

# REDUCING EXPATRIATE PROGRAM COSTS UNDER THE BALANCE SHEET APPROACH

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Given the downturn in the global economy and the pressures facing companies with worldwide operations, many employers are very focused on reducing their human capital costs in a transparent and rational manner, without adversely impacting employee efficiency and morale. Due to the high expense associated with sending employees and their families to foreign destinations (particularly long-term assignments of three-to-five years in duration), organizations are looking more intently at their expatriate programs, and specific areas within these programs where cost reductions are achievable.

The balance sheet continues to be an important compensation methodology for organizations that transfer employees internationally. For 74% of multinationals,<sup>1</sup> the balance sheet approach is the most frequently used, according to ORC Worldwide's 2008 *Worldwide Survey of International*

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*Assignment Policies and Practices.* For companies that follow this approach to compensate their globally mobile employees, there are a number of cost-effective strategies that expatriate program and HR managers may want to consider. The following discussion offers a closer look at some of these strategies (and the program elements they impact) to deliver cost savings.

## THE BASIC BALANCE SHEET FRAMEWORK

The balance sheet approach is a method of compensating expatriate employees for cost differences between countries. Normally used for assignments of limited duration, it seeks to ensure that the expatriate's purchasing power and home-country lifestyle do not change significantly during the course of an assignment—even if costs are higher abroad, as they so often are. This method has the following key features:

- Expatriates are generally kept on the same base sal-

ary structure as peers in the home location.

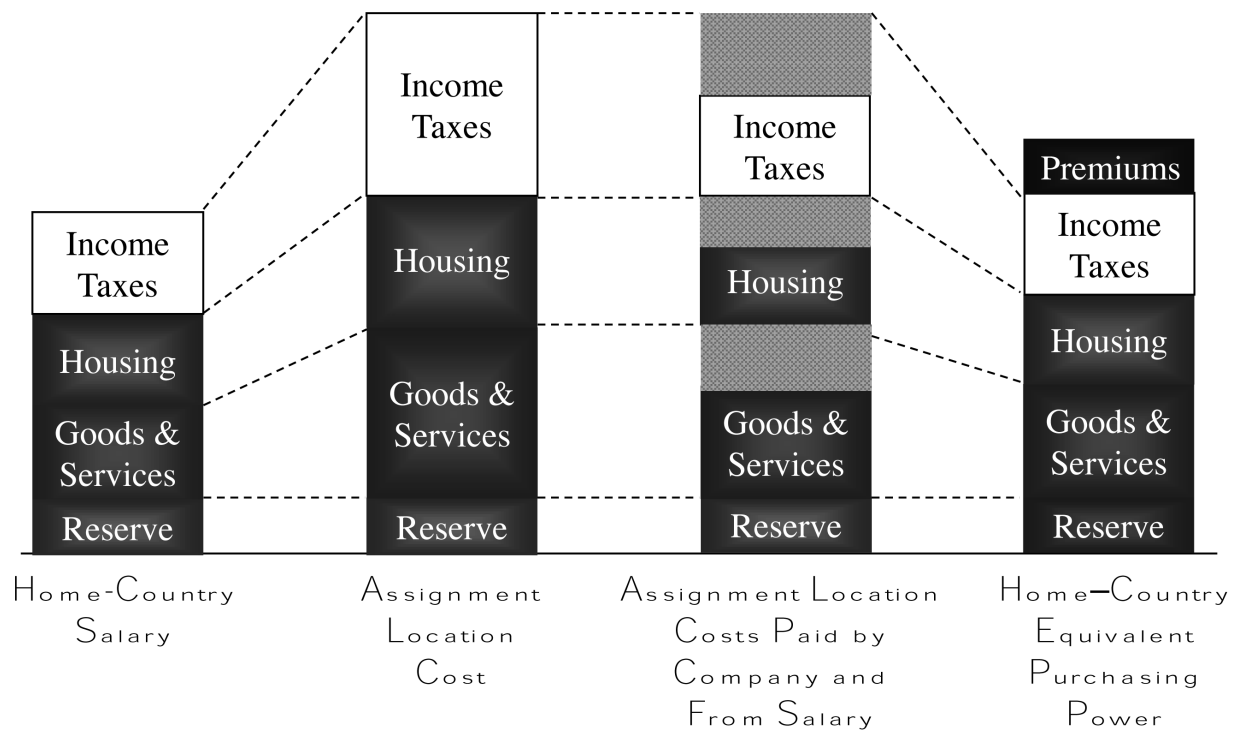
- A series of allowances and differentials ensures that the expatriate neither gains nor loses financially while assigned abroad.
- Some organizations provide additional incentives that include foreign-service or mobility premiums and hardship allowances.

