



Incentivizing long-term value creation

ESG voices podcast series

Host

Hello, and welcome to another episode of ESG Voices. This podcast series addresses the opportunities and challenges within ESG through interviews with ESG specialists from KPMG and beyond.

Throughout this series, we will discuss a broad range of environmental, social, and governance issues, aiming to support governments, businesses, and communities in creating an equitable and prosperous future.

Companies have made significant progress in recent years in identifying the risks and opportunities related to how sustainability is considered in a company's strategy. However, in many instances, the realization of these opportunities or risks falls outside the normal business planning cycle. Therefore, incentivizing sustainability-minded behaviour is a key element of an overall governance model that supports day-to-day decision-making.

A company's strategic course is set by its management, yet it is these managers who must help ensure that this course is adhered to in their daily decisions. An effective way of providing them with further incentives to stay on course is to anchor the company's sustainability targets in their remuneration, in the same way as other strategic aims.

In today's episode, we will hear from Nadine Hönighaus, Global ESG Governance Lead, KPMG International and Partner, KPMG in Germany and Pilar Galán, Partner, Head of Financial Services Legal, KPMG in Spain, and Legal Lead, Global ESG, KPMG International — who will share insights about a recent report launched by KPMG International discussing incentivizing long-term value creation by linking sustainability metrics to board members' pay.

This is a topic with much to discuss, so let's jump right in.

First, could you speak to our listeners about how long-term value creation is defined by organizations, and what key metrics are used to measure it? Pilar perhaps I can come to you first and then we will hear from Nadine?

Pilar Galán

When companies talk about long term value creation. They actually mean building success that lasts. It's not just about making profits today, but also ensuring that they are positively impacting society and the environment over time. So it's really a balance between financial results and things like reducing carbon emissions, improving employee wellbeing or promoting diversity. With these is the background of what means for the organizations to create long term value.

We can ask ourselves how to measure this. Well, in order to measure this, and what companies look at our financial indicators, for example, return on invested capital, but also non-financial metrics such as sustainability goals, employee engagement and customer satisfaction. Also, many companies align their goals with global frameworks like the UN Sustainability Development Goals. So, we have different methods and it's about identifying which are the ones that are aligned with the strategy and make sense, taking into account the activities that the companies are providing.

Nadine Hönighaus

Maybe also commenting on that. I think really long-term value creation says exactly what it is creating long term benefit rather than short term success. And the factors that Pilar just mentioned really play into the long-term benefits. There's one aspect also I would like to stress when it comes to long term value, that is the market position of a company, the power of innovation. You do not normally naturally connect them immediately to sustainability, but thinking innovation sustainably also adds to long term value creation big time.

Host

The report emphasizes aligning executive compensation with long-term value creation. What practical steps can C-suite leaders take to integrate ESG and sustainability metrics into remuneration frameworks without sacrificing short-term financial performance? Nadine can I come to you first?

Nadine Hönighaus

I think, for really taking steps towards value creation with incentivization. The first thing is important is that you really have a clear corporate strategy that includes sustainability. And then you select the indicators, the performance indicators that really deliver on that strategy. Once you have identified them, the suitable, the relevant indicators. And these are not many. You concentrate on the fact what data you have, whether you have available relevant, suitable and reliable data and data that you do not only assess once a year, but over the course of the year. The key data must really be controllable. It should be possible to determine the figures for shorter intervals within a year. So that is really an opportunity for a management to steer it along that data. In a third step then it is for you really to define or C-level to define what is the share of remuneration that should be dedicated to this variable? Is it related to pay and how you want to develop that and communicated it within your leadership and management. And maybe it is a last step. It is also always really helpful and important to be very transparent upfront with your management. What do you want to measure in terms of success? Be transparent within the overall team, not only the management that is in focus of a remuneration and executive pay, but also be transparent to the outside world, to shareholders, to stakeholders on the selected data and how that really adds to the long-term value creation and to achieving the sustainability goals of the company.

