Compensation and Benefits: Essentials of Long-Term Incentive Plans

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Abstract

A long-term incentive plan (LTIP) is a plan under which a reward can be earned over a multiyear period, typically if certain conditions are met. The reward is normally financial and in the form of shares, options, cash, or a combination of these payment vehicles.

LTIPs are used for a variety of reasons, including employee retention, performance improvement, wealth creation, and corporate glue. The way the LTIP is designed and communicated is critical for its success. There are various challenges that can hinder its effectiveness. Issues arise because companies sometimes try to achieve all objectives with a single plan. Other challenges are related to human behavior, perceived value, or responses from competitors in the labor market. Therefore, this chapter asks the question: "How to ensure effectiveness of a Long-Term Incentive Plan?"

Based on four perspectives, i.e., people, economic, risk, and operational perspective, the question is analyzed, and one or multiple answers are provided for each of the chosen perspectives. All answers are provided in light of promoting effectiveness.

In terms of the outlook for the future, it is expected that long-term incentive plans will continue to be important in the tool kit of the compensation professional. LTIPs will further evolve to be able to better measure company success in financial and nonfinancial sense and, in general, to contribute to business needs as well as individual preferences. Multiple plans may be needed to cater to different objectives, with the challenge to keep things as simple as possible.

Keywords

Cash • Compensation • Long-term incentive plan • LTIP • Options • Perceived value • Risk • Shares

Introduction and Overview

In the USA, during the 1990s, the use of stock options exploded. All kinds of HR issues were "solved" with the same solution. If you are holding a hammer, everything starts to look like a nail. Providing a talented employee with something extra? Let's grant stock options. Problems with retention? Let's do options. Trying to create

the one-firm feeling? Why not give everybody options? Creating retirement wealth? You know the answer.

The stock option explosion in the USA caused a ripple effect practically all over the world. Although the stock option vehicle is still an often used payment mechanism within long-term incentive plans (LTIPs), its popularity has diminished, also in the USA. For example, the Wall Street Journal/Hay Group survey of CEO compensation over the year 2015 shows that plain vanilla stock options in the current time only make up a quarter (25 %) of the LTI package. The other quarter is restricted stock (24 %), and half the package is made up by performance awards in equity or cash (51 %).

Apparently, there is a variety of awards possible. So, what could be a more general definition of an LTIP? In this chapter, an LTIP is a plan under which a reward can be earned over a multiyear period, typically if certain conditions are met. The reward is normally financial and in the form of shares, options, cash, or a combination of these payment vehicles. An often used time period before all awards become unconditional is 3 years, but a variety of other practices is observed as well. The conditions, if applicable, are related to continued employment and/or based on performance.

This chapter starts by asking four questions. The high-level answers to these questions will provide the basics of LTIPs, in order to facilitate general readability of the remainder of this chapter:

1. *Why do companies use long-term incentive plans?*
2. *What are some of the challenges of using long-term incentive plans?*
3. *How can a long-term incentive plan be designed?*
4. *Who should be eligible for an LTI?*

These initial answers also provide an overview of the opportunities as well as challenges of LTIPs. The guiding question for this chapter is therefore:

How to ensure effectiveness of a long-term incentive plan?

Why Do Companies Use Long-Term Incentive Plans?

The "why question" relates to the objectives that companies have when using an LTIP. Some typical goals with some initial remarks are shown in Table 1.

Table 1 is not intended to be comprehensive. There could be various other goals such as to promote long-term thinking, to attract talent, to provide for tax-efficient income programs, etc.

What Are Some of the Challenges of Using Long-Term Incentive Plans?

The "what question" is interpreted here in terms of effectiveness. How to ensure achievement of the aforementioned objective(s)? The objectives will not be achieved

Table 1 Why do companies use LTIPs?

Typical objectives	Line of reasoning
Employee retention	Because an LTIP rewards employees over a longer period of time, it may provide recipients of LTI grants with a reason to stay (longer) with the company in light of the future benefits associated with the vesting of these awards
Performance improvement	The word long-term incentive plan reveals an important objective that is often associated with this instrument. Within this line of reasoning, it is an incentive to improve (long-term) performance
Wealth creation	LTIPs can be used in light of value creation for employees. An LTIP is often linked with the development of the value of the company. Employees who obtain multiple LTI grants can build a portfolio of instruments over a period of time. In some countries, net wealth can be facilitated by a tax-efficient design
Corporate glue	Particularly, companies that operate over multiple business units in different countries (across the globe) sometimes use an LTIP with the goal to create alignment and a "one-firm" feeling

under any circumstance. There are various challenges that can hinder its effectiveness. Issues arise because companies sometimes try to achieve all objectives with a single plan. Other challenges are related to human behavior or to responses from competitors in the labor market. Table 2 provides an overview of some of the challenges related to the objective of Table 1.

Solving the issues can be partly done by choosing the right design features that match the objectives and people (eligibility). LTIP design is therefore an important driver of effectiveness.

How Can a Long-Term Incentive Plan Be Designed?

Table 3 shows possible design elements of an LTIP with some initial remarks.

Who Should Be Eligible for an LTI?

If a company operates an LTIP, typically the (top) executives are eligible. A higher level in the organization is related to making longer-term and larger risk decisions. Eligibility can be based on base salary, job title, job grade, etc. Talents are sometimes provided with an LTI grant. Generally speaking, broad-based plans which include the majority or all employees come at the cost of dilution and lower perceived value given the fact of little influence. This is why short-term incentive plan (STIP) eligibility typically goes much deeper into the organization than LTIP eligibility.

The above questions and high-level answers have provided an overview of the opportunities and challenges of LTIPs. Therefore, the remainder of this chapter is based on the following question:

Table 2 What are some of the challenges of using LTIPs?

Typical objectives	Challenge
Employee retention	Retention may not be achieved, for example, as a result of the fact that employees perceive the probability of payment as low or because other companies compensate the employee for forfeited rights. If it does reduce the risk of certain employees leaving the firm, it may have various side effects. Retention may be achieved but also in the case of those people that the company does not want to keep any longer
Performance improvement	Performance improvement can be achieved if employees perceive the LTIP as an incentive. This is only the case if the payment vehicle is desired, there is an impact of the employee's actions on the performance measure (line of sight), and there is a clear relation between better performance and higher payments. If one of the three is missing, there will be an issue in terms of this objective. Issues are furthermore related to human behavior such as the generally low perceived value of rewards in the future (discount) and the optimal mix between intrinsic and extrinsic motivators
Wealth creation	LTIPs can contribute to wealth creation. The more leverage is created, the more wealth can be earned in case of excellent performance. This comes at the cost of increased risk of earning nothing. Finding the right balance is key
Corporate glue	The value of an LTIP may be low for people that receive shares from a company with headquarters on the other side of the world. Cost efficiency may be low, if also the LTIP does not succeed in creating a bond

How to Ensure Effectiveness of a Long-Term Incentive Plan?

