 1. It deserves to point out that Midea has adopted the same marketing system as that of Gree since the year of 2007. Obviously, Gree’s practice, i.e. sinking sales terminals into franchised stores through its own channels, will avoid pressure brought by SUNING, GOME and other appliance chains based on their strong bargaining power. The design also makes Gree seize the key node of the supply chain, for which finally determines the level of profitability in the industry (WANG Zhu-quan & MA Guang-lin, 2005).

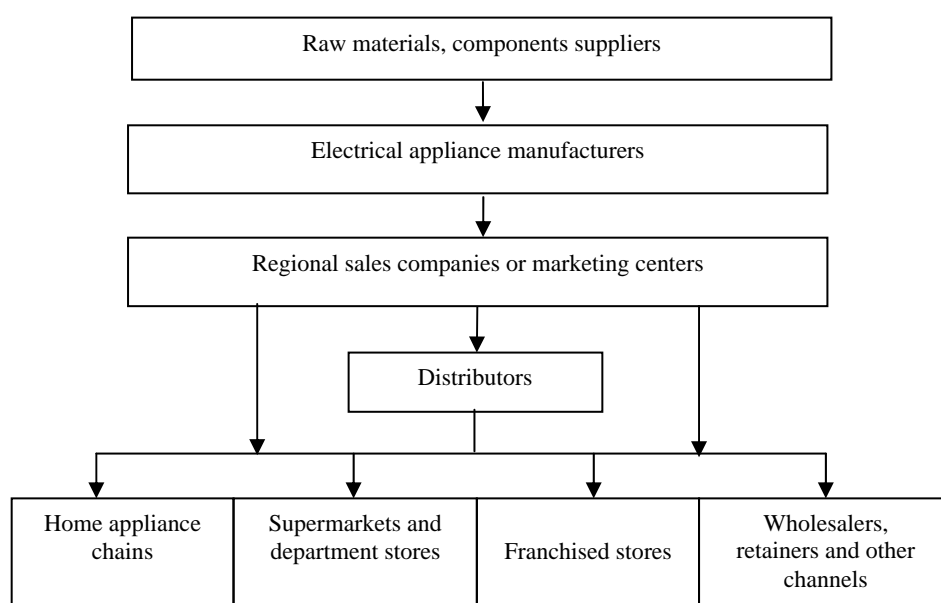


Fig. 1 Typical structure of supply chain in electronic and electrical industry

4. How about the risk of similar financial models?

4.1 Higher risk of short-term solvency

As seen clearly from Table 4, the ratio of operating cash flow to current liabilities of Gree is much lower than that of Midea except in 2007, especially from 2003 to 2006. Gree’s capability of using marketable current assets to pay its short-term interest-bearing liabilities (short-term borrowings+notes payable) is far weaker than that of Midea. Notably, Gree’s higher profits are accompanied with a greater risk. Except in the year of 2006, Gree is weaker than Midea in the ratio of cash inflow from selling goods or services to sales revenue, falling considerably from 91% to 45% from 2003 to 2007. Except in the year of 2006, Gree’s ratio of cash outflow from purchasing goods or receiving services to cost of goods sold is lower than that of Midea, which shows a downward trend—a dramatic drop from 95% to 35%. From the two points mentioned above, it is demonstrated that Gree’s scale of cash flow experiences a shrinking trend, which also reveals Gree is bearing a higher level of risk. Gree’s ratio of operating cash flow to net profit is far below Midea’s from 2003 to 2004 and remains at a very low absolute level. However, during the year of 2006 and 2007, this indicator is considerably improved and exceeds Midea’s. It is because Gree takes the advantage of less cash sales but even less cash purchase so as to keep sufficient net cash sock for operating activities. However, accounts payable are to be paid to suppliers sooner or later. So it is necessary for Gree to prevent its suppliers from asking for cash transactions simultaneously. Midea’s

characteristics of cash flow are quite similar to Gree's in 2006 and 2007.

