KPMG

IFRS Today

Exploring topical issues in financial and sustainability reporting

25 July 2023

Rachel Tucker
Director
Performance &
Reward
KPMG Australia

Anthony Voigt
Associate Partner
IFRG

James Bowe
Communications
& AV Manager
KPMG International
Standards Group

PODCAST TRANSCRIPT

Emissions | ESG measures in executive pay packages

James

Hello and welcome to our new episode of KPMG's emissions podcast series. In this series, we explore emerging trends in emissions and green schemes and the related financial reporting impacts under IFRS Accounting Standards. Today we'll look at the growing trend in major markets of tying executive pay packets to ESG measures. Increasingly, incentives offered to executives can relate in part to delivering on a company's ESG strategy – their bonuses based partly on progress towards the company's net-zero target, for instance.

To unpick all of this, I'm joined today by Rachel Tucker, a Director in the Performance & Reward group of KPMG in Australia, and Anthony Voigt, an Associate Partner in the International Standards Group, to discuss the use of ESG measures in executive remuneration arrangements. We'll be asking:

– what are we seeing in the market;

– what do companies need to consider in setting up ESG measures; and

– what impacts can such measures have on the financial reporting?

So, Rachel, let's start with the basics. Why include an ESG measure in a remuneration arrangement?

Rachel

Sure. So it goes without saying that ESG has climbed up the corporate agenda globally in recent years. And I think this has been driven by an increased recognition that an effective ESG strategy – which essentially involves looking at the interests of stakeholder groups beyond shareholders – is actually important to generating long-term value for shareholders.

So there's definitely growing pressure on companies from investors, from regulators, as well as the broader community around ESG, and discussions on this topic are also fast becoming a key focus area amongst proxy advisors.

When we look at executive remuneration, incorporating ESG measures into incentives sends a clear signal to senior management that executing on the company's ESG strategy is a priority, firstly, but it also sets a clear tone from the top for the rest of the organisation.

We have seen a number of companies in Australia and globally move in this direction, which I think is a really positive trend, and we do expect to see more in the coming years. Anthony, did you have anything to add?

Anthony

Yes. What I would say is that the increased focus in this area is also reflected in the level of interest we are receiving on the financial reporting impacts of including ESG measures in remuneration arrangements. For example, we're starting to get questions on the impact of including emissions reduction targets in arrangements. Including ESG measures gives rise to some interesting accounting issues.

But before we discuss these, Rachel, what type of arrangements have you been seeing in practice in Australia?

Rachel

In Australia, we typically see executive remuneration packages delivered in three components, being:

- fixed remuneration (which is essentially base salary);
- a short-term incentive or bonus-type arrangement (which would look at performance over the financial year); and then
- longer-term incentive arrangements, which are typically delivered in some form of equity (and will look at performance of the company over three years or more).

In terms of how Australian listed companies are incorporating ESG into those arrangements, if we start with environmental measures, I think the message is twofold:

- firstly that they're generally included in short-term incentive plans (so only a handful of companies have these measures under their long-term plans at the moment); and
- they're still commonly found in your traditionally carbon-intensive industries like materials, energy and utilities.

Common environmental measures would include emissions reductions targets, reductions in environmental incidents, as well as broader waste and water management – but they do vary between companies.

If we then look at social measures, these would include objectives like diversity, culture, safety and reputation. Like environmental measures, these are also more common under short-term incentive plans (rather than long-term plans) but unsurprisingly they're much more common across all industries.

And finally, we are also seeing some companies introduce broader ESG modifiers and gateways, which are essentially an alternative to stand-alone measures, and they allow the board to reduce the awards down to zero if the company materially underperforms against key ESG objectives.

James

Okay. So are Australian companies in line with other jurisdictions, would you say?

Rachel

It's a great question. Generally speaking, listed Australian companies are less progressed when it comes to incorporating ESG measures into incentives, compared to companies in the US and the UK.

And I think there are three key differences that stand out to me.

- The first is that there is greater use of environmental measures outside of traditionally carbon-intensive industries in the UK and the US. For example, they are more prevalent in financial services than what we see in Australia.

- Secondly, diversity measures in Australia tend to focus on gender. But overseas we see greater focus on other under-represented groups including based on ethnicity, age, neurodiversity and LGBT status. We are starting to see some Australian companies move in this direction, though, which I think is really positive to see.
- And finally, ESG measures are much more common under long-term incentive arrangements in the UK and the US than what we see in Australia at the moment.

James

Right. And more generally, in global markets, do you think that the use of ESG measures (in particular, emissions targets in long-term incentives) will increase in the future?

Rachel

I think we will see ESG measures included more in executive incentive arrangements in the future, and this reflects that the importance of a company's ESG strategy is only going to continue to grow.

So while there are already a number of UK and US companies with ESG measures under their long-term plans (and there is already pressure from UK investor groups to tie at least 20 percent of those arrangements to climate measures), it is hard to say just how common they will become under long-term incentive plans in Australia.

Having said that, we are aware of companies in Australia which are currently considering what role decarbonisation may play under their long-term plans going forward (as well as diversity and culture).

So I think it really does come down to:

- firstly whether meeting certain ESG goals is key to delivering long-term value for shareholders; and
- secondly whether ESG performance can be forecast and tracked over the long term to set meaningful targets for executives.

