5.6. Budgeting and Controlling

Introduction

When you take over a managerial position in China, there is a high probability that you will be involved in the budgeting process.
Mostly multi-national companies have a clearly laid out budgeting process which will be broken down from a general long-term budget of several years to a very specific budget for the next year.

Market development and segmentation as a basis

Strategic sales planning and budgeting in general starts with estimating market sizes and the market development for the coming years, usually in quite a long-term perspective of mostly at least 5 years. This helps the company to better understand the developments and to come up with long-term strategy and financial plans.
At first the relevant market segments should be identified from a market point of view, meaning that not the strategic business units as defined by the company should be the criteria but criteria that is distinguished from the view of the possible customers segments.
The underlying numbers for current and future market sizes can be e.g. sourced from:

- Specialized market studies form consulting companies;
- Publicly available market data, e.g. Bureau of Statistics or import statistics;
- Industry associations or interest groups in the chambers of commerce, and
- Calculations and estimations based on auxiliary numbers if there is no specific data available.

Market share

Most of the markets in China that are accessible for foreign companies are a Polypoly or supplier oligopoly: A myriad of different brands and vendors offer brands to many different customers; markets tend to be fragmented. Especially in niche markets finding reliable data to identify your own market share can be hard and often has to be based on auxiliary numbers.
For companies organized in interest groups with a similar market, sometimes an independent third party can offer to collect the specific sales data of each company and provide a sum of all sold devices to all participating companies, giving them at least an indication for the market share. Please note that due to antitrust regulations, a direct sharing of sales numbers is not advisable.

Sales plan and turnover

Based on market development and market share you can make estimations for all of your product groups what kind of sales targets might be achievable for each product or product group.
The turnover planning is pretty straightforward: Multiply the achievable price with the planned sales quantity and you reach the turnover, e.g.

$$100\,pieces * 10\,\frac{RMB}{piece} = 1000\,RMB.$$

For details see the pricing chapter.
Even while in China it is absolutely common to show prices including VAT everywhere, most companies create their budget without Value Added Tax (VAT). As a rule of thumb this is advisable, since the VAT can be considered as “collected on behalf of the tax authorities” and actually never belongs to the company.

Variable costs

When providing services or products, in general you have to pay variable cost, e.g. the purchasing cost of your material, wages that are directly connected to providing the services, etc.
For the simple assumption that you sell finished goods that cost you 7 RMB per piece in purchasing, you would have for the example below variable cost

$$100\,pieces * 7\,\frac{RMB}{piece} = 700\,RMB.$$

Contribution margin

Contribution margin is what is left of the turnover after you subtracted the variable cost. With this you can pay for the fixed cost that does not depend on your sales, in the example below this would be

$$1000\,RMB - 700\,\frac{RMB}{piece} = 300\,RMB.$$

Fixed costs

When operating a business, some cost will happen no matter if you produce or not, e.g.:

- Salaries for office staff and related cost
- Banking fees
- Audit fees
- Travel fees
- Insurances
- Marketing cost

For the budgeting of fixed cost, historical data for each category plus adjustments for inflation rates or additional projects in each category can be helpful to determine the future expenses. Some of the fixed cost can also depend on the turnover even while there is no direct relation, e.g. auditing fees tend to grow with the turnover.
For the final budgeting all relevant cost should be considered, meaning in addition to the real money-outflows due to expenses:

- Depreciation (for fixed assets)
- Amortization (for intangible assets)
- Interest income or expenses (for bank savings or bank loans)

They have to considered in the calculation.
For the example below, let us assume that your company has fixed costs and depreciation of 200 RMB in total.
Additionally, let us assume that the company invested some of its cash on a fixed term deposit account at the bank and receives interest of 200 RMB within a period.

EBIT and EBT

The final number, the "Earnings before Taxes" (EBT) is the taxable profit that the company will have according to your budget. Please check the taxation chapter for more information on required adjustments between the trade financial statement and the tax financial statement.
To ensure a transparent comparability within a group of different companies and to evaluate the success of the core business without special influences, except the EBT other success Key Performance Indicators can also be used, for example he EBIT – the "Earnings before Interest and Taxes."
Using the examples from above, the EBIT will be

$$300\,RMB - 200\,RMB = 100\,RMB$$

or 10% of the turnover while the EBT will be 200 RMB higher.
If just checking the EBT, success of the core business might be overestimated.

	Turnover	1000
	- variable cost	-700
	= Gross Margin	**300**
Fixed Cost	- Salaries	-80
	- Marketing	-100
	- Audit	-20
	- Other Fixed Cost	-200
	=EBIT	**100**
	+ Interest	200
	=EBT	**300**

with	
Sales price per piece	10
Variable cost per piece	7

Figure 5: EBT in the Profit & Loss Calculation

Top-down vs. Bottom-up budgeting

Each company will choose their own way of budgeting. Mostly the sales and turnover planning is done centrally by the financial or strategy department while the purchasing department is additionally involved to forecast price developments on the variable costs.
The fixed cost will either be planned top-down by the financial or strategy department as fixed cost blocks—or the single departments are deeply involved to plan their fixed cost for the coming year themselves.
While a decentralized planning of the fixed cost by each department can bring the additional benefit of a more detailed and realistic planning, a centralized planning can speed up the planning process during the budgeting phase.

