esg IN CONSTRUCTION

BY ANDREA CASTLE & VICTOR STURGIS

THE CONCEPTS BEHIND ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) ARE NOT NEW. Over the years, the business world has prioritized mutually independent concepts such as corporate sustainability, corporate social responsibility, corporate philanthropy, corporate governance, environmentally responsible investing, and socially responsible investing. It is only more recently that ESG, which encompasses all of the aforementioned nomenclature, has taken hold of capital markets. Corporate sustainability and environmentally responsible investing are more reflective of the "E." Corporate social responsibility, philanthropy, and socially responsible investing tend to reflect the "S." And, corporate governance is appropriately correlated to the "G."

Since the concepts behind ESG are not new, why is it such an important focus of capital markets and businesses today? And, more importantly,

WHY DOES IT MATTER TO CONTRACTORS?

WHY IS ESG TOP OF MIND?

Regulations

Backed by the idea that embedding ESG factors makes good business sense and leads to more sustainable markets and better outcomes for societies, there is currently a global rise of ESG reporting standards.

In the U.S., it is most evident in the Securities Exchange Commission's (SEC's) proposed climate-related reporting standards for SEC filers, which will have implications on both public and private contractors. The SEC climate proposal Release No. 33-11042 *(sec.gov/rules/proposed/2022/33-11042.pdf*, which was still open for public comment as of publication), will require SEC filers to report on broader climate risk disclosures and metrics.

The rules require organizations to disclose the following levels of emissions among other criteria:[1]

- *Scope 1 emissions:* Direct emissions from assets owned directly by the organization including facilities and fleet emissions.
- *Scope 2 emissions:* Indirect emissions from the purchase of electricity and gas (for heating) for the organization's own use in buildings and other business processes.
- *Scope 3 emissions:* Indirect emissions that occur upstream or downstream that allow a company to operate effectively.

While the current proposed rules are awaiting final decisions, organizations potentially affected by these rules are gearing up for the additional administrative burden of gathering necessary data to comply with these new standards.

WHY ARE THE REGULATIONS IMPORTANT FOR CONTRACTORS?

While most construction-related organizations are not publicly traded, the SEC proposal has created a tidal wave engulfing various stakeholders from all types of organizations beyond those regulated by the SEC. As a result, pressures to focus on ESG from the workforce, consumers, and investors and shareholders are being applied to many organizations. Let's look at each of these through the lens of construction.

Workforce Pressure

With the labor shortages facing the construction industry, contractors will need to appeal to every employee category if they hope to backfill all the retirements of the next decade.

Younger generations typically have different priorities and expectations of their employers than the Baby Boomer and Gen X employees (who contractors are used to recruiting). Millennial and Gen Z employees want to work for organizations that prioritize environmental and social issues. Female employees and individuals from diverse backgrounds might be hesitant to enter an industry in which they don't see a lot of leaders who look like them.

Organizations that can best communicate and promote their contributions to their communities, their actions to reduce the company's carbon footprint, and their inclusive environment are better positioned to secure top talent.

Consumer Pressure

Project owners, especially those that are SEC filers, will likely start to require contractors to measure and provide greenhouse gas (GHG) emissions generated by the projects they procure. If the Scope 3 requirements make the final rules, then the reporting requirements likely will extend to project emissions for subcontractors and suppliers as well.

Even if a project owner is not an SEC filer, emissions reporting information on its GHG footprint – including construction projects – could be required if it is downstream or upstream from an SEC filer.

Contractors that work directly with real estate developers might also begin to feel a significant amount of pressure from developers that are facing pressure from stakeholders to implement various ESG initiatives.

Rating Agencies/Financing Pressure

Various investor reporting and rating agencies such as S&P and Moody's are developing benchmarking and scoring related to disclosed and publicly available organizational ESG metrics. This analysis could begin to affect a contractor's ability to get financing from private investors or banks and even affect the ability to secure bonding from sureties for projects in the future.

With pressure coming from various stakeholders, the questions around the impact of ESG on the construction industry feel much less like an "if" than a "when."

ESG THROUGH THE LENS OF CONSTRUCTION

Due to the pending impact of ESG on the construction industry, let's unpack more details around what each aspect of ESG represents in a broad sense.

