CHAPTER I

INTRODUCTION

1.1 Background of Study

Engaging in business involves creating, distributing, and selling products or services to maximize profits as much as possible. Maximization of profits reflects a firm’s well-being and performance. Financial performance refers to a company's ability to efficiently handle its assets to ensure profit generation and stability in the long-term. Financial metrics, like market valuation, profitability, liquidity, solvency, and leverage, are vital in assessing financial performance (IAI, 2016; Fatihudin et al., 2018). Financial performance is an essential indicator for investors because it reflects management's achievements in improving shareholder welfare and describes the company's performance during a specific period. The company's profitability and liquidity can be measured through financial performance so that shareholders can compare past performance with current conditions.

Financial performance is a reference for investors when deciding to buy company shares. Therefore, improving financial performance is very important to attract investor interest. Financial performance also reflects the company's financial condition, whether good or bad. Having a healthy financial condition is the primary responsibility of management in running a business. Good financial performance is a benchmark for the company's success and the effectiveness of management, which is required to report its results to shareholders.

Financial performance in Southeast Asia shows diverse dynamics, with the manufacturing sector being a key pillar in driving economic growth. This sector contributes significantly to the Gross Domestic Product (GDP), creates many jobs, and is the main driver of exports. Not only that, the manufacturing sector also affects other sectors, such as logistics, finance, and trade. In Southeast Asia, the manufacturing sector in six main countries, such as Indonesia, Vietnam, Thailand, Malaysia, the Philippines, and Singapore, significantly contributes to the regional economy compared to other Southeast Asia countries (Medina, 2024).

Thailand leads with a manufacturing contribution of 27% to GDP, focusing on the automotive and electronics sectors. Malaysia follows with a contribution of 22.3%, supported by strengths in the electronics, machinery, and palm oil-based product sectors. Singapore, focusing on high-value industries such as biotechnology, electronics, and chemicals, recorded a contribution of 21.5%. The Philippines contributes 21.2%, with strengths in the semiconductor, food, and BPO sectors. Meanwhile, manufacturing in Indonesia contributes 19.8% of GDP, mainly driven by the textile, automotive, and electronics industries. Vietnam completes the list with a contribution of 16.4%, focusing on the growing textile, electronics, and furniture sectors (Medina, 2024).

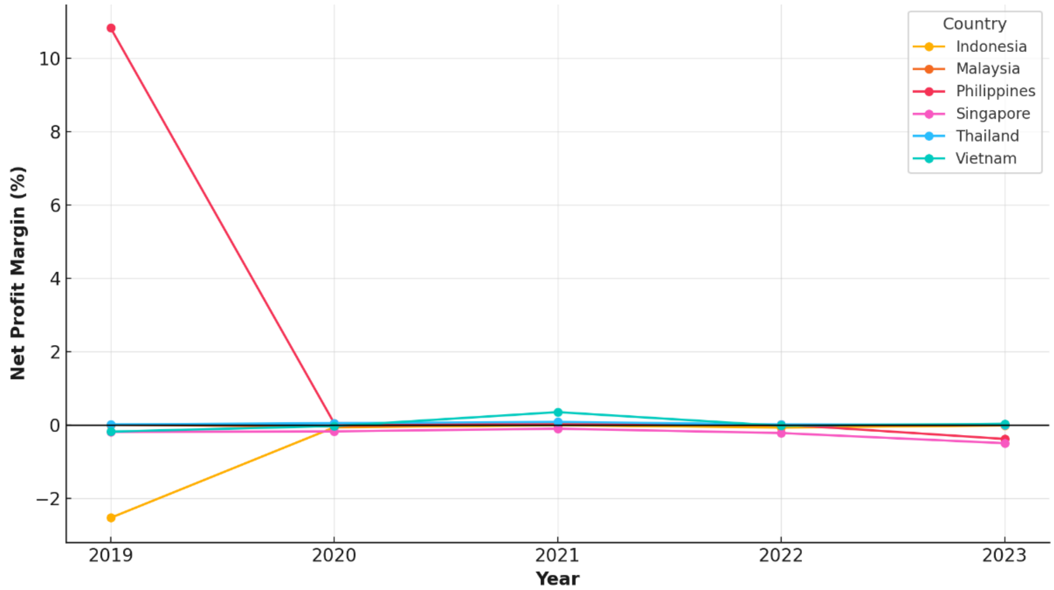

Figure 1 Net Profit Margin of six countries in Southeast Asia Manufacturing Companies (2019-2023)

Source: Thomson Reuters Eikon database (2025)

Despite its important role, the manufacturing sector of six countries in Southeast Asia faces challenges in the form of declining and stagnant financial performance during the 2019–2023 period. Based on the Net Profit Margin (NPM), significant differences exist between countries in the Southeast Asia region. As shown in Figure 1, the Philippines experienced sharp fluctuations, with a high NPM spike in 2019 but a drastic decline and stability in the following years, reflecting growth that is difficult to maintain in the long term. Indonesia recorded negative NPM for almost the entire period, indicating fundamental challenges such as high production costs and weak global demand.