This will be analyzed from four different angles: the people, economic, risk, and operational perspective. Each paragraph will provide one or more answers based on the chosen perspective. This chapter ends with an overview of dos and don'ts, as well as an outlook for the future.

People Perspective

Within the people perspective, LTIPs are viewed from the angle of the impact on people in terms of attraction, retention, and motivation.

Attraction

LTIPs can be used in the process of attracting the right candidate for the job. An often heard reason why companies provide LTIPs is the fact that remuneration packages are typically linked to a market benchmark. If it is a common practice to provide an LTIP within the relevant labor market segment as part of the total remuneration package, they also typically provide an LTIP for competitive reasons. However, in light of attraction, another important aspect of an LTIP can help companies to

Table 3 How can an LTIP be designed?

Design elements	Remarks
Payment vehicle	The basic payment vehicles are cash, options, and shares. Particularly in the financial services sector, other instruments are observed as well such as CoCos (contingent convertibles which are hybrids of bonds and stock). For the equity-based vehicles, the settlement can be either in equity or in cash (i.e., stock appreciation rights and phantom shares). Options provide the employee with the right to purchase company stock at a stipulated price (exercise price) over a specified period of time. In some countries, stock options that follow certain conditions are tax favorable (e.g., the incentive stock option in the USA in contrast to the nonqualified stock options)
Vesting period, performance period, exercise period	The vesting period is the time in which restrictions are linked to the LTI. These restrictions are typically an employment condition and, in the case of a performance plan, one or multiple performance conditions. The vesting period can either be a fixed time period or with a time-accelerated feature that allows restrictions to be removed faster than originally scheduled if certain performance goals are already achieved. Typically, the performance period is aligned with the vesting period and is between 3 and 5 years. The exercise period relates to the instrument of options
Performance measures	If performance measures are linked to the LTIP, certain performance conditions need to be met in order for the LTI to become unconditional. A basic division is between nonmarket-based and market-based performance measures. In the latter category, all measures are related to the share price and (total) shareholder return. The first category entails all other measures. Examples are accounting measures such as earnings per share (EPS), value-based measures such as economic profit (EP), and strategic measures such as market share, strategic milestones, etc. A different taxonomy is between financial and nonfinancial measures
Target setting	If performance measures are used, relevant targets need to be set. Targets that are too stretching will demotivate employees. Targets that are too easy hurt the pay-for-performance principle. In summary, targets can be set based on a budget approach, a delta approach (year-on-year improvement), based on management expectations (typically somewhat above budget) and in relative sense (compared to country or industry standards, against a specific group of competitors, etc.)
Fixed value versus fixed number	The number of LTI vehicles at the moment of (conditional) grant can be determined based on a certain policy value. Each time a new grant is made, the number of vehicles is recalculated to adjust for any value fluctuations (e.g., as a result of share price movements). Alternatively, it can be fixed for a number of years at a fixed number. In the latter case, employees are additionally rewarded for year-on-year improvement of the share price and punished for share price decreases. This results in greater leverage

(*continued*)

Table 3 (continued)

Design elements	Remarks
Capped versus uncapped	Typically, equity-based LTIPs are uncapped in the sense that the number of vehicles that one can receive may be capped, but the value increase as a result of share price increase is not capped. LTIPs that pay out in cash often do have a cap. This implies that the maximum cash amount that can be earned under the plan is determined up front. An important reason for this is that cash plans can become a cash drain to the company
One plan versus multiple plans	The LTI policy can operate one or multiple plans with one or multiple payment vehicles. Different plans may cater to different objectives. Handling more plans can become complex (e.g. in terms of granting & vesting, performance monitoring, administration, accounting). Deciding on a single or multiple plans is therefore a balancing act
Frequency of grants	The basic choices here are to provide employees either with a front-loaded grant that, e.g., covers the upcoming 3 to 5 years or with annual grants. Annual grants have become the most common form because it is better controllable, caters to the need of new people onboarding, reduces the impact of significant stock swings, etc.

compete effectively for those individuals they want to attract. This relates to the design of the LTIP. Below, this is further discussed.

The LTIP is a form of "at-risk" compensation which can be used in the selection process to overcome the problem of hidden information, also referred to as adverse selection. The contracting problem in the case of hidden information is to design a contract that effectively separates individuals with different hidden types, so that people from each class only select contracts intended for their type. Let's take an example. In a standard case, a number of people will apply for the job. By screening, i.e., checking references, education, etc., the company can learn more about the person. However, some information may remain hidden (even after a psychological test). A solution to overcome this problem of hidden information could be to design a contract in which a form of self-selection takes place. Suppose a candidate with entrepreneurial spirit is searched for with a relatively low-risk profile and high performance aspirations (low cost of effort function). In such a case, the contract should be designed to ensure the right candidate will "self-select" into the job. The offered contract may contain more pay at risk, e.g., constructed by the obligation for the candidate to buy a certain number of shares in the company and/or a more pronounced pay-for-performance relationship, i.e., more risk as well leverage. In Fig. 1, this would be the theoretical contract B as opposed to contract A (source: Engesaeth 2011).

The self-selection mechanism thus contributes to a situation in which "the right candidates" will self-select into, or out of, the company.

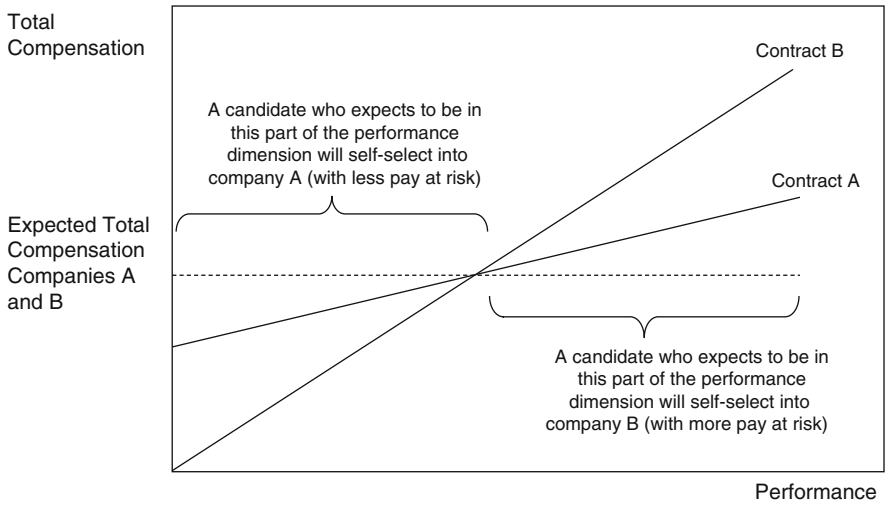

Fig. 1 Adverse selection

The LTIP, together with the other elements of the remuneration package, forms the pay-for-performance relationship. Based on the various possible design features, as discussed in the introduction of this chapter, it can be designed such that it helps in the self-selection process of candidates. An effective design for a retail bank may be such that it helps to attract relatively risk-averse individuals, by making the line flatter. Private equity-controlled companies sometimes look for very entrepreneurial people and typically design the relationship such that the line is (very) steep.