Environmental

In general, the environmental focus of ESG takes into consideration a business's impact on and use of such natural resources as:

- Oil and fuel consumption
- How efficiently water is used
- The makeup of materials for an organization's products/deliverables
- How a company handles the waste of its production processes
- The impact a company has on the biodiversity, ecosystems, or habitats in which it operates

Part of the consideration related to natural resources also includes an organization's compliance with product standards put in place to protect the environment.

Another environmental consideration is a business's impact on climate change or the impact of climate change on the organization. Some questions asked in this area include:

- As a result of your business processes, how much greenhouse gases are being emitted into the atmosphere?
- Do you have a strategy to become a carbon neutral or carbon negative organization in the future?
- What is your organization's exposure to the risk related to climate disasters like heat waves or floods?

The construction industry and related ecosystem have a considerable impact on the climate when viewed through the lens of ESG. As the industry is already taking steps to move in a positive direction, here are some environmental considerations specific to construction where progress is being made:

- Many building standards today are very close to Leadership in Energy and Environmental Design (LEED®) standards *(usgbc.org/leed)*, and many organizations support LEED certification for their designers and engineers. The globally-recognized LEED framework provides a model for healthy, highly efficient, and cost-effective green building.
- Construction companies are recycling material packaging, reusing wood pallets, and finding additional uses for excess materials on jobsites.
- Organizations are looking into various technologies to manage the decarbonization of their vehicle and equipment fleets through electric, hydrogen, and even solar power.
- The emergence of carbon sequestration technology (which is the process of capturing and storing atmospheric carbon dioxide) is becoming more popular. One example is capturing and injecting carbon dioxide directly into concrete mix, transforming it to a mineral that no longer is harmful in the process.

organizations that can **best communicate & promote** their contributions to their communities, their actions to reduce the company's carbon footprint & their inclusive environment **are better positioned to secure top talent.**

esg

Social

The social aspect of ESG tends to lean more on people-related elements and effects. This element can be broken down into an organization's internal and external groups. Internal elements mainly center around a company's human capital, such as:

- Company culture and employee wellbeing
- Diversity, equity, and inclusion
- Employee training and education
- Health and safety
- Working conditions
- Fair and equal compensation models
- Employee benefits
- Labor standards
- Gender equality

Beyond an organization's four walls are considerations such as philanthropy and community investment or its involvement in human rights and social issues. The "S" also can include transparency in the supply chain and relevant business practices.

More Fortune 1000 companies are starting to include additional criteria in their bid documents to meet their supplier diversity goals,[2] which could affect a company's ability to get work if competitors can more effectively address those requirements.

Organizations throughout the construction industry have many internal and external examples of positive social impact.

Some of the items that can be considered include:

- Safety programs
- Suicide prevention programs
- Strong antibullying and discrimination policies
- Community service
- Mentorship programs to support employee learning and growth in the industry
- Scholarships for students looking to gain access to the industry
- Adequate compensation
- Minority- and woman-owned business support programs to improve the diversity of subcontractors in the industry
- Other diversity, equity, and inclusion initiatives

Governance

The governance aspect of ESG addresses how an organization is run, including the structures and processes in place to reduce risk to the company and its stakeholders. Governance elements include:

- An organization's board of directors and executive leadership group
- The independence and diversity of the board
- Succession planning
- Executive compensation

It also considers additional elements such as information transparency, shareholder rights, anticorruption, internal controls, supply chain resilience, data privacy, and cybersecurity.

Construction is a highly regulated industry that usually requires contractors to meet building standards and codes set by states, cities, or counties. Contractors complying with these standards show a minimum level of governance and risk reduction. Even some of the common contract language used in the industry provides a level of accountability that may not exist in other industries.

For example, contractors may have to warrant the materials and equipment used to complete projects, inform owners if hazardous material is found, and ensure LEED standards are met.

Another good example of governance in the construction industry relates to succession planning. Contractors often heavily consider the succession plan of their leadership and ownership. Some organizations have turned employee stock ownership plans (ESOP) to transfer ownership directly to employees as major stakeholders in the organization's success. (This transition can also be seen as a social element.)

Another great example of a proper governance structure is to address the processes around subcontractor prequalification to ensure a company that is bidding on work can actually deliver timely and quality results.

WHERE SHOULD CFPs START?

Establish an ESG Team

One of the first steps to take as a construction financial professional (CFP) is to understand if the leadership team and board of directors consider ESG a priority for your organization and whether they understand its importance.