When those two conditions are met, I think there is a strong argument for including effective ESG measures in long-term incentive arrangements.

James

Yes, that's interesting. So – Anthony – when we see ESG measures included, what impact do we expect to see in the financial reporting?

Anthony

IFRS Accounting Standards have a couple of accounting standards that deal with accounting for employee remuneration. So, the first question to ask is whether the arrangement is a share-based payment or an employee benefit. Share-based payments are remuneration arrangements in which the employee is awarded the company's equity instruments – things like shares and options – or they receive a cash payment based on the value of the company's equity instruments.

Arrangements classified as share-based payments will generally be long-term arrangements, as Rachel mentioned earlier. All other types of remuneration are employee benefits; for example, a fixed cash bonus.

James

Okay. So, Anthony, should we start with the accounting for employee benefits?

Anthony

Sure. In this case, employee benefits can be split into two types.

– Short-term benefits (for example, an annual bonus paid out for specified ESG measures met in an annual reporting period.) These are measured at the amount the company expects to pay.

– The second type is long-term benefits. For example, an arrangement that includes a multi-year emissions reduction target. The calculations for long-term benefits can be more complex. The cost is spread over multiple periods and measurement takes into account the effect of time value of money and the uncertainty with respect to whether the ESG measure will be met.

James

And what about the share-based payments?

Anthony

OK. For share-based payments, I'm going to focus on a couple of key areas that can impact the expense.

The first is classification of the ESG measure. An ESG measure is most likely to be classified as either a non-market performance condition or a non-vesting condition. If the measure is classified as a non-market performance condition, it is taken into account in estimating the number of awards expected to vest. And if the ESG measure is not met, the expense recognised for the arrangement is reversed.

Whereas if it's classified as a non-vesting condition, it's included when determining the value of the award and there is no reversal of the expense recognised if the ESG measure was not met.

The second issue relates to determining the grant date. Grant date is the date on which the fair value of the share-based payment arrangement is measured. Grant date is achieved when there's a shared understanding of the terms of the award, and the terms have been accepted. The question for an ESG measure is: "Is there shared understanding of the terms?" This might not be the case if the company does not yet have processes in place to capture information it needs to evaluate a measure – such as data and supplier emissions. Or if the board is given significant discretion to revise an ESG measure during the vesting period.

A delay of grant date can lead to volatility in profit or loss, because companies still need to recognise an expense from the date the employee starts providing services, so they're required to make an estimate of the fair value of the award and update the estimate at each reporting date until the grant date is achieved. It's this re-estimation that can lead to volatility.

James

Yes. So it's interesting to hear that point you make, Anthony, about there not always being enough information to reliably evaluate some ESG measures. So we know we've got mandatory sustainability reporting standards coming down the track. Can we expect to see an impact of these on the use and the structure of ESG measures?

Anthony

Yes, it's a good point. I think they will have an impact. Many jurisdictions are in the process of introducing sustainability reporting requirements. The new disclosures will definitely improve the quality and availability of information required to set and evaluate ESG measures.

For example, many frameworks include requirements to disclose quantitative information about greenhouse gas emissions. As we start to see more of these disclosures, they'll provide a good starting point for developing environmental measures.

James

Thank you, Anthony. So that brings us neatly onto the last point we wanted to discuss today. And that is – how does a company go about developing effective ESG measures for inclusion in its remuneration arrangements? So, Rachel, on this point, what would you say are some of the key points to consider?

Rachel

Sure. So the external focus on greenwashing is a really important reminder to Remuneration Committees and Boards that they should avoid simply jumping on the bandwagon and adopting ESG measures without considering some key questions. And I think these would be:

- Firstly, is ESG currently part of the company's overarching strategy and is that supported by a clear action plan and programmes of work?
- Then it's worth considering: are there ways to track and measure progress against those ESG issues that are most important to the business, and can that be transparently disclosed?
- Another question would be: should ESG measures be incorporated into the short-term incentive or long-term incentive? Some ESG conditions may lend themselves better to annual goals vs longer-term goals. And I think the ability of a company to set targets will be relevant to this.
- Consideration should also be given to the weighting placed on the ESG measure and ensuring it is sufficiently meaningful to influence executive behaviour. We generally see weightings of between 10 and 30 percent on these measures.
- And finally, how will you disclose and communicate externally the ESG measures and how they link back to the company's overarching strategy and delivery of value to shareholders? Because that would be important to gaining external support.

James

Thanks, Rachel. So, any final thoughts for companies considering including ESG measures in their future remuneration arrangements?

Rachel

I would say that remuneration committees and boards really need to consider what ESG issues are most important to their business, as measures linked to these most critical issues are the ones that should be prioritised within executive remuneration.

Anthony

And I would say, similar to sustainability reporting requirements, ESG measures will require information not collected as part of the financial reporting process. So, consider how you will collect that and collate that information needed.

And also, think about how incoming sustainability reporting requirements might be used when setting ESG measures.

James

That's great. There's a lot to consider here.

You will find a whole lot of other detailed information on ESG reporting matters and much more in this space on our website. Just type KPMG IFRS into your browser.

All that leaves for me to say is thanks for listening and stay tuned!

Publication name: *IFRS Today: Emissions | ESG measures in executive pay packages*

Publication date: July 2023

kpmg.com/ifrs