Under this approach, an expatriate's base salary is allocated into four main categories of expenditures (see Chart 1, "ORC's Balance Sheet Approach"):

- *Goods and Services.* Spending on everyday goods and services—for example, food at home and in restaurants, clothing, household furnishings, transportation, and others—represents the largest expenditure for most expatriates and their families.
- *Housing.* This category represents most of the costs associated with the employee's principal home-country resi-

CHART #1

# The Balance Sheet



Source: ORC WORLDWIDE, INC.

dence. As the balance sheet endeavors to ensure that expatriates pay no more for housing abroad than they would pay at home at their salary level and family size, the employer expects them to contribute a portion of salary (a norm) toward comparable home-country housing costs. If this norm is deducted from salary, the employer would then pay all approved housing costs in the host location; otherwise, the assignee would receive a differential for housing costs above the norm.

- **Income Taxes.** To achieve equitable tax treatment for expatriates, the company assesses a tax burden comparable to what expatriates would pay

had they remained at home. Through “tax equalization,” employers deduct this hypothetical home-country tax from base salary, then pay all home-country (if any) and host-location tax obligations directly to the tax authorities or reimburse the expatriate.

- **Reserve.** The miscellaneous expenditures covered by this category include contributions to private pension and insurance programs, savings and investments, education expenses, the equity portion of auto purchase costs, social security payments, alimony, mortgage principal, improvements to dwellings and additions to property, principal and interest on personal loans, and charitable contributions.

Because reserve is generally paid and used in the home country, it is not subject to differential payments or equalization treatment.

Within this basic framework, expatriate program and HR managers can find numerous ways to reduce the expenditures on assignment-related compensation without adversely affecting employee morale or the fairness of the pay package. The following options represent a sample of the cost-effective steps an employer can take.

## **ASSIGNMENT PREMIUMS: SMALLER, OR NONEXISTENT**

The balance sheet approach does not address incentives as part of the four major expenditure cat-

egories. However, for some organizations, foreign-service premiums are a key addition to the pay package. Many organizations continue to use some form of incentive, typically developed to encourage employees and their families to accept an international assignment—even to desirable host locations—in recognition of the willingness to leave the familiar behind and move into unfamiliar territory.

However, over the years, there has been a trend to provide fewer and/or smaller premiums, if not eliminate them completely. Thirty-six percent of participants in ORC's 2008 Worldwide Survey do not provide any foreign-service premium. Comparing the average premium paid by participants in ORC's 2006 and 2008 surveys, the premium amount decreased by approximately 28%.<sup>2</sup> These trends, in part, reflect a change in thought on why individuals accept international assignments: The opportunity to develop a differentiated skill set through an international assignment is a powerful motivator. Consequently, an increasing number of organizations now consider the assignment itself to be an incentive, particularly if it provides another step up the corporate ladder or experience that makes the employee more internally or externally marketable.

### **GOODS AND SERVICES DIFFERENTIALS: COST-EFFECTIVE INDEXES**

Under the balance sheet approach, the goods and services index reflects the relative cost of a representative market basket of goods and services in the expatriate's home country com-

pared with the costs of the same or similar items in the host location on the same date. The index measures the home-host price relationship and determines the goods and service differential (or, cost-of-living allowance) that will balance the difference (if any) between home-country and assignment-location spendable income (the portion of income spent on goods and services). This approach keeps employees' purchasing power comparable to what they enjoyed at home, excluding any incentives the employer might provide. However, an important aspect of managing the cost of goods and services differential is selecting and applying an index that most accurately reflects the spending profiles of an organization's expatriates in both their home and host locations.