If leadership is committed to furthering the company's ESG efforts, then establishing a cross-functional ESG team is one of the next major steps. If a company's leadership isn't committed to ESG, then it may be a good opportunity for financial leaders to tie the benefits of focusing on the subject to what is important to them, such as having the best people, a strong backlog, being considered a leader in the industry, working with well-known customers, etc. All of these priorities can likely be addressed in some way by the organization focusing on ESG.

Since ESG touches almost every area of a business, creating a team or optimizing teams already in place is essential. CFPs are an important part of this team.

Here are five steps to consider:

1. Understand where the organization is & where it's going.

With an increase in demand for transparency around ESG reporting, this task can no longer solely fall in the hands of the marketing team and sustainability leader. A cross-functional team or steering committee can help to inventory existing capabilities and identify strengths and gaps in processes and data of the organization.

A team of this nature can position the organization well to perform a materiality assessment (an assessment to help identify and prioritize what is important to the organization in this area) and engage with stakeholders to help prioritize reporting and goals. This team also will be vital in creating a road map to execute the resulting ESG strategy.

2. Build the ESG team based on the organization's specific needs.

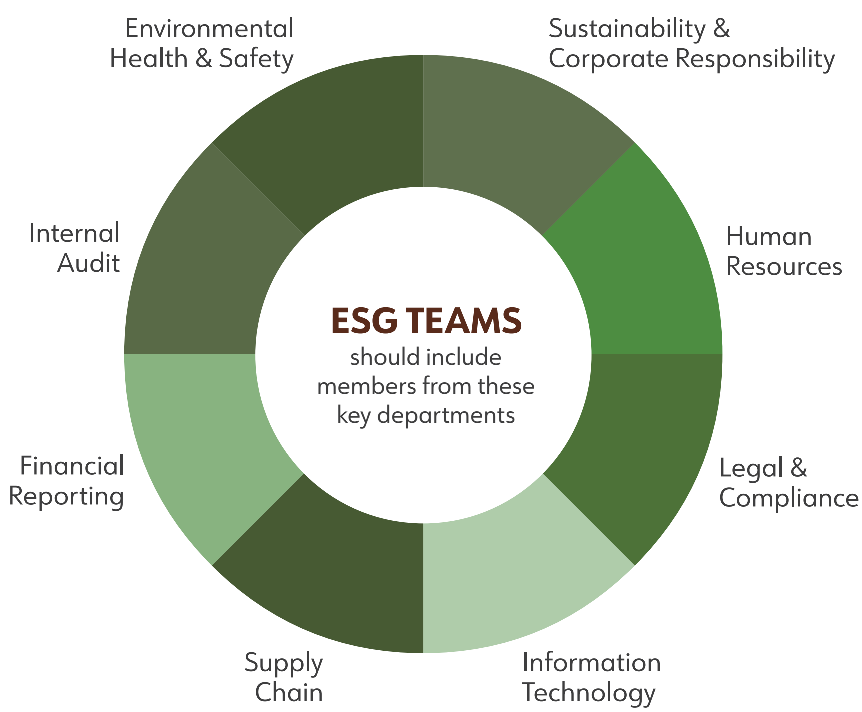
Not all organizations are the same. Industry, client base, size, specialty, and other factors will play major roles in identifying an organization's ESG strategy and reporting needs. It's important to ensure the ESG team includes multiple individuals with differing perspectives of the organization's stakeholders. Exhibit 1 shows key departments that should be included as organizations build their ESG teams:

- *Sustainability and Corporate Responsibility* for information about corporate practices
- *Human Resources* to capture policies and programs around employee welfare
- *Legal and Compliance* for updates on regulatory reporting and obligations
- *Information Technology* for identifying, gathering, and analyzing existing and new data streams
- *Supply Chain* for information about responsible sourcing practices
- *Financial Reporting* to align metrics and prepare for increased disclosures related to ESG
- *Internal Audit* as a first line of defense in testing data and controls to generate investor-grade information
- *Environmental Health and Safety* to offer guidance and data on programs and align with regulatory reporting
- *Operations* for insight into business processes
- *Subcontractor Management* for information about subcontractor practices

3. Choose an ESG leader who can make things happen.

The ESG leader must recruit support from colleagues across the organization, build consensus on execution, and solidify executive commitment to the strategy and goals. The right person can make the case for ESG, identify risks and opportunities, and garner support across the entire organization.

