

## **F/X CONSIDERATIONS IN COMPENSATION**

Margaret Park Kwiatkowski | April 2015

The latter half of 2014 saw the early signs of a weakening loonie against the U.S. dollar with some analysts predicting a more significant decline for 2015 that could end with a possible floor of 75 cents. With an uncertain outlook as to when the loonie will regain strength against its U.S. neighbour, one thing is for sure, Canadian-based compensation programs that are highly influenced by the U.S. dollar will face many challenging issues over the coming months.

Canadian-based companies can be affected in several ways from the falling loonie:

- Companies that benchmark executive compensation against a U.S. peer group will see an immediate decrease in competitiveness relative to their U.S. counterparts primarily due to foreign exchange (“F/X”).
- The same holds true for Canadian companies with U.S. based directors.
- The assessment of performance to determine payouts under variable plans will be directly impacted by F/X for Canadian companies that operate in commodity-driven sectors that are tied to the U.S. dollar, have U.S. operations, etc..
- Proxy disclosure, year over year comparisons in compensation, pay for performance analyses, etc. will all be affected by F/X.
- Recruiting and retention efforts will become more challenging for Canadian companies that look to a North American / global talent pool for sourcing executive talent.

## **TOP FIVE THINGS COMPANIES SHOULD BE THINKING ABOUT IN 2015**

Discussions have already started around the boardroom table with respect to some of the issues noted above with likely a few companies having already grappled through the issue of performance measurement for 2014 incentive payouts.

As part of the ongoing dialogue and debates that will inevitably take place in 2015, boards and management should consider the following when making decisions about executive compensation in light of the loonie’s weakened status against the U.S. dollar:

### **1. Benchmarking and Setting Executive Pay Relative to a U.S. Peer Group**

Companies that benchmark and set pay relative to a U.S. peer group will see competitive compensation decrease by up to 25% (at current rates) purely due to F/X. While companies may refer to a U.S. peer group for different reasons (e.g., a lack of comparable Canadian peers, the scope of roles have a North American / global footprint, provides a supplemental reference, etc.), decisions will nonetheless, need to weigh in on the impact of these pay differentials for compensation decisions going forward.

While the obvious considerations are financial in nature, companies also need to consider whether potential changes to compensation currency will be temporary or permanent in nature and whether those changes will create internal equity issues among the senior ranks.

To shape the conversations on the potential financial impact of either making a move to U.S. dollars or keeping the status quo, companies should have a clear understanding of the potential range of compensation dollars at stake. Modeling various scenarios using current, average, and potential future F/X rates, to determine how that impacts the relative, competitive positioning of its incumbents against the compensation peer group, would serve well to provide that picture.

Consideration also needs to be made regarding how compensation will be paid; set in U.S. dollars and paid in U.S. dollars or the Canadian equivalent. If compensation is converted to Canadian dollars, variations in “setting the F/X rate” for conversion purposes may provide some ability for companies to smooth out extreme swings from pay period to pay period.

## **2. U.S. Directors on Canadian Boards**

U.S. resident directors serving on Canadian boards is not a new phenomenon and while some companies have policies in place to compensate both U.S. resident and internationally resident directors in U.S. dollars, this creates an immediate internal equity issue amongst the entire board. Not only does this pose a challenge for annual cash-based retainers and other cash-based compensation, equity-based retainers would be further impacted by a weakening loonie for Canadian-listed companies.

Notwithstanding that the overall cost of a director pay program is materially less than that of a named executive officer (“NEO”) program, boards should weigh the need to balance internal equity amongst the entire group with the incremental cost of creating that internal equity where U.S. resident directors comprise less than 20% of the board.

## **3. Performance Measurement and Variable Pay**

The assessment of performance to determine payouts under variable plans will be directly impacted by F/X for Canadian companies that have U.S. operations, import U.S. goods for production and manufacturing, etc. While some companies take the view that senior leadership should not be held accountable for factors outside of their operational control, others take the position that the management of interest rate risk, F/X risk, etc., are all important areas of corporate risk, for which senior leadership should have some oversight.

While both philosophies have their own merits and challenges, ultimately, any decisions related to the methodology to be used for measuring performance for variable pay should be determined at the **start** of the performance period. In particular, decisions should consider:

- Whether to adjust or neutralize for F/X.
- Whether to adjust outside of reasonable F/X shoulders.
- What potential range of shoulders would warrant an adjustment.
- Whether any of the above decisions should vary depending on the performance period (i.e. annual plans vs. long-term plans).

## **4. Disclosure**

Disclosure of a change in pay policy to compensate executives in U.S. dollars must be clearly explained in the proxy disclosure. For companies that disclose in Canadian dollars, they will see

significant swings in year over year compensation and pay for performance outcomes that do not directly align with performance.

To neutralize the F/X effects for purposes of year over year comparisons of pay in the Summary Compensation Table and other comparative exhibits, the use of supplemental exhibits related to the impact of currency and long-term incentive valuations in a constant currency will assist in stripping out any F/X noise enabling readers to clearly see the relationship between executive compensation and company results.

## 5. Recruiting and Retention Efforts

Recruiting and retention costs may be the one unknown variable as lost opportunities for talent may be difficult to quantify; the potential value that a new executive hire will deliver is neither guaranteed nor easy to measure in the short-term. In addition, the cost of uprooting family and leaving the socio-cultural benefits that Canada has to offer may be far greater than the lure of financial gain south of the border. In other words, when dealing with cross-border mobility, many other variables may influence an executive's decision to stay or leave.

Notwithstanding the above, in the area of recruiting and retention, companies must have a clear understanding of what the financial impact **could be** should key talent need to be sought or replaced from the U.S. and what it **will be** to retain existing talent. These are all answers that may be derived from some of the analyses and discussion topics mentioned above. From there, decisions on how far to move the needle on F/X can then be made with a clearer picture of both:

- a. The potential gain by attracting key talent from a broader market; and
- b. The potential cost of doing nothing (due to lost talent).

## FINAL THOUGHTS

The jury is out on how long and how low the descent will go for the loonie. While no crystal ball will tell us when the ride will end, there are steps that companies can take to lessen the bumps along the way. Thoughtful and preemptive analyses and discussions will serve well to clarify and understand the issues at hand and the stakes at play when it comes to F/X in compensation.

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