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ARTICLE | FEB 2026 | NACD

How to Balance Long-Term Incentives After an Acquisition

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In an evolving business landscape, companies frequently engage in mergers and acquisitions to enhance their competitive edge and create value. For companies making acquisitions, questions often arise about how the results of acquired businesses should affect in-process, performance-based long-term incentive (LTI) awards.

For serial acquirers, performance-based LTI goals may explicitly incorporate a defined level of inorganic growth. In these cases, the bar for any adjustment is higher, and in many situations no adjustment is warranted.

Companies that make acquisitions less frequently should ensure fair treatment of their in-process, performance-based LTI awards. Compensation committees typically seek to ensure that:

- management is not disincentivized from pursuing acquisitions,
- management has sufficient compensation linkage to the acquired business, and
- the company is protected against unearned compensation windfalls or the perception that management is pursuing acquisitions to benefit their own pay.

Below is a framework companies can use to evaluate the impact of an acquisition on in-process LTI cycles.

The Flow-Through for Smaller Acquisitions

For smaller acquisitions, it is often reasonable to leave performance goals unchanged and simply include the acquired business in actual results from the closing date forward. This approach is unlikely to create a compensation windfall, rewards employees for executing the transaction, and establishes performance accountability for the acquired business.

Handling Larger Acquisitions

Larger acquisitions require a more formal assessment to determine the appropriate treatment of in-process LTI cycles. Because the risk of a compensation windfall is greater, companies should carefully review the incentive's impact and confirm that it supports pay program objectives and broader business goals.

Plan documents, grant agreements, or a separate policy may specify a default treatment. In other cases, there may be little or no formal guidance. In practice, compensation committees have the discretion to adjust results if they determine that doing so is consistent with shareholder interests.

There are several approaches used in practice, which may include the following:

1. Exclude acquired business results without adjusting goals. Under this approach, these results of the acquired business are excluded from in-process performance cycles and goals are not adjusted. As a result, there is no direct accountability for the acquired business until the start of the next LTI cycle. This approach may weaken the near- and mid-term linkage between performance-based LTI and results of the acquired business.

   Some companies may bridge this concern by creating a separate, one-time incentive arrangement that directly measures the performance of the acquired business through an integration period.

2. Include acquired business results without adjusting goals. When a company has a clear strategy that combines organic and inorganic growth, it may be appropriate to include the results of the acquired business in incentive metrics without changing goals. Before adopting this approach, companies should model the expected impact on incentive funding and determine whether it is likely to produce a disproportionate pay outcome.

3. Include acquired business results with an adjustment to goals. Here, performance goals are restated to incorporate the acquired business. The revised goals reflect the increased scale and capabilities of the company after closing.

   In some cases, companies align adjusted goals with the performance assumptions used to price the deal. Committees should evaluate this approach very carefully. Acquisition prices often include a takeover premium, and incentives are only one of the many drivers of financial results. In certain situations, goal increases may discourage management from pursuing acquisitions, particularly when the target has underperformed and will require significant restructuring or if it will take time for the acquiring company to reap the benefits of the acquisition.

4. Implement a hybrid approach. In many cases, the most practical solution is a tailored approach that varies by metric, time remaining in the cycle, and the performance

profile of both the company and the acquired business.

For example, revenue metrics may need higher goals to reflect the scale of a large acquisition. If the acquired business has a similar margin profile or is functionally break-even, profitability or net profit goals may not need adjustment, which can sharpen incentives to improve profitability at the acquired business.

It may also be appropriate to adjust goals for cycles with significant time remaining, while leaving goals unchanged for cycles that are near completion and where the impact is limited. Finally, companies should pay particular attention to the impact on cash flow metrics and any measures that rely on balance sheet inputs.

A thoughtful approach can create the right performance accountabilities for the acquired business while protecting against windfalls and preserving management's incentives to pursue value-accretive acquisitions.

No Adjustment to TSR, Options, or Stock Awards

For total shareholder return (TSR) plans and other stock price-based instruments, such as stock options, restricted stock, and restricted stock units, no adjustment to goals is needed. These awards are self-correcting because the stock price already reflects investor expectations about the acquisition.

Additional Accounting and Disclosure Considerations

Compensation committees should understand the accounting and disclosure effects of any departure from the default treatment. In some cases, a decision to adjust goals or results may be treated as a modification for accounting purposes, which can trigger incremental expense based on the stock price at the time of the change. Companies may also benefit from obtaining advance guidance on how their incentive plans would apply in these situations and how any related expense would be measured.

From a disclosure perspective, companies should be prepared to provide clear, transparent explanations of any acquisition-related adjustments to incentive funding.

Right-Size and Balance the LTI Approach

Effective goal calibration of performance-based LTI plans is essential to driving long-term success and performance-aligned pay outcomes, particularly in the context of acquisitions. By applying a proportionate approach—using a simple flow-through for smaller acquisitions and rigorously testing the incentive impact of larger transactions—companies can design incentive plans that motivate management, support value creating acquisitions, and protect shareholders.

A version of this article originally appeared on www.nacdonline.org. (https://www.nacdonline.org/all-governance/governance-resources/directorship-magazine/online-exclusives/2026/february-2026/acquisitions-long-term-incentives/)

About the Author

Brett advises boards and management on executive compensation, including performance measurement, incentive design, and technical matters spanning tax, accounting, and SEC requirements.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.