EXHIBIT 1: ESG TEAM MEMBERS



Source: McClure, Christopher. "5 steps to create a cross-functional ESG team." Crowe. August 23, 2022. *crowe.com/insights/5-steps-to-create-a-cross-functional-esg-team.*

4. Clearly structure the roles & responsibilities of the ESG team.

Organizations can generally align roles in three main areas: functional, process-related, and technical. But first, someone needs to take charge of baseline ESG education to help build awareness. To commit to doing their part, people need to understand why they're being included, why they are critical to the team, and how they fit into the team strategy.

It can be helpful to include a mix of internal working sessions, external educational opportunities, and specialized consultants; it's also important to communicate that this education is an ongoing commitment, not just a one-time event. Once everyone understands their roles, organizations should develop a process for how ESG team members work together:

- Who identifies new regulatory obligations for the team?
- Who triages and prioritizes customer requests?
- Who collects industry and competitive benchmarking?
- Who determines next steps?

Establishing roles and responsibilities early can help everyone stay abreast of regulatory changes, customer requirements, and other new and impactful information.

5. Get started today.

The time to assemble this team is now. Is the organization prepared to address upcoming regulations, stakeholder demands, competition, and other goals? ESG data and reporting needs are evolving, and they arise at different levels of the organization. So, it's critical to establish processes to identify, triage, and plan for stakeholder expectations. This is no small task, as it takes time to assign responsibility, select technology, consider external support and managed service options, anfill internal staffing needs.

UNDERSTANDING REPORTING STANDARDS

It also is important for companies to understand what information to disclose and how to disclose it. Numerous publicized frameworks for reporting exist as guidelines as the industry waits for the SEC rules. The Sustainability Accounting Standards Board (SASB) *(sasb.org)* has industry-specific guidance on reporting. The Taskforce on Climate-Related Financial Disclosures (TCFD) *(fsb-tcfd.org)* also has comprehensive disclosure requirements for organizations. These frameworks and others provide standards on areas such as safety metrics, board oversight, and greenhouse gas disclosures.

Note that, while both SASB and TCFD provide what needs to be disclosed, they do not provide a grade or rating of the information. There are other independent rating organizations that provide this type of service. If your stakeholders need external assurance on the information being provided, then make sure to talk to your accounting professional.

CONCLUSION

While getting ready to comply with ESG standards might seem like a lot to take on, many contractors are better positioned than they realize for having initiatives in place to show a strong focus on all aspects of ESG. It will be important going forward to build a strong cross-functional team to examine and inventory current ESG initiatives and start to assess what's material and important to stakeholders – not just regulators and customers, but also investors, employees, activists, and ratings agencies, too. The more information an organization has about competitive behaviors and best practices, the more effectively it can begin to setup processes to gather and report on the data that is valuable to those who matter most. **BP**

ANDREA CASTLE, CPA, CCIFP, CCA, is Managing Partner and Audit Practice Leader at Crowe LLP *(crowe.com)* in Atlanta, GA. She performs financial statement audits on a national basis for both publicly traded and private construction companies that perform work throughout the U.S. and abroad. Within CFMA, Andrea sits on the Board of Directors for the Georgia Chapter and serves on the Membership Committees for her local chapter and at the national level. She has presented on various construction-related accounting topics at both CFMA regional and local conferences and meetings. Andrea can be reached at *andrea.castle@crowe.com.*

VICTOR STURGIS, CPA, CCIFP, is Tax Partner at Crowe LLP *(crowe.com)* in Grand Rapids, MI. As an ESG tax leader, innovator, change maker, and thought collaborator at Crowe, Victor is driven by his beliefs and core values. He represents the firm on many diversity and inclusion task forces and committees throughout the accounting and construction profession, including roles within CFMA and the Michigan Society of CPAs. Within CFMA's Western Michigan Chapter, he has also served as Treasurer and won the Member of the Year Award in 2020. He can be reached at *victor.sturgis@crowe.com.*

Endnotes

1. *"The Enhancement and Standardization of Climate-Related Disclosures for Investors." Securities and Exchange Commission. sec.gov/rules/proposed/2022/33-11042.pdf.*
2. *"Why Fortune 1000 Companies Must Have a Supplier Diversity Program." Supplier.io. July 5, 2022. supplier.io/blog/fortune-1000-companies-must-have-a-supplier-diversityprogram.*

DON'T MISS

Learn more about ESG at CFMA's 2023 Annual Conference in Colorado on July 15-19!
conference.cfma.org