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# Financing from Customers for Small and Medium-Sized Enterprises and Managing Financial Risks: The Role of Customer Relationships

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***Abstract*—**This study investigates how Chinese Small and Medium-sized Enterprises (SMEs) manage financial risks in financing from customers from the perspectives of ethics and national culture. A grounded theory approach is adopted to identify the causal conditions, actions/interactions, and consequences. 32 interviews were conducted, and systematic coding methods were used to identify themes and categories. This study found that Chinese ethical principles, including integrity, friendship, and reciprocity, and cultural traits, including collectivism, acquaintance society, and long-term orientation, provide conditions for financing from customers. The SMEs establish trust-based relationships with customers through personal communications and social networks and reduce financial risk through diversification, frequent operations, and enterprise reputations. Both customers and SMEs can get benefits like financial resources and customer experiences. This study creates a theoretical framework that connects the causal conditions, processes, and outcomes, providing a deeper understanding of financing from customers. A resource and process capability theory of SMEs and a customer capital and customer value model are proposed to connect accounting and finance concepts. Suggestions are proposed for the authorities as more guidance and regulations are needed for this informal finance.

***Keywords*—**Culture, Customer Relationships, Small and Medium-sized Enterprises, SME, Risk management.

## I. Introduction

SMEs are critical to the economic development of any country. In China, SMEs account for over 90% of all businesses and contribute to over 60% of the country's GDP [37]. Despite their importance, SMEs in China often struggle to access financing, which hinders their growth and survival. The financing gap remains a significant challenge, with SMEs facing difficulties such as the lack of collateral, high transaction costs, and asymmetric information. Historically, commercial banks in China have focused on lending to large state-owned enterprises (SOEs) and have been reluctant to lend to SMEs due to their perceived high risk. Although commercial banks in China are gradually increasing their lending to SMEs [1], the financing gap remains a critical issue. For instance, a study by Cheng et al. [2] found that SMEs in China face higher borrowing costs than large enterprises, particularly for smaller and younger SMEs. Another study by Wu et al. [3] found that the lack of collateral remains a significant obstacle to SME financing in China.

Financing SMEs from customers, also known as "customer financing," is a financing model that involves raising capital directly from customers. This model is particularly relevant for SMEs that have established relationships with their customers, as it allows them to leverage their customer base to raise capital. Recent empirical studies have shown that customer financing can be an effective financing model for SMEs. For instance, a study by Fornaro and Woerter [4] found that SMEs that use crowdfunding as a financing source experience a higher growth rate than those that do not. Another study by Zhang et al. [5] found that customer financing can reduce SMEs' cost of capital and increase their financial flexibility.

However, customer financing also has some limitations and challenges. For example, SMEs may face difficulties in managing customer capital and high costs in customer financing. Customers may face the risk of default and lack of legal and regulatory guidance. Therefore, in order to obtain a better understanding of this phenomenon, this study investigates the process of customer financing from customer and SMEs' perspectives, evaluates the effectiveness of this financing model, identifies problems and proposes practical suggestions for Chinese SMEs and policymakers.

The next section reviews relevant literature, identifies research gaps and justifies research questions. Section III discusses the research methods adopted in this study. Section IV presents findings, and conclusions are followed in Section V to make theoretical and practical implications.

## II. Literature Review

### *A. The Role of SMEs*

SMEs play a crucial role in economic and social development worldwide. SMEs are considered the backbone of many economies and have been widely recognized as engines of growth, innovation, and job creation. In recent years, there has been an increased interest in understanding the role of SMEs in economic and social development. Firstly, SMEs have long been recognized as key drivers of economic development. They contribute to the creation of jobs, the promotion of entrepreneurship, and the development of innovative products and services. Al Mamun and Sohail [6] found that SMEs significantly contribute to economic growth in developing countries. Similarly, a study by Manolova et al. [7] found that SMEs are critical for promoting innovation and economic growth in emerging economies. Another study by Prasad and Yadav [8] found that SMEs are an important source of

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employment and contribute significantly to poverty reduction in developing countries.

Secondly, SMEs play an important role in social development by providing employment opportunities, empowering individuals, and fostering community development. Ratten and Usmanij [9] found that SMEs are a significant source of employment in many countries and can help to alleviate poverty and promote social inclusion. Todorović et al. [10] found that SMEs can contribute to sustainable community development by creating local employment opportunities, supporting local suppliers, and investing in community development projects.

However, SMEs face several challenges including limited access to finance, lack of infrastructure, regulatory barriers, and limited access to markets. For example, a study by Baah et al. [11] found that access to finance remains a significant challenge for SMEs in developing countries. Chen et al. [12] also found that SMEs face significant regulatory barriers in China. Although Bönte and Keese [13] found that the use of digital technologies can help SMEs overcome market barriers and improve their competitiveness, SMEs still face other challenges like financing operations and strategic development.

