

## ESG COMPLIANCE – CHALLENGES FOR MSMEs IN MALAYSIA

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**Abstract:** *As Malaysia now facing many problems like high living cost, unemployment, natural disaster, corruption and high crime rate, adopting Environment, Social and Governance (ESG) standards and practices is a must by every business entity. For large company like public listed companies (PLCs), complying with ESG not a huge problem due to their size and nature of business that directly impact the ESG elements. However, Micro, Small and Medium Enterprises (MSMEs) find difficulties to meet ESG rigorous standards due to lack of fund, expertise, and knowledge. Besides, it is not feasible for them to meet all the requirements due to their small size and narrow nature of business. Thus, the objective of this paper is to discuss the problems and challenges faced by MSMEs to adopt ESG at every level of their business operations.*

*Keywords: ESG; sustainability; environment; small and medium enterprises; SMEs.*

### 1. Introduction

Environmental, Social and Governance (ESG) nowadays is an important mantra for Malaysian business. In the last few years, ESG become a key element in Malaysian business and economic policy due to many issues raised and discussed globally. ESG basically is a framework that is designed based on three core elements or pillars namely environment, social and governance to guide and measure entities degree of operation in a sustainable manner (Lee et al., 2022).

For the first element, environment, issues like climate change, frequent natural disaster, heavy and frequent flood, global warming, carbon emission, deforestation, food waste, energy efficiency, loss of biodiversity, plastic pollution, deterioration of air and water quality, rising of sea level due to melting ice caps and affected marine ecosystem become more important and give significant impact to the human quality of life. The second element, social, highly related to business relationship with their stakeholders like employee, customer, supplier or vendor and surrounding communities. The issues that are largely debated under social pillars include workforce health and safe environment, diversity and equal opportunities in employment and career development, fair wages, and sufficient training. Lately the issues related with customer data security and theft (Abidin et al., 2019) and protection to internal whistle blower (Nawawi & Salin, 2018) also largely discussed by scholar and practitioners under this pillar. The last element, governance, is mainly about how a company is properly directed and governed. This

includes issues on board independence, shareholders' rights and engagement, top management compensation, and business ethics (Shahar et al., 2020; Alias et al., 2019; Nor et al., 2018).

As ESG become more important and global agenda, Malaysian companies irrespective of their nature, size and industries must seriously consider ESG in their business strategies and operation. This is including business that fall under the category of Micro, Small and Medium Enterprises (MSMEs) which must embrace ESG to ensure the investors, both local and foreign choose Malaysia as their choice of investment hub rather other neighboring countries like Singapore that has become the frontrunner of ESG champion in ASEAN countries. As a backbone of country economics that established more than 98 percent of business entities, the role of MSMEs in ESG is important because they are part of the business supply chain ecosystem. Thus, complying with ESG is a must because many groups of stakeholders are under pressure to meet certain element of ESG. For example, many large companies need to ensure their vendor and supplier to be ESG-compliant. This is to ensure their products can be exported to the developed countries like United State of America and Europe which really emphasis on the meeting the strict labour and environmental standards.

However, this is not an easy task. MSMEs in Malaysia in particular, still not familiar with the ESG components and its implementation in business. The regulatory bodies in Malaysia itself yet to construct and issue a concrete and clear ESG guidelines that can be referred by Malaysian business players. While many international organizations has recommended many ESG-related guidelines, their recommendation may not applicable in Malaysia due to different local custom and geographical characteristics. Thus, the objective of this paper is to discuss the problems and challenges faced by MSMEs to adopt ESG at every level of their business operations and recommend how government should assist MSMEs to alleviate this problem.

## **2. Problems and Barriers by MSMEs to Comply with ESG.**

### **2.1 Many Complicated and Complex ESG Standards**

Many MSMEs are currently only adhered to clear and direct laws and regulations. Unlike public listed companies, MSMEs largely form for the need of family business and hence, they only need to comply with a few laws as their base of stakeholders are small. Due to this, MSMEs will experience difficulties to meet ESG more complex requirements.