A *Full Expatriate Index*, which covers all categories of goods and services, reflects the profile of an expatriate who spends like peer local-nationals in their home location on goods and services; goes on assignment; is unfamiliar with the customs, language, and products available in their new foreign home; and tends to shop in locations geared toward newly arrived and/or inexperienced expatriate consumers. Further, this index is not modified to reflect any reductions for goods or services that may be provided to the expatriate as a consequence of the assignment (e.g., company car, transportation allowance). Therefore, this index typically represents the most costly approach. However, depending on the circumstances, cost-saving alternatives are available by looking at either the pricing profiles, weighting, or expenditure inputs used to develop an index.

### **Pricing Profiles**

*Efficient Purchaser Index (EPI)*. Some expatriates in industrialized or developed locations may find it easier to assimilate into the lifestyle and shopping pattern of their host country if the culture and language are not too dissimilar. These individuals recognize that changes in their choices of stores, restaurants, or even brands can produce savings while still offering the same quality and quantity of goods and services. In these situations, the company has an opportunity to save money by basing the pay package on a fair and cost-effective index, such as an EPI. With substitutions of less-expensive products, the overall market basket is less expensive, resulting in a lower differential. According to ORC's *2008 Worldwide Survey*, 48% of the participants use EPIs, and 83% implement such indexes from the very beginning of the assignment without providing a transition period. As the EPI is not feasible for all host locations, companies may need to utilize both EPI and full expatriate data for locations where an EPI is not available.

*High Income Purchaser Index (HIPI)*. Developed largely in response to the growing use of expatriates moving from developing countries, this approach accounts for the spending habits of high-income individuals who are leaving economically developing home countries. Consequently, they have different spending profiles than a typical national of that country in that they tend to purchase higher-cost consumer goods in their home location. Although calculated like an EPI with respect to host-location prices, the HIPI utilizes higher-level prices

in the *home* location to determine an index. Since the home-country price profile is higher, the corresponding index and differential are lower.

### **Removal of Home-Country Weighting**

*International Index.* In contrast to the EPI and HIPI, an international index uses a “budget approach” to construct a cost-of-living comparison. This approach looks at how much money is required to purchase a given basket of goods and services at home and host at a given foreign exchange rate. The index uses fixed quantities of each item consumed in both locations. It does not attempt to replicate a home-country spending profile in the host location, but instead utilizes an international market basket of goods and services priced between a home and host location. Consequently, this index is more appropriate for expatriates who do not have a clearly defined home location, have been on sequential assignments, or have worked or lived in other locations within the general region of their current host location. These indexes are typically lower than the EPI.

### **Removal or Reduction of Expenditure Inputs**

*Modified Index.* Many employers provide (or subsidize) certain items that are normally covered in the goods and services spendable income—for example, one or more cars, a transportation allowance, medical care, furnished apartment, or domestic servants. Other employers prefer not to subsidize tobacco and alcohol purchases. If items ordinarily included in spendable income (and priced as part of the market bas-

ket) are provided separately or purposely excluded, an employer can remove those items or entire categories from the index calculation by using a modified index. According to ORC’s 2008 Worldwide Survey, 41% do so.

### **GOODS AND SERVICES DIFFERENTIALS: POLICY AND IMPLEMENTATION**

In addition to choice of index, there are other opportunities to minimize the cost of goods and services differentials, which include:

*Negative Differential.* When the cost of goods and services is lower in the host location than in the home country, the differential is negative. It is consistent with a balance sheet approach to deduct a negative differential from another positive allowance to avoid distorting the approach and overcompensating expatriates. If the employer ignores the negative differential, the expatriate benefits from a windfall that is not available to those assigned to “positive-index,” or higher-cost, countries. Fifty-seven percent of the 2008 ORC survey respondents take no action, but 26% do.