### *B. Financing Challenges Faced by SMEs*

Access to financing is one of the most significant challenges faced by SMEs worldwide. SMEs often lack collateral and a credit history, making it difficult to access traditional sources of financing. Moreover, the high cost of borrowing and lack of access to long-term financing are additional challenges. Beck et al. [14] found that SMEs in developing countries face more significant financial constraints than those in developed countries. They suggested that SMEs' access to finance can be improved through financial sector development, such as promoting competition among financial institutions and improving the legal framework.

SMEs in China have difficulties accessing bank loans due to a lack of collateral [3]. Zhang et al. [1] found that government policies that promote bank lending can help alleviate this problem, such as the provision of government credit guarantees. Li et al. [15] found that credit guarantee schemes and tax incentives can significantly improve SMEs' access to finance. Another financing challenge faced by SMEs is the high transaction costs associated with obtaining loans. SMEs often lack the expertise and resources to navigate the complex loan application process, which can be time-consuming and costly. This can result in SMEs being discouraged from seeking financing or being forced to pay high fees to intermediaries such as brokers or consultants [1]. Yu and Zhang [16] found that local government financial support can improve SMEs' productivity and profitability, particularly for firms in less-developed regions.

Furthermore, SMEs often face asymmetric information problems, where the lender has less information than the borrower about the project or business, leading to adverse selection and moral hazard issues. This makes it difficult for lenders to assess the creditworthiness of SMEs and leads to higher interest rates or rejection of loan applications [17]. Xu et al. [18] argue that business group affiliation can increase SMEs' access to bank loans, while political connections can increase their access to government grants. Lin and Sun [19] found that good corporate governance can increase SMEs' access to bank loans, especially for firms with weak financial conditions.

Informal financing, such as family and friends' loans and trade credit, is an essential source of financing for SMEs. However, the reliance on informal financing can limit SMEs' growth potential, as it is often limited in terms of the amount and duration of financing available. Miao et al. [20] found that informal financing is the most significant source of financing for SMEs in China, but it is not enough to meet their financing needs. Furthermore, technology and innovation can play a vital role in addressing SMEs' financing challenges. For instance, the emergence of fintech has led to the development of alternative financing models, such as peer-to-peer lending and crowdfunding, which provide SMEs with an alternative source of financing [4]. In recent years, fintech has emerged as a new source of financing for SMEs in China, particularly for younger and smaller firms [21].

### *C. Financing from Customers*

Financing SMEs from customers is a financing model that involves raising capital directly from customers. Customer financing can take various forms, including pre-sales, advance payments, and crowdfunding. Pre-sales can be particularly useful for SMEs that need capital to fund production or inventory. For instance, Berglund and Olofsson [22] found that pre-sales can be a viable financing option for early-stage SMEs in the fashion industry, as it allows them to finance their inventory without having to rely on expensive bank loans. Advance payments can be particularly useful for SMEs that provide customized or personalized products, such as software or consulting services [23]. Crowdfunding can be particularly useful for SMEs that have a strong social media presence or that provide unique or innovative products or services [24]. Customer financing can be an effective financing model that helps SMEs overcome the financing gap and obtain less expensive capital than traditional forms of financing, such as bank loans or venture capital [5].

However, customer financing also presents some challenges for SMEs. One of the main challenges is the risk of customer default, which can have a significant impact on SME’s cash flow and operations. A study by Cholakova and Clarysse [25] found that SMEs that rely on crowdfunding as a financing source can face challenges such as managing customer expectations and dealing with customer complaints. Moreover, customer financing also has some limitations and challenges, such as the need for a strong customer base and the risk of managing customer expectations and demands.

In general, SMEs play a critical role in economic and social development. However, SMEs also face significant challenges, in particular, limited access to finance due to lack of collateral, high transaction costs, and asymmetric information. Customer financing can be an option for SME financing and can provide several benefits including overcoming the financing gap and reducing the cost of capital. However, SMEs must carefully consider the risks and challenges associated with customer financing and more research is needed to further explore the challenges and opportunities facing SMEs and identify solutions. Therefore, this study investigates how SMEs manage risks and challenges from ethical and cultural perspectives.

## III. Research Methods

A grounded theory approach [26] is adopted in this research, which involves the development of a theory based on empirical data collected through observations, interviews, and other forms of data collection. The purpose of this study is to develop a theoretical understanding of the phenomenon and therefore grounded theory is suitable as a qualitative research method that emphasizes the inductive development of a theory from the data. Grounded theory involves several stages, including data collection, coding, categorization, and the development of a theoretical framework. Grounded theory has been used to study various aspects of financing SMEs in China, including the role of government policies in SME financing [27], the impact of financial constraints on SME growth [18], and the effectiveness of different financing models [28].