Currently, ESG may being implemented by large and public listed companies, but these different companies may adopt different ESG standards. There are many standards that can be used by the company generally and MSMEs specifically such as Global Reporting Initiative (GRI), Bursa Malaysia Sustainability Reporting Guide, Task Force on Climate-related Financial Disclosure (TCFD), SASB Standard, CDC Investment Works ESG, IFC performance Standard, United Nations Sustainable Development Goals, Bank Negara Malaysia Climate Change and Principle-based Taxonomy, Paris Climate Agreement and RAMSus' Sustainability Rating Report. With this many suggested guidelines and best practices that recommended by various organizations, not only MSMEs but certain public listed companies will find it confusing and impossible to comply (Singhania & Saini, 2023).

Besides, this compliance makes it more difficult to comply if companies such as MSMEs want to operate in the different countries or at least want to export their product to several countries. This is because several countries may set different ESG standards and hence, making it difficult or impossible for companies to develop one product with many variations to fulfill

these different ESG standards. Compliance requirements can vary across regions and industries, posing additional challenges for small businesses with limited legal and regulatory expertise.

## **2.2 Lack of Visionary Framework and Local Guidance on ESG**

Besides, there is no standardized criteria and acceptable ESG standard that are now applying and adopting especially in Malaysia. MSMEs may struggle with understanding and complying with complex ESG regulations. This is because the rules and regulation may derive different interpretation and hence, producing possible wrong action by MSMEs. This is worsened as ESG reporting frameworks and standards are still evolving, and the absence of clear guidelines can make it difficult for MSMEs to navigate the ESG landscape. The absence of standardized reporting formats and metrics can create confusion and make it challenging for MSMEs to measure and communicate their ESG performance effectively.

## **2.3 Lack of Fund**

MSME is the most affected business entities during the pandemic. This is due to poor financial management, small capital and lack of savings. Survey by McKinsey (2020) reported that between 25 percent to 36 percent of small firms in several countries are going into liquidation because of the disruption in the first few months of the pandemic. Some of these businesses are already in financial risk before the pandemic. Due to this, many MSMEs that just recovered from the pandemic crisis do not have spare cash to set up ESG practices. Implementing ESG initiatives may involve upfront costs, such as adopting environmentally friendly technologies, improving labor conditions, or conducting sustainability assessments (Haiyang & Xiaohui, 2022). For MSMEs with tight budgets, these expenses can be a barrier to ESG implementation. Unsurprisingly, even after the pandemic end MSMEs are still experiencing cashflow problem. After their money was wiped out to save the business from going into liquidation, the other problem persists after pandemic.

## **2.4 Poor Expertise**

MSMEs also do not have sufficient expertise to blend ESG in their operation. For example, as global trend is now moving to green economy, MSMEs need to start developing green-based products and provide green-based services to ensure they do not lag this major business trend. However, this initiative surely requires some technical knowledge and skill combining with a large sum of money to transform their operation, acquire more sophisticated machines and employ new workers with sufficient expertise (Van Song et al., 2022).

Lack of technical and operational know-how can be due to lack of access to specialized ESG expertise or sustainability consultants who can provide guidance on ESG implementation. This is worsened if the MSMEs operators themselves do not have any background or formal education which make them difficult to understand the issues of ESG. Without external support, it can be overwhelming for MSMEs to develop and execute effective ESG strategies.

## **2.5 No Clear Benefits Complying with ESG**

ESG is driven for a longer-term impact such as reduction of carbon emission or popularly known as net zero by 2050, reduction of world warming by 1.5 degree Celsius, phasing out fossil fuels-based and carbon-intensive energy, and replacing it with more clean energy that sourced from solar, wind and hydro by 2030. This ambition may not become an interest of the MSMEs because their main objective of the business is to earn the best returns for the company and hence, to the owner. Including ESG in their business agenda may distract their original business mission and vision, reduce net profit, and decrease cashflow of the companies. The main dilemma that is faced not only by MSMEs, but also large companies is to strike the balance between the need to generate sufficient cashflow and maximizing profit to ensure their performance sustainability with the agenda of ESG. Many MSMEs may not be fully aware of the concept of ESG or the potential benefits it offers. They may not understand how ESG practices can contribute to their long-term growth and competitiveness.