Operative planning: Cost-center budget and distribution over the year

Since a business usually does not perform constantly with a stable output during the whole year, the whole budget will be broken down to single months. Even for non-seasonal businesses at least the spring festival and national holidays in October should be considered: These shutdown times can have a serious impact on your turnover.

	Salaries	Marketing	Audit
January	-7	-10	0
February	-7	0	-20
March	-7	-10	0
April	-7	-20	0
May	-7	-20	0
....			
Full year	**-80**	**-100**	**-20**

Figure 6: Breakdown of Fixed Cost to Months

Usually, at least for the next year, the total planning has to be broken down to single cost centers to give the management an insight if there are deviations between the actual cost and the budget.
Depending on the type of budget planning, as mentioned below, this can be done either during the budget process itself or after a top-down-budget has been approved.

	Cost Center 1			Cost Center 2		
	Salaries	Marketing	Audit	Salaries	Marketing	Audit
January	-2	-5	0	-5	-5	0
February	-2	0	-6	-7	0	-14
March	-2	-3	0	-7	-7	0
April	-2	-6	0	-7	-14	0
May	-2	-6	0	-7	-14	0
....						
Full year	**-24**	**-30**	**-6**	**-7**	**-70**	**-14**

Figure 7: Breakdown of Fixed Cost to Months, Cost Centers

Controlling

When a plan is fixed, it usually does not get adjusted anymore: This is the “bottom line” that has to be achieved. Still, changes can happen even after a plan has been approved.
Controlling can basically be defined as comparing three key figures:

- Plan/Target: The (accumulated) numbers according to budget. While fixed costs usually have a plan that does not change, the target can change with the output with variable cost.
  For example: For a marketing department it does not matter how much products are produced; their cost will remain the same.
  For wages for production workers, if the output doubles then the amount of required working hours doubles too—therefore, the target wages would be twice the plan.
  If you would compare the original planned working hours without considering this direct relationship between output and input, you might think that you are over budget even when you are not.
- Actual: The accumulated number of what already happened in the current year.
- Forecast: The expected year-end number which is a mix of actual cost and adjustments to the plan that happen after a budget has been approved.

When comparing these numbers, it can be much easier to identify where deviations are coming from so that management attention can be directed in the right direction.
While the controlling department can provide insights about the numbers itself, e.g. how the actual numbers are composed, most of the qualified feedback actually has to be collected from the owners of the cost centers themselves.

Cost Center 1 Report

	Plan YTD	**Actual YTD**	**Forecast**	**Plan Year**
Salaries	-2	-2	-25	-24
Marketing	-2	-2	-30	-30
Audit	-2	-3	-6	-6
Full year	**-6**	**-7**	**-20**	**-20**
Deviation	-1		0	

Figure 8: Simplified Cost Center Report

In this case the controller would see that the actual cost is higher than planned but the forecast for the full year is the same as the plan. Reasons could be that cost occurred earlier than planned, that currently the purchased audit services are higher but there exist plans to reduce them again, and so on. This kind of expertise is only in the departments; a central controller just checking the numbers will not have that insight.

Common pitfalls and considerations

- China can be a very dynamic market and you should take a risk-oriented, conservative approach especially for the mid- to short-term. The general market development can suddenly start turning, your home country might be bashed in some outrage with business influence on yourself or some company-specific impact, e.g. by a misbehaving manager who turns it into a shitstorm on social media with a deep impact on your business.
  On the other side, this dynamic is mostly short- to mid-term and long-term trends can be more predictable.
- A too conservative approach might have serious influence on your ability to deliver, though. Most business models cannot scale very quickly: Material for production can have a long leading time to adjust to sudden market spikes above budget and your staff in the service industry cannot be built up and trained quickly enough if you do not ensure their availability during the budgeting process.
- Data quality is lacking in China since most data sources are not very reliable. This is especially true for market sizes and market shares where even the comparison by specialized market research companies can be different by a factor of more than 10.
- When using a combined top-down and bottom-up process for fixed cost planning, e.g. by first planning the fixed cost centrally for the company and then letting the departments make a bottom-up planning for themselves, certain buffers can add maneuverability to the company management.
  The difference between an approved top-down budget and the sum of the bottom-up-budget is a budget buffer which can be used if required.
- Managers often add some buffers in their budget planning. While in general a conservative planning is recommended, these buffers can add up to a totally overblown budget. The budget plan should be checked thoroughly if it is reasonable.
- During the budgeting process, it can be very helpful to check the actual numbers of the last year, the actual numbers of the current year so far and budget of the actual year. This can help you to find a realistic budget and to consider a curve: While some expenses happen monthly, others might just happen in single months.
  Please keep in mind that budgeting should not be based purely on past data since it is an outlook into the future!