The target population for this study includes SMEs that have used customer financing as a financing source in China. A purposive sampling strategy [29] is used to select SMEs that have experience with customer financing and that are willing to participate in the study. The sample size for this study is 20 SMEs, which is considered sufficient for a qualitative study of this nature [26]. Data collection methods include in-depth interviews with SME owners and managers, as well as observations of SME operations. The interviews are semi-structured, allowing for flexibility in the questions and responses. The interview questions focus on understanding the motivations, challenges, and outcomes of customer financing from the perspective of SMEs. The data collected from the interviews and observations are coded and categorized using a grounded theory approach. The data analysis involves several stages, including open coding, axial coding, and selective coding [30]. Open coding involves the identification of concepts and categories from the data. Axial coding involves the development of relationships between the categories. Selective coding involves the integration of the categories into a theoretical framework.

The theoretical framework developed from the data is validated through member checking, which involves presenting the findings to the participants and seeking their feedback. Member checking is a common method for validating qualitative research findings and ensuring that the findings accurately reflect the participants' perspectives [31]. The findings of this study are expected to contribute to the understanding of customer financing as a financing model for SMEs in China and to provide practical implications for SMEs and policymakers. The next section presents the findings of this study.

## IV. Findings

A grounded theory model (Fig. 1) is developed to present the findings where customer financing is a central phenomenon studied in the context of Chinese SMEs. Ethical concepts and cultural traits are causal conditions which influence the perceptions and actions of SMES and their customers. Chinese ethical principles including integrity, friendship and reciprocity and cultural traits including collectivism, acquaintance society and long-term orientation are conditions for customer financing for SMEs. The SMEs establish trust-based relationships with customers and open financial accounts for customers where customer capital and drawings are recorded. SMEs maintain and improve relationships through personal communications with customers, expand customer base through recommendations and finally build a social network through customer relationship management. The SMEs manage financial risk through diversification, frequent operations and enterprise reputations for reducing financial risks. Customers have great experience and get financial rewards through dividends, vouchers and discounts. SMEs can get financial resources and increase their customer base. However, there are some difficulties and problems in customer financing, for example, customers may face default problems and no legal and regulatory guidance for them. SMEs may increase financial costs when financing from customers.

### *A. Context – Chinese SMEs*

In the context of Chinese SMEs, customer financing has emerged as a promising financing model for SMEs. As SMEs often struggle to access bank loans due to their lack of collateral and credit history, customer financing allows them to leverage their established relationships with customers to raise capital. This model has been adopted by many SMEs particularly those in customer service and consumer goods sectors. The SME opens an account or issues a customer card for a customer and records activities, financial changes, and balances for customers. For example, a 40-year-old male customer of a hairdressing salon expressed that:

> "I have a personal account with the enterprise, and I have my hair cut here at least once a month. I put 1000 RMB in my account and topped up my balance when it dropped to 500. I just show my club card or tell them my telephone number and they will record my consumption and adjust my balance and I do not need to carry a bank card or any cash." (N1C)
>
> "I am the owner and manager of this shop, and we invested 100 thousand RMB, but we need more money to pay suppliers and bills. We can only borrow a small amount of money due to government policies. We have more than 2 thousand active customers and most of them have kept a stable balance in their accounts for many years. This is a long-term capital for our enterprise, and we can use the money to buy more products for customers." (N7M)

### *B. Causal Conditions: Ethics*

Integrity

90% of SMEs argued that integrity is a fundamental principle in their business ethics which is also a basic condition for financing from customers. Integrity shows the quality of the enterprises being honest and having long-term strong moral principles. Honesty has been a fine virtue in Chinese tradition for thousands of years. For SMEs, honesty is regarded as an important cornerstone. They develop a code of conduct to bring actual benefits to customers and establish relationships with consumers. If an enterprise provides lower quality products or services, for example selling or using counterfeit and shoddy products, and charging unfair prices, it will not only be boycotted by consumers. For example, a sales manager at a local grocery shop says that:

> "'A business cannot prosper without integrity.' We have many local and loyal customers who buy our products every week, even every day. Our products are genuine and of good quality and with fair prices, otherwise customers would not buy any more and even report us to the authority. We provide good service for them with enthusiasm and patience; otherwise, they would not come back as they have many choices. Only those long-term customers will have a customer account and put money in their account and keep a stable balance." (N2M)

Friendship

More than 80% of interviewees emphasize the importance of friendship in establishing relationships between SMEs and their customers. A good customer relationship can be built only when customers have consistent experience and leave a good impression. There will be mutual regard and understanding between customers and SMEs for a long period of time. When SMEs are doing business with long-term customers, both parties feel comfortable and relaxed. Having friendships with customers makes work more enjoyable, more productive, and more efficient. For instance, a manager in a restaurant shares his experience expressing that:

> "As human beings, we all have emotional needs. We need to experience friendship when communicating with other people. We want our customers to 'feel at home' when they come to our restaurant. We meet customers like old friends, and they bring their friends to us. Customers not only bring in profit but also promote our products and services to others. A true friend will be an "Apple Fanboy" who buys all of our products and shares with their friends." (N3M)