## **2.6 More Reserves are Needed to Face Challenges Ahead.**

The future of business and economics is still uncertain. While a few economic indicators such employment rate and gross domestic product (GDP) of 4.5 percent shows that Malaysian in the sign of recovery, the other local and global economic factors require MSMEs to prepare for any economic headwinds ahead. Locally, the price of goods and services keep on increasing which put cost of living pressures among the public.

Some of the factors that affected the operational cost of the MSMEs are the regulatory requirements to make minimum wages of RM1,500 compulsory effected 1<sup>st</sup> May 2022. However, for micro enterprises with less than 5 employees the requirement is delayed until 1<sup>st</sup> July 2023. The requirement of minimum wage will result in a steep cost increase among the MSMEs.

In addition, there is also a loud call by the employee for government to instruct employer to increase employee contribution in national pension fund, Employees Provident Fund (EPF) up to 20 percent from current 13 percent per month for employees earning RM5,000 and below. Although this is a welcome move to help employees after four withdrawal programs during the pandemic amounted to RM145 billion and boost their retirement savings, together increasing EPF capital investment accumulation that help to regenerate local investment of the country, this is certainly a major financial burden for MSMEs. Mathematically, an increase in employer's contribution will increase the operational cost of the business which will be passed on to consumers in form of price increases. Besides, employers may stay in shadow economy and make it informal to sustain their business as labour cost become more expensive. Drastically, employers may reduce their workers to keep their costs manageable, but this will increase the unemployment rate.

Coupled with higher interest rates, the Central Bank of Malaysia will continuously increase the overnight policy rate to protect Malaysia from slipping into recession. This action effectively will increase borrowing costs and hence, reduce the net disposable income and discretionary income by the consumer. Thus, the purchasing power of the consumer will reduce, and this will affected the sales and revenue of the business entities.

Global economic factors on the other hand include prolonged elevated inflation globally due to post-pandemic crisis especially in the developed countries including China, war and political tensions between Russia and Ukraine, trade friction between China and other Western economic superpower, economic sanctions, and instability of banking sector in United States of America (US) with the recent collapse of Silicon Valley bank and Signature Bank. In addition, Swiss banking namely Credit Suisse Group AG was forced to merge with UBS Group AG to prevent devastated global financial system.

On top of that, an ageing workforce, weakening investment and slowing productivity are the other factors that may prevent the economic recovery process. For example, many companies have problems in managing their inventory and supply chain which may deteriorate financial performance, either as a manufacturer or distributor (Karim et al., 2018). All of these factors contributed to the volatility in the commodities and financial market which would result in higher operating costs, rising uncertainties and limit business opportunities. As Malaysian is an open market economy which rely to export for growth, stagnation in global growth will negatively affect the export prospects for the commodities.

## 2.7 Less Financial Support from Banks and Financial Institutions

Getting approval for loans and microfinancing becomes tougher as lenders and financial institutions heavily scrutinize business past records such as credit history, prior business performance and market experience. Ironically, many of these small businesses are unable to apply for loans with bigger commercial financial institutions due to their poor and incomplete recordkeeping. Besides, this small-scale business does not have healthy credit score or worse, no credit history due to their financial modelling before the pandemic that rely on self-funding (Khan, 2022).

Thus, the MSMEs are only able to apply for the specific SMEs business loan and microfinancing backed by government grant. However, incomplete records make their application unsuccessful. With the rising price of raw materials, increasing minimum wage and higher overhead costs, it is difficult for MSMEs to get help from banks and financial institutions for their ESG initiatives.