Table 4 Comparison of risk between Midea and Gree from 2003 to 2007

Ratios	Firms	2003	2004	2005	2006	2007
Ratio of operating cash flow to current liabilities (CLR, %)	Midea	31.27	17.12	32.67	14.09	14.00
	Gree	2.28	1.33	7.84	13.66	14.19
Ratio of short-term interest bearing liabilities to marketable current assets (IBLR, %)	Midea	28.02	93.91	100.8	74.64	88.92
	Gree	1.55	37.55	38.75	26.57	14.67
Ratio of cash inflow from selling goods or rendering services to sales revenue (CSR, %)	Midea	1.14	1.16	1.12	0.49	0.62
	Gree	0.91	0.70	0.67	0.58	0.45
Ratio of cash outflow from purchasing goods or receiving services to cost of goods sold (CCR, %)	Midea	1.07	1.23	1.17	0.34	0.52
	Gree	0.95	0.68	0.63	0.48	0.35
Ratio of operating cash flow to net income (OCR, times)	Midea	9.92	3.89	4.86	2.21	0.98
	Gree	0.41	0.32	1.52	2.79	2.17

Notes: (1) Ratio of short-term interest bearing liabilities to marketable current assets (IBLR, %)=(short-term borrowings + notes payable)/(current assets—inventory—accounts receivable—deferred charges).

Data source: Indicators in Table 4 are calculated based on the annual reports of the above listed companies.

4.2 The risk generated from expansion of scale

Both Midea and Gree are leading enterprises among the industry. As seen from Fig. 2 and Fig. 3 below, their sales revenue increases from about 10 billion Yuan to about 35 billion Yuan from 2003 to 2007. This figure of Gree shows faster growth, rising from 10.042 billion Yuan to 35.798 billion Yuan with an increase of 256.48%. During the same period, two companies' total assets jump from 8 billion to 25 billion. Gree performs better, whose total assets stand at 8.289 billion Yuan in 2003 and rise to 25.548 billion Yuan in 2007 with an increase of 208.22%. We should pay attention to so high a growth rate when we draw lessons from the collapse of Kelon (Kelon Electrical Holdings Co., Ltd.) led by GU Chu-jun before August, 2005. When rapid expansion encounters great depression, the similar financial models will go through a period filled with amplified risks. When short-term floating funds are invested on long-term projects, it is quite possible that we will suffer much from low return on investment or inefficient investment. It is absolutely necessary for us to learn lessons from Kelon and GOME.

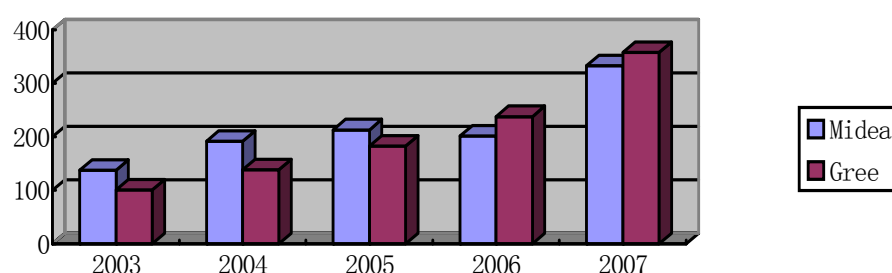


Fig. 2 Revenue comparison between Midea and Gree from 2003 to 2007 (Unit: 0.1 billion Yuan)

Data source: The data derives from the annual reports of above two companies.

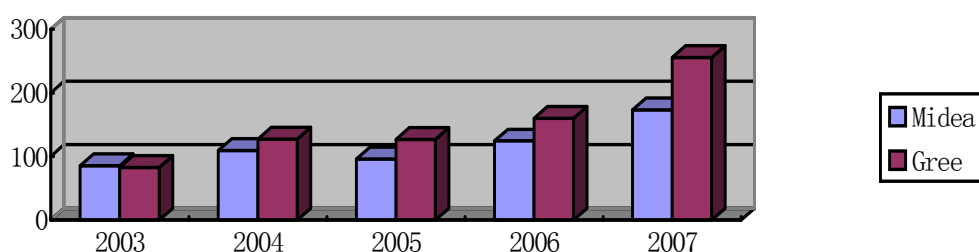


Fig. 3 Comparison of total assets between Midea and Gree from 2003 to 2007 (Unit: 0.1 billion Yuan)

Data source: The data derives from the annual reports of above two companies.