Retention

Because an LTIP rewards employees over a multiyear period, it may provide recipients of LTI grants with a reason to stay (longer) with the company in light of the future benefits associated with the vesting of these awards.

If the objective is to retain people, the LTIP therefore needs to be designed in such a way that it effectively does that. The selection of the right people is of course key; however, here the design is focused based on two examples. In some plans, multiple objectives are used. This can limit the effectiveness in terms of the goal of retention. For example, if performance hurdles need to be met after 3 years, this can immediately undermine the retention objective if it is already clear after 1 year that it will be very difficult to achieve the goals. A second example relates to the payment vehicle. If this would be in the form of options, it would hurt the retention objective if the stock price would fall below the exercise price. These so-called underwater options have limited to no value to the recipient, especially if they do not believe the options will become in the money again within a reasonable time frame and therefore will not have the desired effect. An effective retention plan is therefore a plan that has

value. This implies that it pays out in shares or in cash and has either a positive performance multiplier or no performance conditions at all. The only relevant condition would be an employment condition, i.e., the requirement that the individual stays with the firm for a specified period of time (vesting period).

Motivation

In light of motivation, a discussion of the "I" within LTI is needed, i.e., incentives. A lot can be said about incentives and motivation. Here, only the basic elements will be highlighted. The standard economic assumption is that people respond to incentives. Although this may be the case, various researchers within the behavioral economics area have shown that people may behave differently and often less rationale than typically assumed in the original economic models.

For any incentive to work, the design needs to take into account at least the following basic elements:

- The reward needs to be something that people want and can understand. This seems obvious, but complex LTI plans are sometimes observed with limited to no incentive effect. An effective LTI design is therefore "as simple as possible." Furthermore, any form of future reward is heavily discounted. Basically, the level of attractiveness decreases if the time horizon is longer.
- The reward needs to be higher in case of good performance and lower in case of bad performance. This is the essence of providing an incentive for good performance. Setting appropriate targets that strike a balance between "what is required" from a business point of view and "what is achievable" from an employee point of view is a balancing act. In addition, setting long-term targets can be difficult given the fact that it involves predicting performance expectations for several years in the future.
- The actions of the individual need to impact the performance outcome. This is typically referred to as "line of sight." If there is no (direct) relationship between actions and outcome, there is no "line of sight" and therefore no incentive working. Choosing the right performance measures is the most challenging aspect of this.

The above elements show that designing an effective incentive is a balancing act. Most of this is related to the comprehensive trade-off between line of sight and goal alignment. Academically, this is referred to as the trade-off between "risk and distortion" (Baker 2002). The "risk" refers to the risk for the employee. Measures are less risky if there is more control over the outcome and riskier if there is less control. The part of "distortion" refers to the goal of the company. Performance measures that are more in line with long-term value creation are less distorted, and measures that are further away are more distorted. Organizations rarely have low risk and at the same time low distorted performance measures and remuneration vehicles and therefore choose a combination from the categories "low risk and high distortion" or "high risk and low distortion," as shown in Table 4 (source: Engesaeth 2011).

Table 4 Classification of performance measures and compensation vehicles (risk and distortion)

Line of sight (low risk – high distortion)	Goal alignment (high risk – low distortion)
Short-term focused performance measures	Long-term focused performance measures
Individual performance measures	Group performance measures
Accounting-/internal-based performance measures	Value-based/external performance measures
Relative performance measures	Absolute performance measures
Multiple measures	Single measure
Cash-based vehicles	Equity-based vehicles

Table 4 also provides insight into the "perceived value" of compensation instruments. Perceived value could be defined as the certainty-equivalent cash amount that the employee would be willing to give up in exchange for the risky award. Generally, the higher the risk, the lower the perceived value, assuming a risk-averse employee. Combinations of items from the left-hand column of Table 4 generally have a higher perceived value than combinations from the right-hand column. For example, a yearly cash bonus based on an internal measure of individual performance has a higher perceived value than a long-term-performance option plan based on the achievement of an absolute total shareholder return (TSR) hurdle. For a quantitative analysis, see the "risk perspective" further in this chapter.

After performance measures have been selected, targets need to be set. Targets can be set using various approaches. Often, the budget method is used. This is worrying, as Jensen (2003) has shown that setting targets based on budgets actually "pays people to lie." However, there is no easy solution. Different methods of setting targets, such as using a delta approach, i.e., year-on-year growth, or peer comparison, have other drawbacks. Year-on-year growth is not always possible or even desirable. Peer comparison results in the issue of selecting the right peers, and often there are comparability problems.

Besides setting adequate targets, the performance or payment range should be determined. Basically, this implies determining threshold, target, and maximum objectives as well as the associated payment in each of these states of the world as well as the intermediate results. The target level would be the expected performance outcome for fully satisfactory performance. At threshold performance level, the first payment above zero is made. Nearly all companies cap the amount of LTI vehicles that can become available. In case of share-based payments, the uncapped part is formed by the share price development. Cash plans or cash-settled equity-based plans typically have a cap as a result of the unknown cash impact in case of an uncapped plan.

Concluding (in Terms of Effectiveness)

From a people perspective, an LTIP can be helpful in light of attraction, retention, and motivation of employees. An effective LTI, in this light, is designed to cater to the most important objective. An LTIP that is effective in terms of retention may not be effective in terms of providing a performance incentive. This implies that multiple

Table 5 LTIP effectiveness road map based on a checklist of issues

Element	Remarks
Performance measures	1. As there are no perfect performance measures, multiple criteria can be combined to ensure line of sight, i.e., being able to influence the outcome, as well as goal alignment, i.e., long-term value creation. Overemphasizing line of sight measures can result in destruction of company value. Overemphasizing goal alignment measures can result in unmotivated employees and increased retention risk (in case of a single LTIP) 2. Although the plan may operate multiple measures to capture the above trade-off, operating too many performance measures can result in a lack of focus regarding what is important and divert effort away from important tasks 3. Contracts in practice are typically incomplete. When exact definitions of performance measures are not clearly laid down in the contract, including how to deal with exceptional items, goodwill, acquisitions, etc., before the performance period starts, this results in ambiguity at the time of assessing the performance. When EPS is used, for example, will this be undiluted or diluted EPS? When economic profit is used, will there be an "investment relief," and to what extent, or not? etc. 4. Discretionary elements improve effectiveness of the plan when used adequately. If this is not the case, they result in decreased effectiveness
Performance targets	5. Targets that are too challenging will result in demotivated executives and add to potential retention risk. This can, for example, be checked by comparing the actual payment versus target over a number of years relative to competitors 6. Targets that are not challenging enough hurt the pay-for-performance principle
Performance incentive zone	7. Performance incentive zones that are not linear over a vast portion could reward gaming and volatility. Cutoff points, if any, should be carefully chosen
Payment vehicle	8. If the payment vehicle (cash, options, shares) is not properly selected, this results in excessive risk-taking or insufficient risk-taking. Employees/executives are exposed to both firm specific as well as systematic risk. This indicates that the risk position between the shareholder and the employee/executive is different

LTIs may be needed if multiple objectives are equally important. Designing the LTI as an effective performance incentive is the biggest challenge. This is a result of the fact that it is easy to kill the incentive strength of an LTI. This puts pressure on the "I" in LTI, as summarized in Table 5 (source: Engesaeth 2011). Addressing these elements is a road map to an effective LTIP.