## 2.8 Prioritizing Other Issues

MSMEs also need to arrange other business matters as their priority more than ESG. A survey conducted by Alliance Bank, UNGCMYB and SME Corporation Malaysia among 610 respondents from SMEs reported that many SMEs still prudence and remain caution post pandemic uncertainty situations. Profit growth, cash management, sales, customer retention and business expansion are the top five concerns of MSMEs for the next 12 months period. Unfortunately, ESG and corporate social responsibility sit among the least concerns by MSMEs (Table 1).

**Table 1: Top Concerns in the next 6-12 months among SMEs**

Rank	Concern	Percentage
1.	Profit growth	36%
2.	Cashflow management	35%

3.	Sales planning	32%
4.	Improving customer retention	24%
5.	Business expansion into new markets / segments retention	21%
6.	Improving customer service	20%
7.	Increase market share	20%
8.	Staff management (hiring/streamline/restructure/training/upskilling)	20%
9.	Product / service innovation	18%
10.	Branding / marketing	17%
15.	Implementation of Environment, Social and Governance	5%

Source: Alliance Bank (2023).

Below is the recommended framework for problems or barriers for ESG compliance by MSMEs.

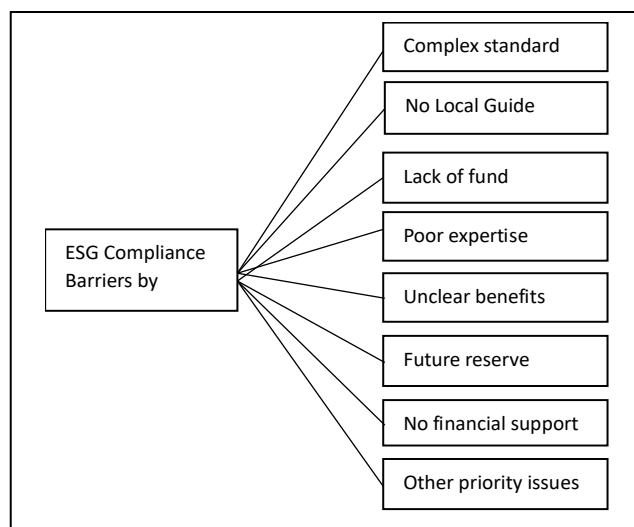


Figure 1: ESG Barriers Compliance by MSMEs

### 3. Incentives from Government

As ESG can be a big thing in the future, the government should step in to help small players like MSMEs. The help that can be given includes financial incentives, education, access funding and investment, simplified ESG regulations, collaborations, awards and recognition and integration to public procurement.

#### 3.1 Financial Incentives

Governments can provide financial incentives such as grants, subsidies, tax breaks, or low-interest loans to encourage MSMEs to adopt ESG practices. In foreign countries, green tax incentives such as green investment tax allowance are awarded. These incentives can help offset the initial costs associated with implementing sustainable technologies or improving social and environmental performance. In Malaysia, although several tax incentives already introduced in 2014 such as Green Investment Tax Allowance (GITA) Assets, Green Investment

Tax Allowance (GITA) Project and The Green Income Tax Exemption (GITE) Services, the scope are still limited. Malaysia needs to enhance their tax incentives to a broader scope such as taxes on energy, transport, pollution, and resources. In Europe, green taxation has been used to encourage industry and public switching to cleaner energy, more sustainable industry and greener habits.

### **3.2 Capacity Building and Education**

Governments can offer training programs, workshops, and educational resources to increase MSMEs' awareness and understanding of ESG concepts. Continuous education programs targeting MSMEs specifically their owners and directors can be implemented. The Human Resource Development Fund (HRDF), an agency under the Ministry of Works can provide certain allocation for ESG-related training fund to attract employers to send their employees on ESG training. Providing guidance on integrating ESG considerations into business strategies and operations can empower MSMEs to effectively implement sustainable practices. ESG-related subjects also can be introduced at every education level starting from primary, secondary and higher learning institutions. The approach needs to be more practical and hands on activities rather than too much theoretical in nature so that the students able to appreciate how important a greener world for their life and next generation.