Pilar Galán

Actually, Nadine this is a key challenge. It's a key challenge to identify what are the steps to be carried out for leaders. And on top of what you said, it is very important for leaders to take into account the different legal aspects that are very relevant for setting up an ESG metrics. Actually, you have to take into account labour laws, remuneration, and also whether there are specific requirements depending on the sector. For example, if we think of the finance as sector, you will have to comply with the specific requirements that are set out to comply with ESG regulations, but also to comply with labour laws and regulations. So setting those quantitative and qualitative metrics and goals should take at all times into consideration the compliance and legal aspects that are required in order to make sure that the company stays full compliant with regulation.

Host

The report highlights the importance of transparency in reporting ESG and sustainability outcomes. What challenges do you see in standardizing ESG and sustainability performance metrics across industries, and how can executives overcome them?

Pilar Galán

As Nadine mentioned, standardizing ESG metrics is tough, mainly because every industry faces different challenges and there is really no single global standard or depending on what is your starting point? It will make sense to implement one metric or the other. And also these differences in the metrics used make also, it very difficult

to compare companies or to even know what good looks like. So in order to overcome this, executives should engage with standard setters, with industry groups, in order to understand what are the frameworks and what are the metrics that would fit better depending on their company or their strategy and the information available. Transparency is key and companies should explain why they choose certain metrics, and they should be able to provide the context so that the stakeholders understand what are the metrics that they are selecting and what is how they link with their strategy. It is true that it is not easy that, as Nadine said, there could be not only quantitative metrics or information, but also qualitative ones. And it is also true that it might represent additional burden for the companies. But I truly believe that having the proper data to be able to follow up and to give transparency is about setting the base that will enable the progress for the future, as you will be able to measure how you are evolving, and you will be able to identify how you are really advancing towards the goals of ESG that your company has established.

Nadine Hönighaus

We could also see that really doing our data assessment period for the global report that was published. We looked at the top 25 companies in 15 countries and only had publicly available sources on remuneration. This could be management reports or remuneration reports, policies, maybe, and it was not so easy to really find all the data referring to remuneration. I think today it is really with widely accepted frameworks, like for example, the CSRD for the EU countries, or also ISSB providing international standards, it has become a bit easier to speak one language of what is relevant, what are relevant data. But when we look at which areas there is the most knowledge, you can definitely see that for example, when you look at environmental figures to be connected to remuneration and that is already a bit more advanced than when it comes to, let's say, figures in social or in governance areas. So I think we are making progress, but it's still in development. And our report also lists the most commonly used figures and indicators. And I think it's always good to have a look at that. What are others doing? What are the peers in my industry doing and in the end really match it with your situation as a company, your business model, what are really the relevant indicators that adds to the performance and sustainability?

Host

Can you share examples of companies that have successfully implemented the report's recommendations for linking ESG and sustainability goals to executive incentives, and what measurable impacts have they seen?

Nadine Hönighaus

I think what we can see, and that's what the report shows, that we have an amazing number of companies that have already linked there, the remuneration of their executive members, to some extent to sustainability and to some extent to their materials so strategically relevant topics. Whether it is companies follow the exact steps we laid out in the report or not. I think there are several ways to do that.

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We give recommendations for first steps, but also with voluntary reporting, for example, that a couple of companies already did, many years ago, companies were taking steps into the direction. So I think we are on a good path. There's good progress, as I already said may be, the dimensions of social and governance are a bit more challenging compared to the dimensions of environmental figures, because there simply are a bit more quantitative figures in the environmental dimension. But what we see is really that it is important for a company to assess their own ambitions, to assess how realistic it is to achieve a certain goal and to really discuss in the run up as a company themselves, how they want to achieve that. And with sustainability goals that are linked to executive pay there is a very, very in-depth and honest discussion of how ambitious a company wants to be in their strategy and how realistic it is, and what needs to be done in terms of investment and engagements to achieve certain goals. And I think a bit independent from how ambitious the executive remuneration link, in the end, looks like the simple discussion about that in-depth that is taking place on the highest level of the company already really paves the way for change.

Pilar Galán

Well, I loved Nadine what you said about the fact that linking ESG goals to executive pay is about having an honest conversation about the embedding of ESG or sustainability in your strategy. So I agree that we can find many companies already that are aligning incentives with ESG goals, and that by doing so, are being able to drive real measurable progress. And that a lot of examples in the different sectors and industries are companies there are linking big part of executive pay to sustainability goals. And although it is true that there could be more, I think that really the fact that in the majority of the companies there is something you can see that by linking bonuses to sustainability goals, they are making progress in those areas where they want to be better focused or, advance in terms of sustainability. We will probably see further advances in the future.