Reciprocity

Most interviewees expressed that reciprocity is important which means that both SMEs and customers need to get fair benefits. Fair trade is a fundamental principle in any business activity, and it has been embedded in Chinese culture. Firstly, SMEs need to respect their customers and treat customers fairly although SMEs have information advantages and dominant status. Secondly, customers should get a fair return when SMEs finance their operations from customers. For instance, a customer of a grocery shop expresses that:

> "We believe both SMEs and customers should get fair benefits and if our customers cannot get fair benefits, they would not stay with us for a long period of time. 'There are no waves without wind.' This is a competitive market, and our terms and conditions need to be competitive." (N4M)

### *C. Causal Conditions: Cultural Traits*

Collectivism

Interestingly, 80% of interviewees' perceptions represent a highly collectivist culture which means a group of people may be more powerful than any person. Collectivists value personal relationships, harmony within groups and social reputations. People see themselves as part of a group and work together to achieve a collective goal rather than focus on their own individual targets. As a result, people cooperate with each other to take collective responsibilities to support and protect collective interests and even sacrifice personal independence. For example, a medium-sized construction company manager says that:

> "'Unity is power'. An individual person is weak and cannot do everything. 'As one fence needs three stakes, a good guy needs three fellows. When there is a team, wonderful things will happen. 'We are one in all and all in one.' In particular, we need to work together with our customers. They are like our parents who give us money, ideas, and pressure, and without them, we cannot do anything." (N5M)

Acquaintance Society

Some 70% of interviewees believe that they are living in an acquaintance society. Many people live in a big city or a big community nowadays, but they do not know each other and do not usually interact with neighbours. People tend to have a small society where they know each other, trust each other and would like to do things together. This is a condition for connecting with a group of customers and financing from customers. For example, a woman, as a club member of a local gym, shares her thoughts.

> "A Chinese proverb says that 'birds of a feather flock together'. I have some lifetime close friends (Gui Mi) and we have common interests and hobbies. We get together regularly, and we do things together. We always come to this gym to do exercise and we are all club members here. My friends recommended this gym to me, and one of the managers is her relative who takes good care of me every time." (N6)

Long-Term Orientation

Most interviewees (90%) exhibit a long-term orientation and expressed that they would think about the future when interacting with others. Customers would consider the long-term benefits when they choose products and services and decide where and how to use their money. SMEs would consider how to get financial resources at the current time and how to use the resources efficiently in the future. For example, a female customer of a local supermarket expressed that:

> "A Chinese proverb says that we always need to 'plan' or 'get ready for the rain'. Mencius told us that 'preparedness ensures success, unpreparedness spells

failure'. I would like to plan my money for the future. I have a budget for my living cost and save my money in this shop and I do not worry about my future living for the whole year." (N7C)

These ethical principles and cultural traits provide fundamental conditions for SME customer financing along with other causal conditions like advances in technology, private financing and limited financial markets and institutions. Therefore, SMEs can acquire and keep their customers and further use customers as a source of financing. Customers invest money in SMEs for the long-term (capital) and get returns in terms of different benefits including vouchers, discounts, and cashback to their account (customer value). However, there are still many problems in this financing model, for example miscalculation, theft, technical problems, even accounting fraud and premeditated financial fraud. Because of legal and regulatory difficulties, it is hard to investigate the cases and recover the losses. Reported cases on TV and social media reduced market confidence and even caused social uncertainty. This study further explores how SMEs and customers manage risks in particular financial risks in customer financing.

### *D.Perceptions and Actions*

#### Trust-Based Customer Relationship

The interviewees believed that trust-based customer relationships are important in customer financing. This relationship (Guanxi) refers to having personal trust between SME managers and customers. Customers need to trust the managers and then transfer their money to the enterprise. This relationship is very informal and sometimes has no legal terms but moral obligations. The enterprise builds trust with customers through long-term transactions or personal recommendations. In Chinese traditional culture, people need to keep their promises and build a reputation in their acquittance society and treat personal reputation as an important asset. SMEs see customer relationships as an important social capital and customer financing provides important financial capital. SMEs and customers would avoid any actions that could damage their relationships, thereby reducing the default risk. For example, a manager of a local leisure centre shares his opinion:

"There are more than 1000 active club members in my club, and they are my old friends or friends' friends. I would take good care of them, and would not like to lose our friendships, and would never cheat them. We are living in a human world and cannot survive without friends. 'Face is as important to man as the bark is to the tree.' If I did anything wrong even a careless mistake, I would feel shameless, and it would be very embarrassing for me to see any friends." (N6M)

#### Communication

A majority of interviewees argue that they communicate regularly with customers to keep and enhance their relationships. The communications could be a seasonal greeting, updating account information, or even sending a birthday present. Moreover, the SMEs can promote any new deals or cross-sell other products. More than half of the interviewees emphasized that communication should be detailed and personal as people are emotional and sensitive and they can feel if the behaviour is whole-hearted or hypocritic. For instance, a customer of a local shop conveys that:

"The shop contacts me very often through a telephone call, or a text message or posting a card or a small gift. 'It's the thought that counts.' When I received a birthday card from them it was heart-touching. They remember my birthday and give me blessing words. We need to exchange favours, and I can update my account or bring more friends and businesses to them." (N7C)

#### Network

The interviewees argued that satisfied customers were more likely to refer to others, which increased sales and generated more profit. In this case, SMEs build a large and solid customer base, and customers may bring suppliers and partners, and gradually the enterprise builds a business network including a supply chain, a sales chain and a social network including relationships with other organizations and local communities. For instance, a manager of a local entertainment centre says:

"If one day I meet a gentleman that I do not personally know, I know he must have a relationship with other managers or other customers. It is a good way to get an advocate and get new clients by word of mouth at the marketplace, by recommending us to their friends. This is a small world and who knows when or where we will need him? Moreover, 'good things don't go out, bad things spread thousands of miles.' We need to be careful at any time." (N8M)

The above themes explain that because people value their relationships, financial risks in customer financing are reduced. Customers trust the managers and therefore invest their money in the enterprises. Information asymmetry decreased through information exchanges in regular communications. Default risk is reduced because damaging a business and social network causes huge losses. Furthermore, both SMEs and customers manage financing risk in customer financing through other activities like diversification of financial resources, frequent operations, and business reputation.

#### Risk Management: Diversification

More than half of the interviewees indicated that an enterprise should not be over-reliant on a single customer or group of customers, which can lead to a concentration of risk. Customers would not invest a huge amount of money in a single enterprise. SMEs diversify their financial resources and get money from a big customer base while customers invest funds in a variety of sectors and enterprises. Most SMEs operate in food, household items, and daily service sectors in which customers do not spend much money. For example, a customer of a local dry cleaner expressed that:

"I do not mind keeping some money in my account with the enterprise as this is a good investment opportunity and convenient for my consumption. But I would not put a lot of money as just in case this small shop goes bankrupt, I would get a huge loss. 'Do not put all your eggs in one basket.' There are many other cardholders, and as 'small steams merge into big rivers' they will get enough working capital from everybody." (N9C)

Frequency

SMEs prefer that customers visit them frequently. Firstly, in the retail market, the marketplace needs popularity. Managers would love a busy market, not a quiet hall. Secondly, customers monitor the enterprises' activities frequently and they know the enterprise is a vivid organization and are full of confidence. Finally, frequent transactions or regular communications will improve relationships and add more value to the enterprises and customers. For instance, a manager of a local clothing shop says that:

> "We always say 'I'm not afraid that you won't buy, but I'm afraid that you won't come.' If you come frequently, you will know better about our products and operations. There will be a possibility that you will buy products from us. Other people see we have many customers, and they presume this is a good company and may come to us as well. I want to see my customers' accounts change frequently not a 'dormant account'." (N10M)

Reputation

70% of interviewees believe in that the Chinese culture reputation (Face), a desire for respect from others, is very important. Therefore, enterprise managers and customers like to keep their promises, even informal commitments, to protect their reputations. Reputation is important, particularly within a small community and among acquaintances in their daily life. Many SMEs use their family name as the company or brand name, and they treat this reputation as a business image (Face), and a valuable asset. There are many time-honoured local brands with reputations built over hundreds of years and across generations. These businesses would not engage in any opportunistic behaviour that could destroy their well-established reputation, thus reducing business risks. For example, the owner of a local restaurant says:

> "I inherited this restaurant from my father, and he inherited it from my grandfather. This restaurant has hundreds of years of history with special formulae and skills. I would like to protect this family's honour and if I destroyed its reputation, I have no face to see my friends and see my ancestors after death. Not only is it a business investment but also an emotional investment." (N11M)

*E. Consequences and Problems*

Customer Experience

A majority of the interviewees mentioned that they would like to improve customer experience, defined as customers' holistic perception of their interaction, consumption, retention, and advocacy with the enterprise. The case SMEs measure customer experience by conducting customer satisfaction surveys. Only satisfied customers bring sustainable profits and invest their funds in the enterprise. In order to improve customer experience, enterprises need to understand customers, including their preferences and even personal characteristics, deliver high-quality products and services, think of, and feel for customers. For example, a customer of a local restaurant shares that:

> "I often go to that restaurant as I like the food they make. When I am in the restaurant, I feel comfortable, and they know what products I like and even keep the drink that I did not finish last time. They treat me well and I reflect well. 'We stand in each other's shoes'. I have an account and they just record my consumption when I check out. It is convenient. I always come with my friends and recommend this restaurant to them." (N3C)