On the other hand, countries such as Thailand, Malaysia, and Vietnam showed more stable performance because a strong manufacturing structure and supportive government policies supported them. However, their financial performance stagnated, and there was no increase in NPM in these three countries. Despite having a low NPM, Singapore was able to maintain its stability because it only focused on high-value industries with smaller profit margins. The impact of the COVID-19 pandemic in 2020 was also very significant, with a decline in NPM in almost all countries due to disruptions to the global supply chain and weakening demand. However, since 2021, there have been signs of recovery, especially in Vietnam, Thailand, and the Philippines, although significant increases in NPM have not been seen. Meanwhile, Indonesia and Malaysia still face obstacles to improving the performance of their manufacturing sectors.

Environmental, Social, and Governance (ESG) practices can answer various major challenges the manufacturing sector faces, such as high production costs, fluctuating market demand, and weak global competitiveness. Through the environmental pillar, companies can maximize energy efficiency and raw material usage, cutting operational costs and attracting investors who care about sustainability. On the social pillar, focusing on worker welfare and good relationships with surrounding communities can create a more productive and loyal workforce, especially in countries with large workforces, such as the Philippines and Vietnam. Meanwhile, the governance pillar encourages transparency and accountability, increasing investor confidence while reducing business risk. By integrating ESG, companies can increase profitability through operational efficiency, open access to sustainability-based funding, and meet increasingly stringent global standards.

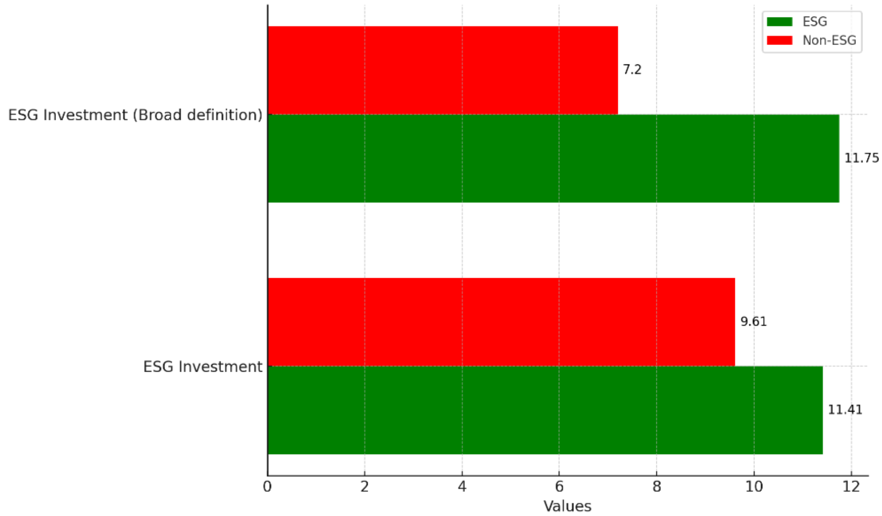

Figure 2 Average Net Profit Margin of ESG VS Non-ESG Companies

Source: Korwatanasakul and Majoe (2019)

ASEAN–Japan Center (AJC) conducted a survey in 2018 to explore ESG investment in 143 companies from 10 industries across all ASEAN Member Countries (Korwatanasakul and Majoe, 2019). The survey classified companies into two categories: the companies that include ESG in their strategy and reporting (ESG investment) and those reporting sustainability activities without explicitly including ESG in their strategy and reporting (ESG investment (broad definition)). Figure 2 shows that both categories showed higher average profit margins (11.41% and 11.75%) than companies without a focus on ESG (9.61% and 7.20%). This suggests that implementing ESG strategy into business operations helps to increase financial stability and profitability by mitigating risks related to environmental, social, and governance issues(Friede et al., 2015). This finding aligns with the idea that ESG-focused companies tend to experience more stable income streams due to reduced risks, unlike non-ESG companies.

The global business landscape is increasingly focused on corporate responsibility and sustainability. This is reflected in the emphasis on implementing Environmental, Social, and Governance (ESG) practices into their core operations and strategies. The UN Global Compact encourages companies to set their ESG efforts with the Sustainable Development Goals (SDGs) (United Nations Global Compact, 2023). This means businesses should actively contribute to global sustainability initiatives through their actions to support SDGs. The World Business Council for Sustainable Development (2020) states that companies that adhere to ESG standards often show a better position to manage risks for long-term survival and better to handle global market uncertainties. Companies with ESG performance are also more attractive to investors to see which companies run their operations productively and efficiently while contributing to sustainability (UNPRI, 2020). So, ESG considerations are no longer optional but key to successful and sustainable business practices today.

