VISTRA

Budgeting for International Expansion

Contents

Introduction

One of the biggest mistakes many companies make when planning for overseas expansion is applying a cookie-cutter approach to budgeting and not adequately accounting for the tax laws, employer obligations, cultural nuances and other quirks of their target countries. All of these factors and more vary widely from country to country and can significantly affect your bottom line. Even if you've already established an overseas location, you can't assume that experience will prepare you for setting up shop in another market. Each new target country presents a unique set of challenges and related costs and timelines.

While no one has a crystal ball to predict the future, informed budgeting and forecasting from the outset can help you avoid unexpected surprises, such as significant cost overruns, a longer time period to become fully operational, hiring roadblocks, tax penalties and more. Arming yourself with as much knowledge as possible before the budget process is crucial to avoiding headaches down the line. After your global budget gets approved, it can be difficult and time-consuming to go back and get support for major adjustments.

Remember that it helps to be flexible. Budget for contingencies and expect to make some strategic adjustments after your first full year of operations.

Rule of thumb: Regardless of your business or target location overseas, understand that everything will take more time and be more expensive than you might have initially anticipated.

Getting Started

Creating a realistic budget will involve research and multiple constituents across your organization. The process may take months and numerous iterations. The process should culminate in a financial vision and goals, an action plan and tools for monitoring and measuring results. This directional compass will ensure that all stakeholders are on the same page with respect to timelines, obligations and actual efforts needed to achieve your business goals.

As with your domestic operations, your international budget will be done annually. To get started, use the checklist on the next page, which contains common expenses associated with expanding into a new market.

Ideally, your international budget should be detailed and robust. It should include a profit and loss statement that ties to your end-of-first-year balance sheet and statement of cash flows. The best format is one that mirrors the structure of accounts in your general ledger. It's ideal to forecast for two years out, with the majority of your effort focused on the first year.

Your 12-month budget should have sufficient line-item detail without getting your organization mired in too much minutiae. The level of detail will be influenced by the relative size and materiality of your overseas operation in relation to the rest of the business.

For foreign operations, you will need to consider three budget factors:

- Foreign exchange rates, including transaction rates and translation costs
- Inflation rates for the new country
- Interest rates for the new country

While CFOs have no control over these factors, it's critical that you evaluate them and examine how they can impact your strategic financial plan. Remember to document your assumptions.

Looking at your existing profit and loss statement for the parent company, determine which revenue and expense line items will carry over to the new entity. Then estimate a realistic revenue stream. Your first year may simply involve putting a stake in the ground. As you can guess, it's best to be conservative rather than overly optimistic in your outlook for your new operation.

Rule of thumb: Doing the necessary homework during the budgeting process will take considerable time and effort, but will pay dividends in the end.

Staff-related expenses:		Office-related expenses	
Recruitment		Office rental	
Employment contracts and translation		Ongoing fees and taxes	
Salaries		Equipment	
Mandatory salary increases		Computers	
Mandatory bonuses		Software	
Pension funds		Communications services/phones	
Profit sharing		Supplies	
Social security		Health and safety inspections	
Unemployment insurance		Building security	
Health insurance		Utilities	
Vacation, sick time, other leave		Licenses and permits	
Payroll services		Maintenance and repairs	
Meal allowances		Waste removal	
Travel expenses, including site visits		**Tax-related expenses**	
Tracking employee travel (to avoid PE)		Corporate taxes	
Expat expenses		Indirect taxes, including all VAT	
Tax equalization/protection		Import/export obligations	
Immigration (visas, work permits)		Accounting and auditing	
Employee handbook and translation		Converting accounting to US GAAP	
Mandatory employee training		Transfer pricing reports/documentation	
Cultural training		**Sales and marketing expenses**	
Anti-corruption training		New sales and marketing materials	
Security services		Advertising, PR and lead generation	
Non-compete obligations		Website translation	
Employee-termination obligations			
Setup expenses		**Other expenses**	
Legal and tax consulting fees		Foreign exchange and transaction rates	
Legal entity establishment		Inflation rates of target country	
Filings		Interest rates of target country	
Bank account establishment		Ongoing regulatory expertise	
Accounting/audit		Data protection compliance	
		Winding down operations	

Total:

Planning for New Expenses

The typical "gotchas" in opening an overseas office often result from a lack of clarity in the strategic plan. Here are key areas and unexpected costs that regularly surprise our clients and prospects.

