

6.5. Budgeting and Controlling (RC)

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 goes from a general long-term-budget of several years to a more specific one-year-budget and 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 (5+ years). This helps the company to understand better 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 are the criteria but criteria that is distinguished by the possible customers segments

The underlying numbers for current and future market sizes can be e.g. sourced from

- Specialized Market studies from consulting companies
- Publicly available market data, e.g. bureau of statistics or Import statistics
- Industry associations or interest groups in the chambers of commerce
- 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: Several 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 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.:

$$100 \text{ pieces} * 10 \text{ RMB} = 1000 \text{ RMB.}$$

For details see the pricing chapter.

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 above variable cost

$$100 \text{ pieces} * 7 \text{ RMB} = 700 \text{ RMB.}$$

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 do not depend on your sales, in the example above this would be

$$1000 \text{ RMB} - 700 \text{ RMB} = 300 \text{ RMB.}$$

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. 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. There are several other KPIs that can be internally used (EBITDA, EBT, EBIT, etc.) for the final budgeting all relevant cost should be considered, meaning additionally 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)

have to be considered in the calculation.

For the example above, let us assume that your company has fixed costs and depreciation of 200 RMB in total.

EBT

The final number, the “Earnings before Taxes” 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.

Using the statement above, the EBT will be

$$300 \text{ RMB} - 200 \text{ RMB} = 100 \text{ RMB}$$

or 10% of the turnover.

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

with
 Sales price per piece 10
 Variable cost per piece 7

Figure 4: EBT in the Profit & Loss Calculation

About taxes

During the calculation, you should always use numbers without VAT since you basically are just the agent who collects the VAT for the tax office.

Some other taxes depend on your fixed assets (e.g. land using right tax) or your sales (e.g. some stamp duties), these should be recognized within the fixed costs.

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 the same 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.

	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 5: 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 and the budget.

Depending on the type of budget planning as mentioned above 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 6: Breakdown of fixed cost to months and cost centers

Controlling

When a plan is fixed, it usually does not get adjusted anymore. Still, changes can happen even after a plan has been approved. Controlling can be basically be broken down in three key figures:

- Plan: The (accumulated) numbers according to budget
- Actual: The (accumulated) number of what already happened
- Forecast: The number of the expected year-end number which is a mix of Actual 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 give you insight 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 7: Simplified Cost Center Report

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 makes it into a shitstorm on social media with a deep impact on your business. On the other side, this dynamic is mostly short- to midterm 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 quick 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 true 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 critically checked 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!