Economic Perspective

In light of the economic perspective, various cost aspects will be discussed, i.e., fair value calculation (Black-Scholes-Merton, binomial, Monte Carlo simulation), accounting charge, tax, overhang, and dilution.

Fair Value

Determining the fair value of an LTIP is, among others, relevant in the process of determining the size of the award. In the case of a fixed-value approach, the employee is granted a certain number of options and/or shares that match the intended grant size. Let's assume a value of 100,000 is granted each year (typically identified as a percentage of base salary), and the value of one LTI vehicle is 10. The grant is then 10,000 vehicles. This amount is recalculated each year to determine the award size. In the case of a fixed-number approach, the number of 10,000 would be fixed for some years and would not be adjusted regardless of the underlying value.

In terms of determining the fair value of the LTIP, basically two aspects need to be valued: the underlying vehicle and the performance component. In case of an LTIP without performance component, obviously only the underlying vehicle will be valued. In the remainder of this paragraph, first the value of a share is discussed, subsequently the valuation of a plain vanilla option, and finally a performance share/option.

Shares: The value of a share without performance conditions is basically equal to the share price. If a vesting period is linked to the share based on an employment condition, the value may be adjusted downward if the employee is not entitled to receive the dividends that were paid out during the vesting period. An alternative approach is that dividends are accrued and put in an escrow account and paid at the moment of vesting (either in cash or in shares). In this case, no downward adjustment is needed. Finally, a holding period, in which shares are blocked for sale, may impact the value downward. Tax authorities may allow a discount in terms of income tax related to shares with a holding restriction (e.g., a discount of 2.5 % per year).

Plain vanilla options: The value of an option is typically determined by the binomial model because it allows for various eventualities to be factored into the model. The binomial tree is typically used because it can also work with American-style options, which implies that the option can be exercised at any time before the expiration date (from the moment of vesting). The alternative Black-Scholes formula (including dividends based on the addition of Merton) is typically less accurate and can only determine the value of a European-style option (i.e., an option that can only be exercised at the expiration date). For options with a short term to expiry, the formula provides relatively accurate results, but the binomial model is preferred in other cases. Figure 2 shows the simplified underlying logic.

The binomial value of the option is the average payout over all exercisable share price scenarios minus the exercise price, discounted to the day of valuation. In the example in Fig. 2, assuming that the option can only be exercised at time $t = 3$, the binomial value, after subtracting the exercise price in each exercisable scenario (otherwise zero), is based on the following formula: $S(3,1) \times P(3,1) + S(3,2) \times P(3,2) + S(3,3) \times P(3,3) + S(3,4) \times P(3,4)$.

Performance shares/options: In case of performance shares or options, a performance condition is linked to the vesting of the vehicles. There are various ways to take into account nonmarket-based and/or market-based performance conditions. For example, in the case of a performance peer group in which vesting depends on the achievement of a certain total shareholder return relative to peers, a simulation model is needed,

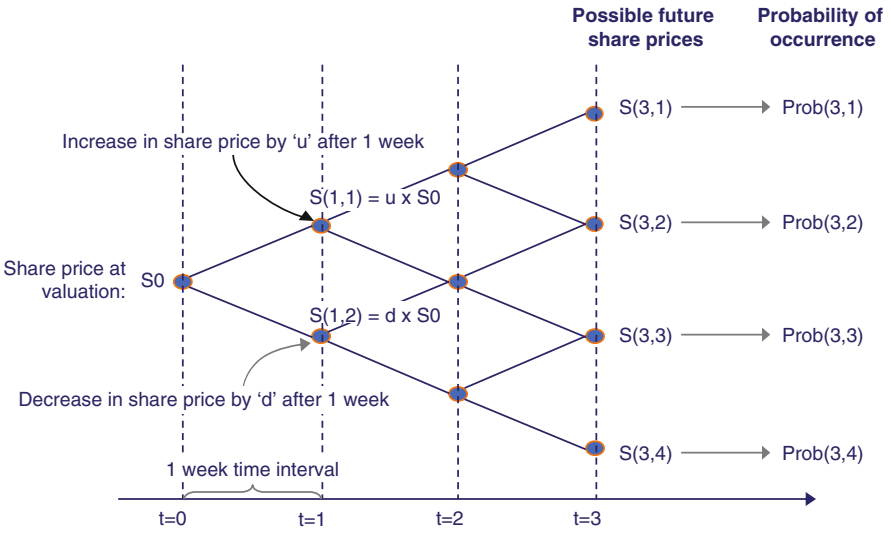

Fig. 2 Binomial option tree

for example, based on the Monte Carlo approach. Typically, for each of the companies in the peer group, the share prices are simulated based on the following distribution:

$$LN\,S_t \sim \Phi\left[\ln S_0 + \left(\mu - \frac{\sigma^2}{2}\right)T,\ \sigma\sqrt{T}\right]$$

This assumes a lognormal distribution of share prices, of which the distribution parameters are as follows:

S_T = share price at future time T

S_0 = share price at time 0 (grant date)

μ = expected return (equal to the risk-free rate minus dividend yield)

σ = volatility (e.g., 36-month historical volatility per company)

T = future time (here, 36-month performance period after the grant date, T = 3y)

A graphical representation of the Monte Carlo model is shown in Fig. 3.

Based on the distribution, and the correlation coefficients between the companies in the peer group, 10,000 possible share prices are simulated for each company at time T = 3. Based on the results in combination with the performance incentive zone characteristics, the fair value can be calculated as per the grant date by discounting the value to T = 0.

Accounting Costs

Under IFRS and US Generally Accepted Accounting Principles (GAAP), accounting costs need to be determined. These are based on fair value calculations as

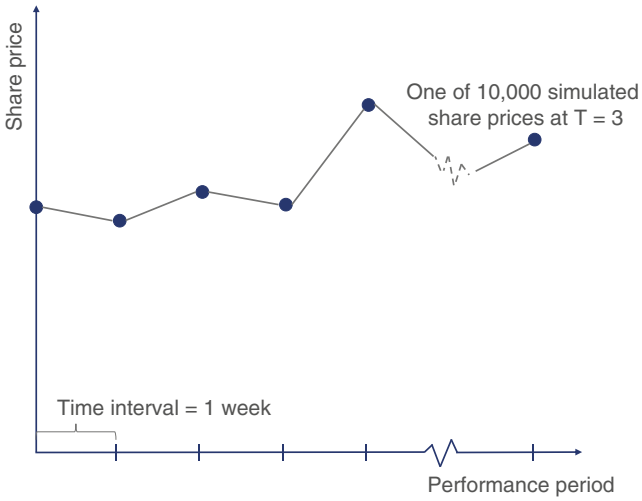

Fig. 3 Monte Carlo simulation

described in the previous paragraph. These calculations are typically executed by an outside party and validated by the external auditor. Expensing of the costs takes place over the vesting period. Forfeited LTI as a result of people leaving the firm (bad leavers) may be subtracted. Here, the example of the IFRS 2 accounting standards is taken.