Financial Reward

Both SMEs and customers believe that this relationship should be a mutually beneficial and win-win relationship in terms of financial return on customer financing. Financial reward to customers includes a discount on the price (5-10% off on sale), gift vouchers with restored funds or advanced payment (usually 10–20%), add on balance at the end of the year (5-10%), gift products on top-up balance (5–10% market value) etc. For example, a customer of a local hairdressing salon says:

> "I always come to this salon, and they do my hair very well. They always give me a good deal, even a special offer like 20% off when I show my VIP card to check out or tell them my account which is my telephone number. They have the product I like, and I want to buy the products, but they give me a gift when I top-up my account. They sent me a proposal that said bring your friends to us and you will get a 100 RMB voucher." (N1C)

Problem: Default

The interviewees mentioned some problems in customer financing. Among others, the most serious one is default, where the enterprise fails to deliver the promised products or services or are unable to refund pre-paid funds and required interests. One of the common reasons is that the enterprise could not finish the products and broke promises due to other related risks. Another reason is that the enterprise closed or went bankrupt due to bad management, which meant customers could not get full refunds back. Sometimes, the promoter or the owner of the enterprise embezzled the funds with fraudulent practices. For example, a customer of a local construction company describes that:

> "I would like to buy a new home and a local construction company planned to build some apartments in my town. They would give me a good deal, 20% off the market price and allow me to be involved in interior design. One of my friends recommended the company to me and I prepaid half a million RMB deposit. However, the company could not complete the project and could not refund my deposit. The manager disappeared recently, and I suffer the loss." (N5C)

Financial Resources

The case SMEs use customers as a financial resource not only from customers after sales but also from customer investment. Big companies can get financial resources from capital markets by issuing shares or other securities, loans from financial institutions and other financial support from governments and organizations. SMEs are constrained in accessing these financial resources due to regulation, credit risk and lack of collaterals. Informal finance allows SMEs to get funds from customers as customers can prepay for their consumptions. Typically, the prepayments for products and services are considered as a short-term liability and recorded in a liability account as the amount will be cleared within 6 or 12 months. But if the customers keep the balance for more than 12 months and are involved in operational and financial activities they are recognized as funding providers. For example, a manager of a gym explained that:

> "We will need a lot of working capital to run this gym, but it is very hard to get a loan from banks. There are more than 1000 club members, and everyone keeps at least 1000 RMB in their accounts. We have cleared our liabilities owed to other parties and our customers are the stakeholders and we are managing this enterprise for them and serving them. We are working as a member society." (N6M)

Customer Base

The case SMEs treat the customer base as a fundamental asset and a source of profit and capital. A customer base is a group of clients who do regular operations and have a relationship with the enterprise for the long term. Sometimes financial analysts measure an enterprise value by using customer value. Without a strong customer base, SMEs cannot have a competitive advantage over others and it is not possible to get finance from customers in advance. To build and maintain a customer base, enterprises need to consistently provide high-quality products and services, offer fair benefits or returns to customers and keep regular emotional and informative communications. For instance, a manager of a local shop conveys that:

> "I would like to keep long-term relationships with them, and they visit our shop regularly and keep their money in the shop. You know I need money to purchase the goods and sell the goods. However, I will treat them honestly and fairly as I know we cheat them once they leave immediately and never come back. This is 'Vote by foot' as they have other choices. We are all human beings, and we need to 'return a favor with a favor'." (N7M)

Problem: Financial Cost

More than half of the case enterprises argue that the financial cost of customer financing is high and volatile. The financial cost of customer financing refers to the weighted average cost of capital received from customers including the returns to customers in terms of discounts on prices, gift vouchers and other management costs of customer capital. Moreover, the total customer capital should be adjusted by the possibility of withdrawal. Normally the enterprises will need to prepare a 10% reserve for customer lump withdrawal. The managers estimated that the cost of customer financing is over 20% on average and even higher during a quiet season of consumption. For example, a manager of a local restaurant expresses that:

> "Customer financing is not easy and not cheap. Firstly, we need to take time and effort to establish trust and credibility, to accumulate a solid customer base and then to attract enough deposits from customers. Secondly, we need to pay them well, which is much higher than bank loan interest rates. Thirdly we need to keep a stable reserve but if many customers leave us, we will get into trouble. Finally, it increases bankrupt cost as customers see this as an unlimited liability rather than invested capital or a limited liability." (N13M)

The above themes show the benefits to enterprises and customers but also potential problems for both parties. Moreover, customer financing is very informal and if anything goes wrong the solution might be complicated, which causes legal and even social problems. Moreover, customer financing is only suitable for some SMEs that have a customer base and operate in feasible industries.

## V. Conclusion

SMEs are critical to economic and social development but often struggle to access financing, because of lack of collateral, high transaction costs, and asymmetric information. Customer financing which involves raising capital directly from customers, is a popular model in China to alleviate the financing challenges faced by SMEs. However, more research is needed to explore this innovative financing model and to get a better understanding. This study identifies the fundamental causal conditions for this phenomenon, in particular ethical and cultural factors. This study investigates the financing process and particularly focuses on risk management in customer financing. The consequences of customer financing for both SMEs and customers are articulated, and the most eminent problems are specified.