Legal Entity Setup and Real Estate Considerations

If you're going to generate revenue in a country, operate out of a fixed place of business, negotiate contracts or even just conduct marketing activities, you will invariably need to establish a legal entity in that country. Generally speaking, there are three types of legal entities: a representative office, a branch and a subsidiary. Legal entity options — and related costs, restrictions and setup times — will vary by country, and you'll want to consult an expert familiar with target-country tax laws to determine the optimal entity type for your situation. Choosing a restrictive entity type — like a representative office, which typically does not permit revenue-generating activities — may save you money in the short term, but may not serve your needs and could necessitate costlier registrations in the future.

Once you and your tax and legal experts have determined the optimal entity type and related establishment costs, remember that the time it takes to register an entity will vary by country, and sometimes may vary from case to case in the same country. Even something as simple as opening a bank account in another country — often a requirement for establishing a legal entity — can take months. For example, it is extremely challenging to open a bank account in many Latin American countries due to anti-money-laundering and other regulations designed to stop drug trafficking and terrorism. Brazil in particular has strict rules governing opening a bank account, and in extreme cases the process may take as long as six months. In cities such as Dubai and Hong Kong, setting up an account is a major obstacle for foreign businesses.

Most companies expanding overseas will want to establish a physical office space, and some countries require one to conduct business there. As a result, you'll need to consider your target country's real estate climate. Conventional overseas real estate leases typically involve a more significant commitment and sizable initial capital investment than in the United States. For example, in London a standard lease often runs "5+5" (five years with a five-year option to extend), or 3+3 in Singapore.

If you get an office that's too small to account for growth, moving can be costly and disruptive. Conversely, if you open an office that's too big, it can impact profitability for several years. If you consider building, you need to question whether you realistically have the capital outlay.

Many firms opt to start with serviced offices or flexible workspaces, which are fully furnished and offer host-country reception and office management.

Your costs will include all of the standard administrative and operating expenses, such as utilities, water, landscaping, licenses and permits, office furniture and fixtures, maintenance and repair, and waste removal. In some countries, such as Brazil, you will need to prioritize safety issues, and you'll want to find a location near a highway or public transit. Expect to pay a hefty premium for prime real estate.

Rule of thumb: It could take anywhere from three to nine months or more just to set up operations in a foreign country. Some countries allow foreign businesses to establish an entity without a physical office space or a local bank account. Other countries require a physical office, and in some countries both an office and a bank account are required. The more requirements, the longer the setup time.

Employer Obligations

HR issues for foreign operations will be unlike anything you've faced in your domestic markets. Factors such as national health, work visas, employment contracts and risks of unfair dismissal claims vary by country.

Will you use local hires, expats, contractors, full- and part-time employees or a mix? US employment practices typically don't apply in other countries. You will want to investigate whether professional employer organizations overseas are viable and allocate resources for recruiters and international headhunters.

You'll also need legal assistance when drafting employee contracts so that they comply with host-country labor laws. In many countries, an employment contract will have to be written in a language other than English. You may pay to have a translation, but the contract written in the language of the host country will prevail.

Maintaining accurate documentation is critical, and the lack of it could result in unwittingly getting slapped with penalties and fees.

In the case of contractors, some companies have found out the hard way that local authorities may deem them as de facto benefits-eligible employees. Employment laws in most countries tend to favor the worker over the employer to a greater degree than in the US, and misclassifying a worker as an independent contractor in almost all countries can result in significant fines and reputational damage. So don't budget for contractors when you need to be budgeting for benefits-eligible employees under host-country laws.