Before 2005, the accounting costs of equity-based compensation in particular options only very limited, if at all, affected the profit of companies in Europe. Since the effective date of International Financial Reporting Standard 2 (IFRS 2) issued by the International Accounting Standards Board (IASB), which is 1 January 2005, this has changed. Per this date, an entity shall recognize the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognize a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction or a liability if the goods or services were acquired in a cash-settled share-based payment transaction. With regard to compensation, this implies that services received from employees, compensated for with share-based payments, will be recognized in the profit and loss account.

Broadly speaking, two important elements determine how share-based payments are recognized:

1. Type of share-based payment:
   - Equity-settled share-based payment transactions (e.g., shares and options): The entity shall measure the services received and the corresponding increase in equity directly at the fair value of the services received. When there is no vesting period, it is assumed that services are directly received and costs will be fully recognized directly. When the executive needs to complete a specified

period of service before becoming unconditionally entitled to those equity instruments, costs will be recognized over this vesting period (services assumed to be rendered by the employee over the vesting period).
- Cash-settled share-based payment transactions (e.g., phantom shares or stock appreciation right (SAR)): The entity shall measure the services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity shall remeasure the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognized in profit or loss for the period.
- Share-based payment transactions settled using a choice of cash or equity instruments (compound financial instrument): The entity shall account for such transaction as cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

2. Type of vesting condition:
   - Market-based condition, such as share price or of total shareholder return: The up-front impact of this performance condition will be assessed and the fair value discounted by this amount. No subsequent adjustment will be made for the actual outcome.
   - Nonmarket-based conditions, such as earnings per share or economic profit: No up-front discount to the value of the vehicle will be applied, but instead the number of shares/options that is expected to vest will be estimated for each accounting period as the progress of the performance condition is tracked over the performance period.

In summary, granting executives with equity-settled share-based payments such as options and shares is more efficient from an accounting viewpoint than providing executives with SARs or phantom stock. In the first situation, the value of the rights only needs to be determined once, and the accounting charge is known up front. In the second situation, the value needs to be reassessed per reporting date (often quarterly) which costs the company money in terms of resources and/or consulting fees. Furthermore, the profit and loss account fluctuates with changes in the share price of the company (apart from hedging) which is often perceived as undesirable.

With regard to tying performance conditions to the vesting of options and shares, the striking difference between tying, for example, a TSR performance condition and an EPS performance condition is the fact that in the first case the value is only determined once and not readjusted. When the value of the TSR plan is assessed at, for example, 100 but at the end of the performance period the condition is not met and no options/shares were actually granted (value for the executive is 0 and the company does not have an actual payout), there is no downward adjustment in the accounting charge. This remains 100 over the vesting period (apart from employees leaving the company during this period). If the same plan would have been linked to an EPS condition, with zero payout, this would be adjusted in the profit and loss account. The total charge would equal to 0 (instead of 100). Thus, providing

employees with a market-based plan (such as a TSR plan) results in no "surprises." The accounting charge is known up front. However, this charge is not adapted to reflect the eventual real situation of vested options/shares. Within nonmarket-based plans (such as EPS plans), the accounting charge is not known up front but is adapted to reflect the actual number of share/option vesting. Please note that only the number is adjusted and not the value of one option/share. This value has been determined at the moment of conditional grant and is not subsequently adjusted (this is only the case for cash-settled equity plans).

Tax Implications

LTIPs are typically associated with favorable or unfavorable tax treatment depending on the design. In some countries, this is not a topic (anymore) because of a level playing field in terms of tax treatment. However, taxes remain important, both from an employer and an employee perspective. In some countries, for example, equity-settled LTIPs may not be deducted from corporate tax perspective, whereas cash-settled LTIPs may be deducted. In terms of the employee perspective, for example, it matters whether or not taxes need to be paid at the moment of grant or at the moment of exercising the option. Because tax implications are highly country specific, no further attention is given on this topic. Please refer to a local tax advisor for the specifics on this matter.

Overhang and Dilution

Dilution refers to an increase in the number of shares outstanding which dilutes earnings per share and therefore may affect the share price. Therefore, dilution is a concern to shareholders, and shareholders require the company to indicate dilution limits. Dilution is less of a concern if the LTIP is funded by repurchasing shares from the market. Overhang refers to the total number of LTI vehicles available and outstanding. The typical limit is 5 % of the shares outstanding. Higher percentages may be deemed acceptable by shareholders depending on the nature of the firm. Start-up companies, for example, may require numbers above 10 %.

Concluding (In Terms of Effectiveness)

From an economic perspective, an effective LTI is cost efficient. It balances the value of an LTI with the costs associated with it. This implies that it minimizes the cost-value wedge and attempts to reduce accounting volatility. The choice of the vehicle has implications in this light and should be analyzed before the final design. If a tax-efficient design is possible, this should be explored. However, tax efficiency should not be the only guiding principle. In some cases, the objectives from the people perspective (attraction, retention, and/or motivation) may overrule a

tax-efficient design. Overhang and dilution are boundaries within LTIPs and can be provided.

Risk Perspective

The risk perspective is based on four different angles. The first angle is based on the perspective of the investor. The second is related to the (compensation) risk from the perspective of the employee. The third relates to risk adjustment in terms of used performance measures taken from the perspective of the company. Finally, the societal perspective is used in terms of reputation risk and the potential consequences. The categorization is somewhat artificial but used for clarity reasons. In reality, the different risks are intertwined.

Investor

A compensation contract, including the design of the LTIP, is part of a broader set of governance mechanisms which together form the corporate governance system. According to Renneboog (2005), these mechanisms (should) ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (the principals). This is a broad view on corporate governance. In the Anglo-Saxon literature, corporate governance is often more narrowly defined. Shleifer and Vishny (1997), for example, state that corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. They indicate that product market competition, one of the most powerful forces toward economic efficiency in the world, cannot solve this problem completely. This is because markets are not perfect, and once capital is sunk, managers can expropriate the return. Corporate governance mechanisms should ensure that people who sink capital are assured they get a return on this capital. Risk is an important matter in this light. Investors are willing to take a certain risk by investing in the company but expect a certain return. The level of return can be calculated based on different methods. An often used approach is based on the capital asset pricing model (CAPM). The model defines the required rate of return based on the risk-free rate and in addition an added market return related to the beta (or risk) of the company. The total return can be in the form of share price increases and/or dividend payments. An analysis of the shareholder base will show which type of investors has invested in the company and what their objectives are. The analysis is relevant in light of attraction and retention of certain shareholders. Different shareholders may wish to see a different type of LTIP in light of their objectives. In this light, the design of the LTIP should match and support the requirements of (desired) shareholders. In light of developments toward more "say on pay," this has become more important given the approval that is needed from shareholders for the LTIP design. Table 6 shows common type of investors and their objective (source: ThomsonReuters).

