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Did you know that 14.8 % of companies adjust the G&S index in high-inflation locations more often than other locations?

Source: Mercer's 2011 Worldwide Survey of International Assignment Policies and Practices

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Goods and Services Differentials: Common Miscommunication Problems

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The balance sheet approach to expatriate compensation maintains your purchasing power and lifestyle at home in the assignment location. It may include an employer-provided cost-of-living "differential," which bridges the gap (if any) between what you pay for goods and services at home and what you would need to pay in your new assignment location. It may change throughout the assignment in response to various economic factors, such as exchange rate movement and the price changes of goods and services at home and in the assignment location. This discussion will guide you through some common miscommunication problems that involve your differential.

Always Best to Start at the Beginning

The balance sheet approach considers a number of factors (goods and services, housing, tax) to ensure the assignee is no better/worse

off in the host location. Two concepts integral to this approach are:

- Home-country spendable income, the portion of salary spent on goods and services at home (based on salary and family size), and
- Assignment-location spendable income (comprised of the home-country spendable amount plus the cost-of-living differential when applicable), the corresponding amount in foreign currency needed for the same or similar items in the assignment location.

The employer fills any gap between home-country and assignment-location spendable income with a goods and services differential. This amount can be positive (costs in the assignment location are higher than at home) or negative (costs are lower than at home). The differential is calculated by means of the goods and services index (the ratio between



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home and host costs) and by applying this ratio against the home-country spendable amount. Typically, companies will not apply a negative differential, in which case the value of the differential represents a windfall to the assignee.

For the purpose of gathering prices, a market basket of approximately 180 individual goods and services is surveyed. It represents items purchased by typical consumers in the following categories of spendable income: food at home (groceries; fruits and vegetables; meat, fish, dairy), food away from home, recreation, furnishings and household operation, tobacco and alcohol, transportation (public and private), clothing, personal care, medical care, and domestic service. Every category is further broken down into subcategories, each of which represents a proportion of total spendable income (a weight). Weights are meant to address the reality that not all nationalities purchase goods in the same way. For example, Americans will spend a greater proportion of their home-country spendable income on private transportation than typical Europeans. This methodology addresses consumption behavior, as well as cost differences.

Periodic surveys track price differences of the items between the home country and assignment location. For each item, an assigned weight represents a proportion of spendable income according to typical spending patterns by local-nationals in the home country. A comparison of home and host prices results in a price ratio for each item, which is multiplied by its weight to represent that item's contribution to the overall index.

The overall index, which is calculated at the exchange rate in effect at the time, is compared with a base of 100, representing home-country costs. An index greater than 100 indicates that costs of goods and services in the assignment location are more expensive than at home; an index of less than 100 (a negative

index) indicates that assignment-location costs are less expensive than at home.

The index is used to determine the differential, which represents the amount needed in home-country currency to maintain purchasing power in the assignment location (or, in the case of a negative differential, the amount not needed). To arrive at the differential, multiply home-country spendable income by the portion of the index greater than 100, expressed as a decimal.

Example. Assume a US-to-London index is 153.98 and salary is USD67,200 (on a monthly basis, USD5,600). According to research, the amount of monthly base salary devoted to the purchase of home-country goods and services is USD2,611 (for a family of three). To determine how much this American would need in London to replicate the home-country purchasing power of USD2,611, multiply the home-country goods and services spendable income amount (USD2,611) by the index above 100 expressed as a decimal:

$$\text{USD2,611} \times 0.5398 = \text{USD1,409}$$

Thus, this expatriate would need a home-country spendable income of USD2,611, plus a differential of USD1,409, or total assignment-location spendable income of GBP2,485 (at an exchange rate of GBP0.6182:USD1), to replicate in London the purchasing power provided by USD2,611 in the United States. In this example, the USD2,611 represents the amount of home-country spendable income (the amount the assignee would spend on goods and services at home had the assignment not taken place). USD1,409 is the cost-of-living allowance (COLA), or the additional amount the company would pay the assignee to ensure purchasing parity.

Where Misunderstanding Occurs

Several variables can affect an index over time: exchange rates, price movement in the host location, price movement in the home country, and updates to account for changes in expenditure patterns (weights). The differential changes to protect you from currency fluctuations in the assignment location. However, the total assignment-location spendable income in foreign currency stays the same—unless a pricing survey establishes new costs between the home country and assignment location or the expatriate's base pay or family size changes.