*Updated Data.* Certain changes can affect an expatriate’s differential: the price of goods and services in the home and host countries, exchange rates, family size, and base salary. Although it may be perceived as an administrative burden, updating each assignee’s pay package on a regular basis can avoid either overpaying or underpaying the assignee. And in terms of cost-effective opportunities, by legitimately reducing the differential—for example, when currency movement indicates the need—an employer can save a significant amount of money,

particularly if a large number of expatriates are in the same home-host configuration.

*Caps.* Another cost-effective option is the use of caps on different pay elements in the package, specifically capping the income used to determine the amount of the goods and services differential or capping the total amount of the allowance at a fixed amount. Eighteen percent of participants in the 2008 survey utilize a cap in calculating the goods and services differential. This option can particularly impactful for organizations that have expatriates with high annual base compensation levels (above USD 200,000). These caps can also be applied to other expatriate compensation elements that are calculated from base compensation: assignment premiums, hardship or danger pay allowances. (see sidebar, “The Use of Caps on Expatriate Pay Components”).

### **CUTTING BACK ON ASSIGNMENT LENGTH, WHERE APPROPRIATE**

Evidence of cost-containment is also apparent with the continuing popularity of short-term assignments, which generally last more than three months but less than a year. Eighty percent of multinational employers today use short-term assignments, according to ORC Worldwide’s 2008 *Worldwide Survey*. Only eight years earlier, this number was 59%.

While these assignments are not feasible in all work situations, they are appropriate for objectives such as on-site training, an assessment of the local or regional market before launching a new product, the opening of a new facility, or a quick troubleshooting effort.

### The Use of Caps on Expatriate Pay Components

*Incentive payments*—10% of the participants cap for salary above a predefined threshold; 13% base their caps on a flat amount; and 77% of the respondents do not set caps.

*Hardship allowances*—15% cap for salary above a predefined threshold; only 9% use a flat amount, leaving 75% not using caps.

*Goods and services differentials*—18% cap for salary above a predefined threshold; 82% do not implement caps.

**Source:** ORC Worldwide's 2008 Worldwide Survey of International Assignment Policies and Practices

In many such cases, a short-term assignment provides several options to trim costs:

*Less-Expensive Accommodations and Meals.* Only 4% of short-term assignees go abroad with a spouse/partner, and 13% with a spouse and children. This factor allows the company to reconsider the type of accommodations in which the employee will be housed. Smaller and less costly housing—perhaps even close to the worksite (which reduces the need for excessive transportation expenses)—may be perfectly adequate. For example, if the individual stays in a hotel without kitchen facilities, the employer might implement a policy similar to that used for foreign business trips: reimbursement of actual expenses or payment of a per diem

for three meals a day in restaurants. If the assignee resides in an apartment suite or shared house with kitchen facilities, a cash allowance (in line with the balance sheet approach) that assumes some meals are eaten at home would be appropriate—and substantially less expensive for the company.

*No Education/Spousal Allowances.* Except for those few assignees who do bring their family along, the majority of short-term packages would not necessitate an allowance for dependent education or spousal job search assistance.

*Reduced (or No) Premiums.* Most companies do not pay premiums for short-term assignments (59% of survey respondents do not). An alternative is to pay a reduced incentive, as implemented by 15% of respondents.

### DIVERSIFY TACTICS

There are a number of practical strategies available to HR and expatriate program managers who seek to reduce their program costs in a meaningful way. In addition to the ones outlined above, there are a host of others (e.g., involving their tax-equalization policy, relocation entitlements, class of travel). A challenge in developing a way forward is understanding the organization's desire for, and commitment to, program cost reduction and appropriately balancing these factors with expatriates' needs and expectations. By developing and executing effective and well-integrated cost-reduction initiatives, HR and expatriate program managers can deliver important bottom-line results to their organization and increase the overall return on investment from expatriate assignments, two critical measures in today's economic environment.

### NOTES

1. 74% of respondents use a home-based balance sheet, and an additional 9% use a headquarters-based balance sheet approach.
2. The reduction is based on average assignment premiums reported in USD in the two surveys.