Table 6 Type of investors and their objectives

Type of investor	Description/objective
Core value	Core value investors focus on buying companies at relatively low valuations on an absolute basis, in relation to the market or its peers or in comparison to an individual stock's historical levels. These portfolios typically exhibit price-to-earnings, price-to-book, and price-to-cash flow multiples below the S&P 500. In addition, secular revenue growth rates of the companies in these portfolios are frequently below market averages, and their earnings tend to be more cyclical
Core growth	Core growth investors typically invest in mid or large capitalization, blue chip companies that have historically performed near the top of their sector or general market in terms of profitability, earnings growth, and revenue growth. These investors are often willing to pay premium PE multiples for highly sustainable businesses, strong management, and consistent growth over the long term
GARP (growth at a reasonable price)	GARP investors try and build their portfolios with two types of securities: (1) those that are trading at a discount to the market or their peers yet are expected to grow at higher than the market average or their peers and (2) those whose forward PE ratio is less than, equal to, or only slightly above the long-term projected growth of the company. Stated another common way, GARP investors will often say they are either looking at large cap stocks whose PEG ratio (forward PE divided by 5-year projected growth) is less than the S&P 500 or at any sized company whose PEG ratio is less than 1. This is a more conservative investment style in comparison to an outright growth-oriented strategy. In addition, dividend yield is generally not a concern of most GARP investors
Growth	Growth investors bridge the gap between the aggressive growth and core growth investment styles. They tend to be slightly more aggressive than gore growth investors, willing to pay slightly higher multiples for stocks and trade at a slightly more active pace. In general, they are looking for companies growing at superior rates than the general marketplace but are unwilling to pay the extremely high multiples associated with the hyper-growth stocks
Index	Index investors generally create portfolios that are designed to match the composition of one or more of the broad-based indices. Therefore, the performance and risk of the portfolio mirror a section of the broader market. Their investment decisions are driven solely by the makeup of the index that is tracked rather than by an evaluation of the company and its business prospects. As a result, index firms are often referred to as "passive" investors
Deep value	Deep value investors employ a more extreme version of value investing that is characterized by holding the stocks of companies with extremely low valuation measures. Often, these companies are particularly out of favor or industries that are out of favor. Some investors in this category are known for agitating for changes such as new management, a merger, or the spin-off of a subsidiary
Momentum	Momentum institutions invest in stocks whose price, earnings, or earnings estimates are advancing at a faster rate than the market or other stocks in the same sector. Momentum investors generally look

(*continued*)

Table 6 (continued)

Type of investor	Description/objective
	for stocks experiencing upward earnings revisions or producing positive earnings surprises. Most of the investors in this category have relatively high portfolio turnover rates due to a short-term (often quarterly) focus and therefore will liquidate positions at the slightest hint of a disappointment or deceleration in earnings
Income value	Income value investors are similar to those in the core value category except that they are as interested in the dividend yield as they are in the low valuation ratios of the stocks they purchase. As a result, income value portfolios typically exhibit above average current income and low PE ratios
Hedge fund	Hedge fund investors have the majority of their funds invested in some sort of market-neutral strategy. Notably, the term "hedge fund" is both a legal structure (as opposed to a mutual fund) and an investment style. Nearly every firm that uses a hedge fund or market-neutral style is legally organized as a hedge fund (and thus only opens to accredited investors). Many are offshore funds that are unregistered, have no investment limitations, and are not subject to disclosure regulations. The common element is that any long position taken in a specific equity is offset by a short position in either a merger partner (risk arbitrage), an "overvalued" member of the same sector (long/short paired trading), a convertible bond (convertible arbitrage), a futures contract (index arbitrage), or an option contract (volatility arbitrage).
Aggressive growth	Aggressive growth investors employ an extreme version of the growth style. This can be seen by their propensity to hold the stocks of companies that are growing their revenue and EPS extremely quickly, are in an early stage of their life cycle, or have minimal or no current earnings
Emerging markets	These investors focus primarily on companies in the developing economies of Latin America, the Far East, Europe, and Africa
Specialty	This category encompasses a range of styles that are not based on the financial fundamentals of the stocks in the portfolio relative to the overall market. Examples include investors that hold a particularly high concentration of a single stock or a very small set of stocks or specialize in convertible securities. This category is also reserved for any institution or mutual fund that does not meet the criteria for any of the other investment styles. TFCG categorizes these portfolios based on its specific knowledge of their historical investment behavior
Venture capital/private equity	Venture capital and private equity investors are usually owners of public companies only when they have participated in a round of financing prior to an Initial Public Offering (IPO) and subsequently retained ownership after the transition from a private company to a public company. Other investors often consider positions held by venture capitalists as an "overhang" on the stock of a publicly traded company since VCs will typically dispose of their holdings of public companies during the first few years following an IPO

(*continued*)

Table 6 (continued)

Type of investor	Description/objective
Sector specific	Sector-specific investors have the majority of their assets in a single major industry category. Many times these investors are "forced" to own most if not all of the stocks in a given sector whether or not they are deemed appropriately valued. Since their portfolio exposure is linked to a single sector, their performance is usually measured against an index that is pertinent only to that industry. As such, tweaking the relative exposure to the companies that constitute a given sector will determine these firms' investment decisions
Yield	Yield investors typically focus on buying companies with indicated dividend yields that are comfortably above the market average and that are perceived to be able to continue making or increasing dividend payments over time. Investors that fall into this category tend to focus on income and safety more than on capital appreciation, and many have a dividend yield "hurdle rate" below which they will be either unlikely to consider owning a particular stock or forced to pare back a current position

Employee

Compensation risk from an employee perspective relates to the structure of the compensation contract. If there is only fixed compensation, basically there is no risk in terms of the payment. Variable compensation, for example, in terms of an LTIP, creates a certain payment risk. After all, in the case of good performance, there will be a payment; in the case of bad performance, the payment will be less or even zero. Question is how to measure this risk and subsequently how to make this risk understandable for employees and other stakeholders. A proxy can be based on Engesaeth (2011) which measures the extent to which variable pay is really at risk. It is based on the coefficient of variation, which measures the variation around the expected pay level (statistical dispersion measure). A payout risk example is based on the context of a lottery. Assume there are three lotteries, each with ten possible outcomes, as shown in Table 7 (source: Engesaeth 2011).

Lottery A and B have an equal expected payout value (μ) of 100,000. Lottery A, however, has higher variability as measured by the standard deviation (σ) but also offers the opportunity to win a much higher amount, i.e., 1,000,000 (with 10 % probability) versus 200,000 in lottery B (with 50 % probability). Lottery C is an atypical lottery as it provides for a minimum reward of 50,000. It furthermore has a lower average payout than lottery A and B but also much more security in view of the coefficient of variation of 1/3 versus 3 for lottery A and 1 for lottery B.