This study makes some contributions to knowledge. Firstly, this study obtains a better understanding of the phenomenon of customer financing for SMEs in China and links concepts from different disciplines. The grounded theory model shows the central phenomenon, context, causal conditions, actions/ interactions, and consequences on a map, connecting the terms, and categories in a factor-process-consequence logic way. This study offers new insights into the phenomenon from ethics and cultural perspectives, which provides fundamental conditions.

Secondly, this study has implications for resources-based theory [32], [33]. Wernerfelt [32] and Barney [33] argue that customer relationships and social networks are a source of competitive advantage. Moreover, customers are a long-term financing resource, and this study defines this resource as customer capital. A social network is also a source of competitive advantage and a fundamental asset for SMEs, which is defined as social capital in this study. This study further developed a resource and process capability theory (Fig. 2), where Chinese SMEs process resources including financial, human, customer and social capital and transform to outcomes including financial return, organizational culture, customer value, and social value. Enterprise performance depends on the process capability in terms of risk management, human resource management, customer relationship management, and social network management.

Thirdly, this study identifies the components of financial costs which make implications for the cost of capital theories in finance [34]. The cost of customer capital refers to the required rate of return that SMEs offer on customers' investments, which include relationship building cost, maintaining cost through financial return on balance or consumption, reserve for customer drawing, and bankruptcy cost etc. It could be shown in (1):

$$K_c = k_b + k_m + k_b + k_o \tag{1}$$

where $k_c$ represents the cost of customer capital; $k_b$: the cost of building customer relationships; $k_m$: the cost of maintaining relationships and return on customer financial balance and consumption; $k_b$: the cost of bankruptcy; and $k_o$: the other costs.

$$WACC = k_c W_c + k_e W_e + k_d W_d \tag{2}$$

Therefore, the weighted average cost of capital (*WACC*) (2) equals to the cost of customer capital $K_c$ times its weight $W_c$ in the total financing and cost of equity $K_e$ times its weight $W_e$ and cost of debt financing $K_d$ times its weight $W_d$.

The enterprise value (EV) could be shown in (3):

$$EV = C_a / WACC \tag{3}$$

where annual cash generated $C_a$ is divided by the average cost of capital *WACC*. If $W_{c} = 100\%$, enterprise value could be shown in (4):

$$EV = C_a / K_c \tag{4}$$

Fourthly, this study makes implications for customer value-based theory [35], which emphasizes the importance of understanding and fulfilling customer's needs and preferences and assesses customer value measured by customers' perceived benefits or sacrifices, value-in-use. Woodruff [35] recognizes that customer value is not solely derived from the product itself but also from the experiences and outcomes associated with its usage. This concept can be linked to value-in-use, also known as economic value or utility value concept in accounting [35]. According to the International Accounting Standards, value-in-use should be determined based on the best estimate of future cash flow expected to be derived from the asset, taking into account factors such as the time value of money, risk, and uncertainties [36]. This study argues that if customers are the funds providers and value receivers, the economic value of an enterprise should be total customer value discounted by the cost of customer capital (see (5)).

$$\text{EV}= \sum_1^n \sum_1^k \sum_1^t (br + o)/(1 + K_C)t \tag{5}$$

where *n* presents the number of customers, *k:* the number of products and services used by the customer, *t:* the time of a customer relationship, *b:* the balance of customer financing, *r:* the return rate on customer financing, *o:* the other benefits customers received, *Kc:* the discount rate cost of customer capital.

Based on the findings in this study, some suggestions are proposed for the case enterprises and the authorities. Firstly, SMEs should realize the importance and fragility of customer relationships and improve their risk management skills. Ethical principles like integrity and reciprocity need to be held as bottom lines. Secondly, SMEs may invest in advanced technology, like digital payment solutions and mobile wallets, to provide regular and secure information communication with customers to enhance customer experience and streamline the financing process. Thirdly, accounting organizations should provide more principles or standards for customer financing. Fourthly, the financial regulators may develop some guidance, rules or best practices for SMEs and customers. Financially, the legal departments may issue some standard terms or conditions for SMEs and customers and also provide legal services to solve disputes.

There are some limitations to this study and further research could be conducted. Firstly, we interviewed only a small number of SME managers and customers in a few cities and more interviews will be conducted in Suzhou, Hangzhou and Guangde. Secondly, some concepts and models, for example, the model of measuring customer value, are only at the theoretical stage and further improvement is needed in future studies. Thirdly, hypotheses could be developed and tested by using quantitative data. For example, a questionnaire survey could be conducted to confirm the relationship between relationship management capability and customer value.