4.3 Risks caused by changes of policy, financial and industrial situations

(1) If the suppliers are pessimistic to the future of the companies with similar financial characteristics, their desire to collect receivables instantly will be so strong that they only ask for cash transactions. The capital supply chains of similar financial companies may break down.

As GOME's semi-annual reports of 2008 show (CHENG Nuo & TANG Gu-liang, 2008), its amount of loans from Chinese banks mature within one year is more than 0.2 billion Yuan, while the amount of payables is up to 14.302 billion Yuan. As a result, these banks are so worried about its solvency that they require GOME to provide cash deposits which amount to 61.71% of its payables plus a third-party guarantee. The direct result is that GOME needs enough guarantees for acceptance of its notes payables. Such requirement will seriously affect its efficiency of capital circulation. SAMSUNG (Samsung Electronics Co. Ltd.)'s headquarters has asked its subsidiaries to stop supplying for GOME. More and more home appliance enterprises have lowered GOME's solvency level, and stopped the non-cash transactions between GOME and themselves. They have changed their trading policies: From sales on account to cash transactions to avoid potential losses.

(2) How long the "expelling suppliers to make profit" model will last depends much on Chinese government's policy

The State Commercial Affairs Department, the State Development and Reform Commission, the Ministry of Public Security, and the State Administration of Taxation released *The administrative measures for fair transaction between retailers and suppliers* on October 18, 2006. This regulation defines principal stipulations over three aspects: retailers' risk-bearing in inventories, collection of channel fees and the payment period. Article 14 of the regulation rules that the retailers and suppliers must clearly stipulate the payment term in the agreement according to the commodity attributes, and that the longest payment period is 60 days after retailers receive the goods. The regulation has begun to restrict retailers from occupying suppliers' capital. Gree's behavior of over occupying its suppliers' capital will not last long.

(3) Now, many big suppliers have strong symptoms because their capital is occupied

Weaker suppliers will be eliminated in the survival competition. The survivors will have more bargaining power, resulting in more difficulty for the companies with similar-financial attributes to occupy their suppliers' capital. And thus similar financial companies fall into a vicious cycle. Therefore, the key for businesses to earn profit continuously and be built to last lies in how the retailers deal with relationships among them, their suppliers and customers and realize a win-win result (WANG Zhu-quan, JIANG Yong-mei & SUN Jian-qiang, 2007).

5. Positioning companies according to their sales-collection planning and purchase-payment arrangement

As described by the following two-dimensional quadrant (QIAN Ai-min, ZHANG Xin-min & ZHANG Shu-jun, 2008) (Fig. 4), from 2003 to 2007, Midea can be positioned in the third quadrant which means sale on account and purchase on credit. It is undoubtedly GOME can be positioned in the forth quadrant which means purchase on credit and sale in cash because GOME sells its goods in cash but delays its payments to customers. Based on the same reasoning, Gree can be located in the third quadrant from 2003 to 2005. But it is in the fifth quadrant which means purchase on credit and sales after receiving down payment from 2006 to 2007 because Gree has relatively larger amount of unearned revenues. Therefore, Gree's similar financial attributes are no less or even more than those of GOME and SUNING.