### **3.3 Access to Funding and Investment**

Governments can facilitate access to funding and investment opportunities specifically for ESG-focused MSMEs. This can involve setting up dedicated funds, venture capital initiatives, or creating platforms that connect MSMEs with impact investors interested in supporting sustainable businesses. For example, the government can provide a platform for MSMEs to pitch their idea or showcase their planning to integrate ESG in the business and hence produce more environmentally friendly products. Any interested private investor can invest in these MSMEs with government agencies under Ministry of Science, Technology and Innovation (MOSTI) can act as a mentor to advise and support MSMEs along the process.

### **3.4 Simplified Regulations and Compliance**

Governments can play a role in simplifying and harmonizing ESG regulations, making them more accessible and understandable for MSMEs. Providing clear guidelines, checklists, and online tools can help MSMEs navigate the regulatory landscape more easily and ensure compliance. For example, the government can establish a reference unit in the Ministry of Entrepreneur Development and Cooperatives that is responsible to facilitate MSMEs in complying the regulations that related with ESG. While the government may introduce an ESG framework by the end of 2023, this framework needs to be supplemented with briefing notes, case study and success stories. The framework also needs to be straight forward, practical and easy to implement by small business.

### **3.5 Collaborations and Partnerships**

Governments can foster collaborations between MSMEs, larger companies, and industry associations to promote knowledge-sharing and transfer of best practices. Creating networks where MSMEs can connect with sustainability experts, consultants, and mentors can facilitate the exchange of ideas and provide valuable support. For example, government linked companies like Maybank already had a good collaboration with ESG partners like Worldwide Fund (WWF), Roundtable on Sustainable Palm Oil (RSPO),

Malaysian Sustainable Palm Oil or Forest Stewardship Council, United Nations Environment Program Finance Initiative (UNEP-FI), Malaysian Palm Oil Board (MPOB) and Business for Social Responsibility (BSR). Thus, government may instruct its GLCs to networked MSMEs with their ESG partners to help small players understand the sustainable and best business practices, assist MSMEs to get and meet the criteria for relevant ESG certification requirements, collaborating with key industry players, knowledge-building workshops and participatory onsite visits.

### **3.6 Recognition and Awards**

Governments can establish recognition programs and awards to celebrate and showcase MSMEs that excel in implementing ESG practices. These awards will showcase exemplary ESG practices in their business model and gain better market access in the long run. This can encourage other MSMEs by highlighting the benefits and positive outcomes of ESG adoption, while also promoting a culture of sustainability within the business community.

### **3.7 Integration into Public Procurement**

Governments can incorporate ESG criteria into public procurement processes, giving preference to vendors and suppliers which are mainly MSMEs that demonstrate sustainable and ESG practices. In Europe for example, the Green Public Procurement (GPP) Directive encourages European Union member states to purchase goods, services and works with the minimal environmental impact possible, thereby contributing to the Sustainable Development Goals. The GPP directive can boost innovation and give industry incentives to develop work, products and services that respect the environment. The same criteria are also applicable for pillar social and governance in which MSMEs that able to show good social policy and exemplary governance practices will be given preference to be awarded government project. Prior study shows that government procurement can significantly affect stakeholders' value by improving supplier firms' ESG performance (Huang et al, 2023). This can create market opportunities for MSMEs while encouraging them to align their operations with ESG principles.

## **Conclusion**

ESG factors are becoming increasingly important in today's business landscape. Environmental sustainability, social responsibility, and good governance practices are all factors that stakeholders such as investors, shareholders, employees, consumer, and public are increasingly looking for in companies. Companies that practice, embed and prioritize ESG factors in their business strategy and operation are more likely to attract stakeholders who are looking for stability and survive for long-term growth. As such, ESG integration is becoming an important consideration for MSMEs to continuously operate and expand their business and achieve significant competitive advantage.

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