Which lottery ticket would you buy, assuming you could pay for it with your own human capital? This is the question an employee needs to answer if it is confronted with different compensation structures, for example, in a case of multiple job opportunities. Comparing only the expected level of compensation provides too little information to make such a decision. The employee is confronted with a trade-off between the expected pay level, on the one hand, and the risk in the actually paid

Table 7 Lottery payments in different states of the world

State of the world	Lottery A	Lottery B	Lottery C
1	1,000,000	200,000	100,000
2	0	200,000	100,000
3	0	200,000	100,000
4	0	200,000	100,000
5	0	200,000	100,000
6	0	0	50,000
7	0	0	50,000
8	0	0	50,000
9	0	0	50,000
10	0	0	50,000
	Average (μ) = 100,000	μ = 100,000	μ = 75,000
	Standard deviation (σ) = 300,000	σ = 100,000	σ = 25,000
	σ/μ = 3	σ/μ = 1	σ/μ = 1/3

Table 8 Lottery payments in different states of the world

State of the world	Package A	Package B	Package C
Vehicle	Options	Shares	Shares
Vesting period	3	3	3
Volatility	50 %	30 %	20 %
Performance condition	Stringent	Less stringent	No condition
Expected payout (μ)	100,000	100,000	75,000
CompRisk index (σ/μ) *100	300	100	33

out compensation (ex post), on the other. This ex ante level of pay equals the average of possible future outcomes (ex post pay level). The degree to which the ex post realizations of pay can deviate from this expected level is captured in the standard deviation.

In the remainder of this chapter, the coefficient of variation times 100 will be referred to as the CompRisk index, or CRI. In the lottery example in Table 7, this would provide risk index figures of 300, 100, and 33, respectively. In order to calculate the CRI for a total compensation package, the weight in the total package as well as the coefficient of variation per compensation element is needed. The CRI of an LTI can be calculated by simulation. Plan details including the vehicle (cash, shares, or options), the performance measure, the vesting period, the vesting schedule, and, in case of relative measurement, the comparator companies are needed as well as parameters such as volatility and dividend yield. Similar results as in the lottery example are found in real-life LTIPs as shown in Table 8.

The risk approach is not always easy to understand. It becomes more intuitive if it is translated into a certainty equivalence (CE). The certainty-equivalent cash amount is the amount that the employee would be willing to give up in exchange for the risky award This implies that the expected value of the LTI is combined with the level of

risk, to obtain a discount based on the fact that people are risk averse. This implies that people tend to put a lower value on payments that are subject to greater risk even if the expected value would be the same. A number of issues observed in reality may clarify why this notion could be relevant:

- A non-listed company wants to keep its top people from going to the competition, so it compares how it rewards them with the rest of the market. But as it is not listed, it can only compare the base salary and bonus levels – and the rest of the market offers long-term incentives, too. So how can the company make a valid comparison?
- To conform to a new regulation, a financial services firm is trading variable pay for fixed in its compensation packages. However, $1 of variable pay isn't worth the same as $1 of fixed. So how can it trade one for the other effectively?
- A retail company with high turnover of staff is rethinking its variable pay by partly swapping short-term incentives for long. How does it know what's of equivalent perceived value to employees?

Essentially, the same answer applies to all three scenarios, based on the same theory. This is Kahneman's theory of loss aversion (see e.g. Kahneman and Tversky, 1979). It can be used to calculate the certainty equivalence for each compensation element: for example, the certainty equivalence of 100 cents of fixed pay is 100 but could be 85 cents in the case of short-term incentive compensation and 60 cents for long-term incentive compensation. By bringing it back to the same denominator, you can make like-for-like comparisons and use what you learn to make trade-offs within the package. A simple overview for share compensation with a 3-year employment condition (here without performance condition) is shown in Table 9 for different levels of volatility.

Table 9 shows that higher levels of risk as shown in the second column are linked to greater discounts in terms of the certainty equivalence under the assumption of equal expected value. Effective levels of risk therefore strike a balance between the desire to follow the pay-for-performance adage, on the one hand, and optimizing the perceived value (certainty equivalence value), on the other. In order to obtain a holistic view, apart from the LTIP, the other elements of the pay package including fixed compensation, short-term incentive plan, etc., need to be taken into account as well.

Company

Compensation risk from a company perspective is here translated into the "direction" of the LTIP. Is the LTIP effective in terms of reaching company goals, or does it stimulate employees to take more risk than desired? The intensity of the LTI can be measured by the CompRisk index as described in the previous section. After all, the risk is higher if goals are more challenging and if there are more significant

Table 9 Example share compensation: relationship between risk and certainty equivalence

Share with volatility (%)	CompRisk index	Certainty equivalence (% of fair value)	CE discount (%)
10	17	93	7
20	36	86	14
30	56	79	21
40	78	73	27
50	109	67	33
60	141	60	40
70	216	54	46
80	230	49	51
90	312	44	56

differences in payments between good and bad states of the world. The direction relates to the chosen performance measures. What is the focus of the LTIP? After the financial crisis that started end of 2008, a lot of debate was focused around the topic of financial incentives. These would have stimulated the wrong behavior especially in terms of taking too much risk. Corporate governance rules for the financial sector have focused on promoting risk-adjusted measures (e.g., risk-adjusted return on risk-adjusted capital (RARORAC)).

But also in the other sectors, an important aspect of an effective LTI is to determine the relevant risk boundaries. This implies working with ex ante risk adjustment by choosing risk-adjusted metrics and/or ex post risk adjustment by introducing a test of reasonableness that can adjust levels downward if risk parameters were breached (and potentially upward in case of a favorable situation). The desire to apply this also to the short-term incentive plan has increased the use of deferred payments because certain risks can sometimes only be established after so many years. The use of the deferral mechanism effectively ensures that a larger part of total compensation is geared towards the longer-term.

Society

Compensation risk from a societal aspect is here translated in terms of public outrage. Especially the scholar Bebchuk advocates the view that the managerial power can be of substantial influence and that executive compensation contracts are curbed by public outrage instead of arm's length bargaining (see e.g. Bebchuk and Fried, 2004). In some countries, this effect is stronger than in other countries among others related to cultural aspects. In any case, there have been multiple examples in which uncapped LTI plans have caused public outrage. Most prominent examples were related to take-overs, especially if the company that was acquired showed bad performance over the period before. The conclusion is therefore that effective LTIPs take into account the possible negative effects of perceived excessive compensation.

This is especially true for business-to-consumer companies that may be confronted with the risk of buyer strikes.

Concluding (in Terms of Effectiveness)

From a risk perspective, an effective LTI either reduces the impact of an unwanted situation or decreases the probability of occurrence. This implies that risk management may result in fine-tuning the LTIP design in such a way that risks are aligned with the risk appetite. This implies that the LTIP is aligned with the requirements from investors; it balances payment risk for the employee with the desire to provide an incentive from the viewpoint of the company and stays within accepted norms of society. Bringing these, sometimes unaligned viewpoints, together is a balancing act.