If you plan to send expat workers, expect a typical overseas assignment to cost two to three times the employee's home-country salary. In order to attract and keep top talent — and to ensure that all overseas assignments are tax-neutral from an employee perspective — many companies develop tax equalization or tax protection policies. These policies offset the personal tax burdens associated with expat assignments. They can be complex and costly to administer and may involve establishing a "shadow payroll" in the host country for the purposes of withholding and remitting income and/or social taxes to host-country authorities while the expat remains on a home-country payroll.

Sending employees across borders will also require immigration and relocation allowances to be paid and planned for well in advance.

It's also important to budget for any planned or possible employee terminations. At-will employment virtually doesn't exist outside the US, and employee termination is highly regulated in many countries. In France, for instance, it can cost a company at least the equivalent of 12 to 18 months of severance to terminate an employee. It is particularly important to budget for terminations when acquiring employees in a cross-border transaction, and also to understand worker rights under local law and any applicable collective bargaining agreements (CBAs).

Also consider that you might need to compensate an employee to sign a non-compete agreement. Your company may also be required to supply mandatory training for its employees.

Rule of thumb: The fastest way to staff your new operation may be to hire competent local nationals. Yet there may be sound business reasons for sending expats, either for a short or long term, to ensure that your business will run as expected. Budget for all possibilities.

Payroll and Benefits

Many companies are shocked to learn they must pay significantly more in their foreign operations than they do in the US for employee taxes, unemployment insurance, health insurance and other benefits.

Among the local labor, tax and social security laws that regulate pay are requirements that extend further than typical US insurance contributions, statutory withholdings, disbursements and filings. Often, overseas employers must offer mandatory salary increases, profit sharing, payments for holidays and bonuses, and allowances for meals and transportation. These can have a profound impact on employment contract terms, compensation and payroll operations.

Foreign employee vacation and overtime pay can lead to even more unpleasant budgeting surprises. In France, for example, workers have a 35-hour workweek and get a minimum of five weeks off each year. When you factor in public holidays, paid time off in France comes to nearly two months a year for every employee, plus more time off for overtime performed.

Sick leave benefits can also be a considerable cost. In the Netherlands, for example, employees can collect 70 percent of their salary for up to 104 weeks.

Many parts of the world have unique requirements. In Canada, Brazil, Belgium and Denmark, for example, employers pay not only for vacation time, but also for a vacation bonus. In most parts of China, employers are expected to contribute between 0.5 and 1 percent of an employee's salary to a maternity-leave fund. In the Philippines, employers must provide workers with one 50-kilogram sack of rice per month or its monetary equivalent.

Rule of thumb: It will take several weeks to research and draft a benefits plan that complies with local laws and makes you a competitive, attractive local employer. At the very least, double your US-based estimate of paid time-off costs for employees in the world's 20 most-developed countries. Research each target country individually.

Tax and Accounting

There are myriad taxes when expanding overseas, including any federal, state and provincial taxes. Depending on your target country, corporate taxes may be lower, but there could be significant indirect taxes. For example, to do business in Brazil you will pay federal VAT, state VAT and a municipal services tax.

To maintain a multicurrency general ledger, you'll need local accountants and internal and external auditors to reconcile different general ledger entries. In addition, converting a foreign subsidiary's accounting into US GAAP can be extremely challenging, and may require costly training and ongoing oversight. In addition, you'll need to make sure your books and records are available for inspection at any time by local authorities, and that those books and records are kept in accordance with local law, not US law.

Depending on your business, you'll also need a robust transfer pricing structure. Tax authorities in all your countries of operation will want proof that your corporation isn't setting internal pricing for goods, supplies or services incorrectly or "creatively" to avoid paying your share of taxes to local authorities. This requires understanding the "arm's length" principle — meaning that your transfer pricing is consistent with the pricing of other similar goods and services in your new country's open market. The trend over the last 40 years has been for tax authorities to steadily increase the amount of documentation required to substantiate transfer pricing and to increase penalties for getting the pricing and/or documentation wrong.