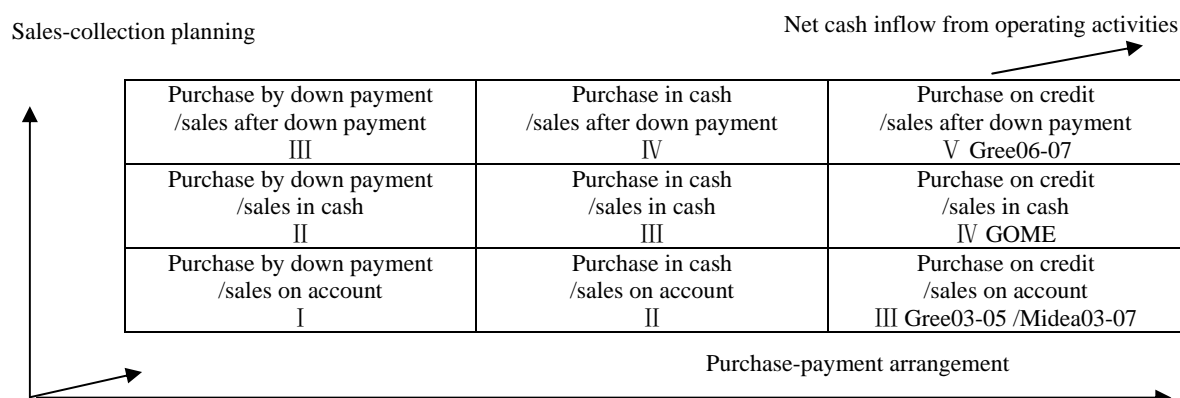


Fig. 4 Influences of sales-collection planning and purchase-payment arrangement on the adequacy of net cash inflow from operating activities

Notes: Other companies absolutely occupy a company's capital at two stages: payment in advance and late collection; Other companies partially occupy a company's capital at one stage: payment in advance and sales in cash; or purchase in cash and late collection; Other companies and a company mutually occupy capital, or vice versa. Payment in advance and sales by down payment; trading in cash or late collection and quite later payment; A company occupies other companies' capital at one stage: purchase in cash and sales by down payment or purchase on credit and sales in cash; A company absolutely occupies other companies' capital at two stages: late payment and sales by down payment.

6. Conclusion

Both Midea and Gree are most comparable companies because they manufacture the same products: air-conditioners. Gree belongs to original manufacturing similar financial company, while Midea is a mimic one. Two companies implemented supply chain management, Gree in 2005 and Midea in 2000. Switching successfully from physical supply chain to the financial one is the key to all forms of supply chains (WANG Zhu-quan, LIU Wen-jing & GAO Fang, 2007; WANG Dong-mei, 2005). As seen from the above three companies' indicators, the more obvious of a company's similar financial characteristics are, the higher the profitability is. However, the financial risk, implicit one in particular, is accordingly higher. There are no free lunches in the world.

As seen from above analysis: Similar financial models are not only suitable for electronic and electrical appliances chain enterprises, but also for other sectors such as home appliances manufacturing, real estate and hairdressing (New Wealth, 2008). The companies which implemented similar financial models generally have the following characteristics:

- (1) Net profit margin is very low, i.e., 1%-3%, no more than 5%.
- (2) Inventory and total assets turnover are high; ROA is acceptable and higher than the corresponding interest

rates of bank loans.

(3) Total debt ratio and financial leverage are higher or very high, resulting in higher or very high ROE.

(4) Net working capital may not be negative.

(5) Interest revenue is always more than interest expense.

(6) Ratio of interest-bearing liabilities to total liabilities may not be high.

(7) Have implemented supply chain management.

(8) Have strong bargaining power or enough voice with their strong brands or high-value channels in the supply chains.

The above features can be seen as a prerequisite for those companies which plan to implement similar financial models. Among them, enough voice in the supply chain because of strong brands or high-value channels is the crux of the problem (Tim Reason, 2005; Randy Myers, 2006; Randy Myers, 2007). It is particularly important.

Finally, it should be noted that the conclusion of this article is based on a series of case studies. The conclusions of case studies may not be universal. This may be a shortage of this article. The author plans to do follow-up empirical studies in the near future to obtain more universal conclusions and some useful enlightenment.

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