Operational Perspective

The operational perspective covers three angles: administration, employee communication, and road to the Annual General Meeting (AGM).

Administration

Part of the administration relates to having the relevant legal documents in place such as plan rules and a plan agreement. The plan rules provide a general overview of the rules of the LTIP. Sometimes, these are very specific; in other case, the specifics are in the agreement letter. Important aspects of the plan rules are also what happen in the case of eventualities. An example is the good and bad leaver provisions. These rules govern what happens in the case of voluntary or involuntary leave. Typically, if the employee is considered a bad leaver, all entitlements with regard to unvested LTIPs are forfeited. A bad leaver is, for example, somebody who leaves the company to join the competition. A good leaver is, for example, a retiree or if the company and employee together decide to end the contract. In this case, the rules determine what happens. Typically, there is time proration of the award. In case of a performance plan, there can be various scenarios in terms of performance proration. The plan could, for example, pay at target. More common is to use some form of performance measurement. This can be intermediate (around the leave of the employee) or at the end of the performance period (typical within large listed companies). In the latter case, the employee has left the firm and needs to wait for the end of the performance period to achieve the award. This may be administratively burdensome but could be viewed as most in line with the objectives at the outset (particularly if there are no personal performance measures linked to the award but only company-wide metrics that are the same for the employee group).

Effective plan rules are clear about important foreseeable eventualities and leave discretion for unforeseen/special cases.

In terms of the overall administration and execution of the LTIP, this is typically taken care of externally by specialized companies that support their clients in managing their employee share plans and other equity compensation programs.

Employee Communication

An LTIP typically measures performance over a multiyear period. The metrics are frequently somewhat less within the direct control of the employee. Payments are often equity based. These aspects may cause the plan to become unnoticed. In such a case, the perceived value for the employee drops to a number close to zero. It is therefore highly important to effectively and proactively communicate the LTIP. Not only at the moment of grant and vesting but also in the intermediate period. Branding the LTIP and tracking and communicating the performance are crucial to keep the plan alive and employees aligned with the objectives of the plan.

The Road to the AGM

Equity-based LTIPs may affect the outstanding share capital. In most countries, the LTIP policy and grant limits need to be tabled at the AGM for adoption/approval. In the remuneration report, companies typically disclose the specifics in terms of grant levels and vesting of the awards. The AGM agenda shows the LTIP policy in case it is a voting or discussion item. It is effective to consult major shareholder in advance to ensure no real surprise at the AGM.

Concluding (in Terms of Effectiveness)

From an operational perspective, certain aspects need to be covered such as plan administration and execution. However, the most important driver of effectiveness is communication. Transparency and timely communication greatly enhance the effectiveness of an LTIP.

Dos and Don'ts for LTI

An overview of dos and don'ts is shown below:

Align with the Corporate Strategy

Strategy is typically defined as the determination of long-term goals and objectives and the adoption of courses of action and the allocation of resources necessary for carrying out these goals. A perfect way to show confidence in the strategy is to link the long-term incentive ("LTI") plan to the goals and objectives in the strategic plan, i.e., "put your money where your mouth is."

Be Clear About the Role of Performance

The effectiveness of the design of the LTI plan can be greatly enhanced by being clear about the role of performance:

- Pay drives performance: If the primary goal is to influence people's behavior, it is vital that the LTI plan is structured in such a way that employees can influence the chosen performance metrics ("line of sight"). This typically involves executing an analysis of the most important underlying drivers of the strategic objectives and cascading these derived performance goals to the appropriate levels in the organization.
- Performance drives pay: If the primary goal is to legitimize pay based on achieved performance ("goal alignment"), the plan can be directly linked to the overall strategic objectives or, for example, a measure such as (relative) total shareholder return. Most individuals will not be able to (directly) influence the outcome on these measures. It may therefore not create an effective *incentive*, but the plan could support other objectives, such as corporate glue, wealth creation, retention, etc.

Consider Different Payment Vehicles

LTI plans are often share-based payments. The basic payment vehicles are stock options versus shares. An additional feature could be that the plan is settled in cash, i.e., stock appreciation rights (SARs) versus phantom shares. Cash-settled share-based payments sometimes have a cap (e.g., to prevent perceived excessive outcomes). The payment vehicle needs to fit the business profile and life cycle of the company. Stock options may be effective in case of a start-up/high-growth company but less effective otherwise.

Mind the Cost Versus Value Gap

When establishing the LTI policy, it goes without saying that it is important to carefully consider the funding, accounting costs, impact on cash flow, overhang and dilution (limits), and corporate tax deductibility. However, this is only one side of the

coin. The other side is the value to the recipient. Individual taxation is an important factor in various countries that sometimes even dominates the way plans are designed. However, another important factor is the "perceived value." The gap between the cost to the company and the perceived value to the recipient can be significant. The driver of the gap is the uncertainty about the reward. This "compensation risk" is, for example, higher if the performance volatility of the company is higher but is also heavily influenced by the plan design and the degree of influence an individual employee has on the reward. A perceived value or "certainty equivalence" analysis is therefore recommended to fine-tune the design and bridge the gap.

Don't Overcomplicate

The road to a simple and understandable LTI plan is not an easy one. Simplifying LTI plans may involve considering simpler structures, fewer metrics, fewer legacy plans, etc. Especially for main board LTI plans, mandatory features are typical, for example, due to governance or regulation. However, there is no need to cascade, these sometimes complex reward features, to the entire eligible population.

Restrict Eligibility

Making LTI available to too many people may lead to awards that are considered too small in light of the intended effect. It may further create a disproportional administrative burden.

Invest in Effective Communication

More transparency, disclosure, and better communication greatly enhance the effectiveness of LTI plans. For internal communication purposes, it is recommended to *brand* the LTI plan and operate a platform where employees can have easy access to the current (and potential future) status of their awards and the associated wealth. The external communication strategy aims to show the added value to shareholders and other stakeholders and to prevent reputational damage, e.g., as a result of top executive realized LTI compensation.

Outlook

*"*How to ensure effectiveness of a long-term incentive plan?*"* was the overall question of this chapter. This question was broken down in four paragraphs, based on the people, economic, risk, and administration perspective of LTIPs. Each of the paragraphs listed ways to promote effectiveness. This chapter ended with a specific overview of dos and don'ts which can be viewed as a conclusion of this chapter.

In terms of the outlook for the future, it is expected that long-term incentive plans will continue to be important in the tool kit of the compensation professional. Given the desire for long-term sustainable business results and alignment with the multiyear company strategy, LTIPs are here to stay. The continued importance is further emphasized by modern forms of LTIPs such as deferred payments from the short-term incentive plan and deferred compensation in light of saving for retirement.

In terms of its characteristics, LTIPs will further evolve to be able to better measure company success in financial and nonfinancial sense and, in general, to contribute to business needs as well as individual preferences. Multiple plans may be needed to cater to different objectives, with the challenge to keep things as simple as possible.

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