## Appendix

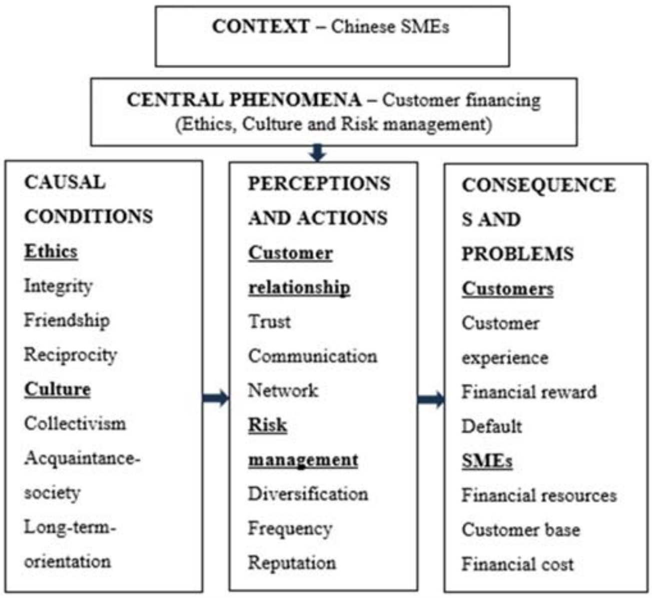


Fig. 1 A grounded theory model of customer financing for Chinese SMEs

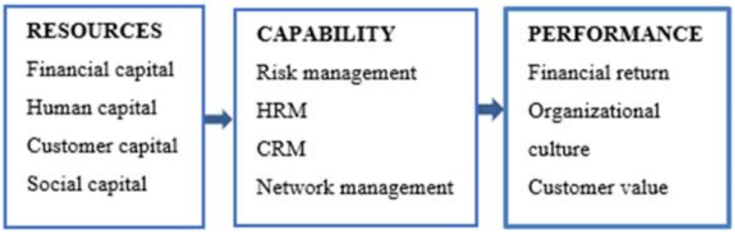


Fig. 2 A resource and process capability theory of Chinese SMEs

TABLE I
INTERVIEWS

| Interviewee | Time | Place | Age | Gender | Sector | Customer/Manager |
|---|---|---|---|---|---|---|
| N1M | 08.08.19 | Anyang | 40s | M | Hairdressing | Manager |
| N1C | 08.08.19 | Anyang | 50s | M | Hairdressing | Customer |
| N2M | 08.08.19 | Anyang | 30s | F | Grocery | Manager |
| N2C | 08.08.19 | Anyang | 40s | F | Grocery | Customer |
| N3C | 12.08.19 | Anyang | 50s | M | Restaurant | Customer |
| N3M | 12.08.19 | Anyang | 30s | F | Restaurant | Manager |
| N4M | 12.08.19 | Anyang | 50s | M | Supermarket | Manager |
| N4C | 12.08.19 | Anyang | 40s | M | Supermarket | Customer |
| N5M | 15.08.21 | Linzhou | 40s | M | Construction | Manager |
| N5C | 15.08.21 | Linzhou | 30s | F | Construction | Customer |
| N6M | 26.08.21 | Linzhou | 50s | F | Local gym | Manager |
| N6C | 26.08.21 | Linzhou | 40s | F | Local gym | Customer |
| N7C | 27.08.21 | Linzhou | 60s | F | Local shop | Customer |
| N7M | 27.08.21 | Linzhou | 50s | M | Local shop | Manager |
| N8M | 16.08.22 | Anyang | 50s | M | Entertainment | Manager |
| N8C | 17.08.22 | Anyang | 50s | F | Entertainment | Customer |
| N9M | 17.08.22 | Anyang | 40s | F | Laundry | Manager |
| N9C | 19.08.22 | Anyang | 30s | F | Laundry | Customer |
| N10M | 19.02.23 | Zhengzhou | 40s | M | Local shop | Manager |
| N10C | 19.02.23 | Zhengzhou | 40s | M | Local shop | Customer |
| N11M | 24.02.23 | Zhengzhou | 50s | M | Food factory | Manager |
| N11C | 24.02.23 | Zhengzhou | 20s | F | Food factory | Customer |
| N12M | 26.02.23 | Zhengzhou | 40s | M | Cosmetic | Manager |
| N12C | 26.02.23 | Zhengzhou | 50s | M | Cosmetic | Customer |
| N13M | 06.03.23 | Anyang | 50s | F | Restaurant | Manager |
| N13C | 06.03.23 | Anyang | 40s | M | Restaurant | Customer |
| N14M | 07.03.23 | Anyang | 40s | F | Clothing shop | Manager |
| N14C | 07.03.23 | Anyang | 30s | M | Clothing shop | Customer |
| N15M | 02.04.23 | Anyang | 50s | M | Leisure | Manager |
| N15C | 02.04.23 | Anyang | 60s | M | Leisure | Customer |
| N16M | 03.04.23 | Anyang | 40s | M | Local shop | Manager |
| N16C | 03.04.23 | Anyang | 70s | F | Local shop | Customer |

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