Host

The report discusses the role of governance in driving long-term value. How can boards and C-suite leaders collaborate to ensure ESG and sustainability priorities are embedded in strategic decision-making processes?

Pilar Galán

Boards and executives need to make ESG a regular part of their conversations. Actually, they need to embed it in their business as usual. And this is the case in many companies, where really ESG has been embedded in the different areas and in their businesses. But in any case, what should continue to make it in their agenda, and they have different ways to make sure that this is happening. On the one hand, by having members in the board with ESG expertise or by having committees focused on these issues, also by training, by helping the different stakeholders to stay ahead of risks and opportunities. So it is really crucial to set clear accountability and linking ESG to performance metrics such as executive performance reviews. So when boards and leaders collaborate this way, ESG under my point of view, becomes part of the company's DNA.

Nadine Hönighaus

Becoming part of the company's DNA really, as you said, pillar is an essential and sustainability, and the conversation about sustainability needs to really become part of the daily operational business, of the leadership of a management team. They need to have a unified vision, a shared commitment. Where do we want to go? What are our objectives? There needs to be a culture for collaboration. There needs to be exchange between them. The strategic integration into business plans, into risk management, into controls. So everything that is kind of the backbone of the company, its governance needs to be integrated and kind of breathe the spirit also of their strategic goals. Also the sustainability goals, accountability, reporting belong to that. And then the other side of that, even though we talk about robust governance system, Pilar, you also stressed that, a spirit and an atmosphere for continuous learning and adaptation, because in fast changing times like the ones we are living in, and I couldn't imagine any, any time in the past 20 years that has changed faster. I think it's more necessary than ever to really also to adapt even a robust governance system to really question yourself. Does that reflect my company's reality and the future I want to stay towards to?

Host

For organizations just beginning to adopt the report's framework, what are the first steps you'd recommend for C-suite leaders to shift their culture and incentives toward long-term, ESG and sustainability-driven value creation?

Nadine Hönighaus

I think we already mentioned a couple of points that are really important here. I want to stress more the ones that maybe we haven't really mentioned so much yet. I think one of the first steps really is to educate and, take on board your leadership team. Because we also, Pilar and me, we do a lot of executive trainings, board members, trainings on sustainability. And what we see is that there is a lot of interest and awareness, but still sometimes a lack of knowledge or lack of what does that mean for my specific business and industry. And you need to have a conversation about that and really integrate it into a learning plan, because in the end can set targets. But these targets need to be implemented and realized, and you need the people, the management and team on board to understand what they are supposed to do. Then you need to have clear objectives. Adapt your incentive structures so that they kind of legally fulfil the requirements they would need to have, and also really reflect what you want to achieve. And in general, take measures not only for top management, but for the wider team of your company, for all employees to really foster a culture of sustainability, because everybody would also need to understand what their management is during the company to what's to. In the end then it is about implementing governance and reporting mechanisms and really also manage your transparent reporting to the outside world, something that is, of particularly importance also to shareholders. And we've mentioned continuous learning and adaptation. I think that really is a key to kind of keep your organization agile and dynamic and to be able to fulfil the needs of the respective situation.

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Pilar Galán

Totally, totally agree. I would, maybe summarizing the need for leadership, the need for communication, for having a vision that values long term. Probably also starting small, pick a few key metrics and be from there. But then, review those ESG criteria and go bigger from there. And very important, create a culture in your company that encourages learning about ESG challenges, celebrating early wins, and building momentum in order to really embed ESG to create long term value.

Host

Nadine and Pilar, it sounds like many opportunities and challenges remain when it comes to linking sustainability metrics to board members' pay. Thank you so much for covering this topic for our audience and I am sure it is a topic we will come back to.

Join us again next time for more insights from ESG leaders and innovators. You can also find the latest KPMG insights covering a range of ESG topics by visiting kpmg.com/ESG.

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Designed by Evalueserve | Publication name: Incentivizing long-term value creation | Publication number: 140040-G | Publication date: June 2025