Regulatory Compliance

Regulatory compliance of every sort, from currency controls, to import/export restrictions, and even environmental matters all have an impact on your budget. You'll need sound international expertise to ensure that you adhere to laws such as data protection and anti-corruption in your sales, marketing and promotional activities.

You will need to rely on experts who can assist in keeping up with new and ever-changing regulations. For example, in 2016, France began requiring mandatory health insurance rather than offering it as a supplemental benefit. And in 2019, for the first time it began requiring employers to withhold income tax from employee paychecks. These changes of course significantly affected payroll.

Keeping current with the evolving regulations of all your countries of operation can be costly, but it's essential to avoid crippling penalties and reputational damage.

Rule of thumb: You must comply with the regulations of all your countries of operation, not just your home-country laws. In some cases, host-country laws may be more restrictive and require developing new company policies and procedures. For example, if you're operating in the UK, you'll need to comply with the UK Bribery Act, an anti-corruption law that is more restrictive than the US Foreign Corrupt Practices Act.

Travel

Your budget will need to account for the number of people traveling to your new location, how many times they'll travel for the year, airfare, hotels, transportation and meals. Travel by board members and senior and operational management must be claimed as legitimate expenses.

Most companies will want to budget for regular site visits from the home office. Site visits promote compliance and controls, and are a crucial means of enhancing communication between headquarters and overseas offices.

If you regularly send employees to countries where you do not have an established legal entity, it is important to track that travel so you avoid triggering a taxable presence (permanent establishment or "PE") under the laws of each country. Instituting this kind of tracking — including understanding what triggers a PE in each country — can be complex and expensive and may require reliance on outside experts and software.

Rule of thumb: Tracking employee overseas travel is necessary to avoid unknowingly triggering multiple tax presences that could force a company to conduct costly financial restatements both at home and abroad.

Winding Down Operations

Understanding the costs and obligations of dissolution is every bit as critical as understanding the costs and time to set up operations. All countries have unique requirements, costs and timelines for winding down operations, and in some cases it can be more costly and burdensome to shut down a business entity than to establish one.

To take some examples: Dissolving a subsidiary in the UK generally takes five to six months, and liquidating a Wholly Foreign-Owned Enterprise (WFOE) in China can take eight to 12 months. And it can cost a lot more than you might think. For example, Target's decision to close operations in Canada cost the company more than $5 billion in pretax losses.

Rule of thumb: When budgeting for overseas expansion, remember to account for the possibility that you may have to close up shop.

Next Steps

A clear budget gives you the best available information to understand your first year of operations and effectively forecast results. Forecasts may be done at a high level, mid-level or detailed level, depending on your business, and should provide action-oriented data.

Many companies prepare rolling forecasts, incorporating actual results each month and then projecting out another 12 to 18 months.

Remember that it can be tricky to investigate material variances, positive or negative trends, or unusual activities in your overseas office because of distance, time zone differences and accounting issues.

Rule of thumb: The steps taken after the first year of operations can be difficult if analytics show that the location has veered off course in sales and revenue. But with proper planning and due diligence, you don't have to assume that you'll experience major pitfalls. Many companies have been able to take advantage of powerful opportunities by expanding into international markets.

About Vistra

Ranked among the top three corporate service providers globally, Vistra is a versatile group of professionals, providing a uniquely broad range of services and solutions. Our capabilities span across international incorporations to trust, fiduciary, private client services, and fund administration. We employ over 4,000 professionals across 46 jurisdictions throughout the Americas, Europe, Middle East, and Asia Pacific.

As a leading global player with expert industry knowledge and location specialists, Vistra has a deep understanding of the professional worlds of our clients, and a proven track record of offering highly versatile solutions, providing the people, processes, and products that help our clients get the most from their international business.

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