To explore the potential misunderstanding related to this issue, assume the following hypothetical situation between the United States and China.

Example I: Baseline Assumptions

- Home-country spendable amount: 1 can of soda at 1 USD
- FX rate 1 USD=6.5 CNY
- Cost of soda in China (Host-country spendable): 9.00 CNY
- Chinese soda in USD: $9.00/6.5 = 1.3846$
USD $\times 100 = 138.46 = \text{COLA index}$
- COLA differential = 1.3846 USD (total cost of soda in China in USD) - 1.0 USD (amount that soda would cost at home = 0.3846 USD)

Example II. Index Shift Due to Exchange Rate Fluctuation

If the home currency increases in value so the USD is 7.0 CNY, the impact on the host-country spendable will be:

- Home-country spendable amount: 1 can of soda at 1 USD
- FX rate 1 USD=7.0 CNY
- Cost of soda in China (Host-country spendable): 9.00 CNY
- Chinese soda in USD: $9.00/7.0 = 1.2857$
USD x 100 = 128.57 = COLA Index
- COLA differential: = 1.2857 USD (total cost of soda in China in USD) - 1.0 USD (amount that soda would cost at home = 0.2857 USD)

Note: The USD value increased approximately 7 percent; the index value decreased approximately 7 percent. All things being equal, the movement in the home currency value will be inversely proportional to the movement in the index value.

Example III. Index Shift Due to Pricing Update

If the exchange rate remains 1 USD = 6.5 CNY, but the cost of soda in China moves from 9 CNY to 10 CNY, the index and, therefore, the COLA will be affected as follows:

- Home-country spendable amount: 1 can of soda at 1 USD
- FX rate 1 USD=6.5 CNY
- Cost of soda in China (Host-country spendable): 9.00 CNY
- Chinese soda in USD: $10.00/6.5 = 1.5385$
USD x 100 = 153.85 = COLA index
- COLA differential = 1.5385 USD (total cost of a soda in China in USD) - 1.0 USD (amount that soda would cost at home = 0.5385 USD)

Note: The cost of soda increases by approximately 11 percent. Assuming no change to the FX rate, the index value will shift due to pricing approximately 11 percent.

Example IV. Index Shift Due to Exchange Rate Fluctuation Plus Pricing Update at Home and Host

- Home-country spendable amount: 1 can of soda at 1.15 USD
- FX Rate 1 USD = 7.0 CNY
- Cost of soda in China (Host-country spendable): 10.00 CNY
- Chinese soda in USD: $10.00/7.0 = 1.4286$ USD
- COLA index = 1.4286 USD (Cost of soda in China)/1.15 USD (new cost of soda in the US) = 1.2422 x 100 = 124.22

Note: The index value in example IV is a result of the increased value of the USD by approximately 7 percent. While the cost of soda increased in China by approximately 11 percent (in CNY), it also increased in cost in the US by approximately 15 percent. The net result of applying these three variables is that the index shows a net change of approximately 10-11 percent when using example I as a baseline.

The conclusion that can be drawn from the above examples is that the index value and, by derivation, the COLA differential will change regularly; these changes are driven by a com-

ination of factors. Additionally, a modest shift in the index value may result in a substantial change to the COLA differential. Regardless of the differential value, when added to the home-country spendable amount and converted into host currency, the result should be an amount that covers the cost of the market basket at host as follows:

- 1.15 USD (cost of soda at home) home-country spendable
- 10.00 CNY (cost of soda at host) host-country spendable
- 1.15 USD x 0.2422 (index) = 0.2785 USD = COLA differential
- Host-country spendable in USD = 1.15 USD + 0.2785 USD = 1.4285 USD
- Host-country spendable in CNY = 1.4285 USD X 7.0 CNY (FX rate) = 10.00

It is important to note that the COLA differential is meant to bridge the gap between the cost of a market basket at home and an equivalent market basket at host. It is not intended as a separate allowance but rather as a tool for achieving purchasing parity.

The Bottom Line

To ensure that you understand your compensation package, keep this point in mind: Do not consider index numbers and differentials without relating them to spendable income.

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