ESG practices are defined as firm efforts to address sustainability and ethical impacts across three key aspects, including environmental protection, fairness to society, and good governance. As the topic of sustainability and corporate responsibility grows in global business, more people are starting to realize that the business of operations has a negative impact on its surroundings. This is also in line with the growing demand for companies to implement and report the ESG based on government regulations, requirements for importing into developed countries, and demands from investors who prefer investing in companies that implement ESG.

Environmental practices refer to the activities practiced in an organization to its environment to manage its waste and reduce its impact on the environment, emissions, and greenhouse gases (Lee and Isa, 2023). Based on legitimacy theory, organizations employ environmental practices to create social acceptance and increase their legitimacy. It is for this reason that the company needs to consider the global environmental responsibility laws and the expectations of society since it leads to numerous benefits such as avoiding legal actions, improving the firm's reputation, and getting an edge over the competitors (Deegan et al., 2002; Mousa et al., 2015). According to stakeholder theory, environmental practices strive to meet the stakeholder needs of customers, investors, and regulators. Firms ready to solve environmental problems valued by stakeholders can expand their links with interested investors in sustainability and enhance consumer loyalty simultaneously (Valentinov, 2023).

Social practices refer to the company's commitment to the welfare of the employees and the surrounding community and its ability to provide for and satisfy stakeholders (Lee and Isa, 2023). Based on legitimacy theory, social practices are the chance under which companies can act in a way consonant with the public norms and stay legitimate. Social disclosures are used to show compliance with the standards of society, which legitimizes the company's operations from the public's perspective (Lanis and Richardson, 2013). Based on stakeholder theory, the need to consider the requirements and demands of stakeholders, including communities, employees, and customers, inspires companies to do social practices (Lanis and Richardson, 2013). Companies potentially strengthen stakeholder relationships by practicing responsible social practices, increasing investor trust, consumer loyalty, and employee retention.

Governance practices refer to the corporate structures and processes that demonstrate how executives and board members work aligned with stakeholders' interests while exhibiting ethical and responsibility of the leadership in the company (Lee and Isa, 2023). Based on legitimacy theory, companies implement governance codes and transparent disclosure guidelines to align their operations with social norms and expectations. Legitimacy is established when companies implement appropriate governance structures and practices that align with social norms or standards (Meyer and Rowan, 1977; Liu and Taylor, 2008). According to stakeholder theory, governance practices mean considering the requirements of all stakeholders, not just shareholders. Alpaslan et al. (2009) highlight that taking care of all stakeholders, especially during crises, can increase trust and cooperation, helping companies recover faster and perform better financially.

As global markets become more focused on sustainability, Southeast Asia region are also embracing ESG practices. Sustainability reporting in ASEAN countries (2018) found that more ASEAN companies are incorporating ESG factors into their business planning to meet global standards and requirements. According to the report by the ASEAN-Korea Centre (2023), ESG practices in ASEAN have been driven by external elements such as financial institutions and international supply chains. European and US regulations, especially those related to supply chains, play a significant role in setting ESG standards. Companies exporting to these regions often require disclosure of their ESG practices to meet legal and buyer requirements. In financial markets, ESG disclosure has been integrated into the lending procedures of banks and stock exchanges. These banks include the World Bank and the Asian Infrastructure and Investment Bank (AIIB) (ASEAN-Korea Centre, 2023).

According to a report from the ASEAN-Korea Centre (2023), the implementation of ESG practices across 11 countries in Southeast Asia varies. Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam, have developed ESG frameworks involving significant government projects and required sustainability reporting. In the early phases, Brunei and Lao PDR concentrated on developing their capacities and putting the policies into action. Cambodia and Timor Leste are new to ESG, with more people becoming aware of it, but there are not many rules everyone has to follow. Due to necessity and recent wars, ESG implementation has been limited in Myanmar. While some countries in Southeast Asia lead with comprehensive ESG practices, others still develop their frameworks and awareness. So, this research only focuses on examining the ESG performances in 6 countries in Southeast Asia that have developed ESG frameworks.

The manufacturing company is a production process that converts raw materials into finished products that have added value and are ready to be used by consumers for other industrial needs (Nabila, 2021). To make sure that their products, services, and processes are safe, effective, and of high quality, manufacturers must follow a set of rules called ISO (International Organization for Standardization), GMP (Good Manufacturing Practice), or HACCP (Hazard

Analysis Critical Control Points) (ASEAN-Korea Centre, 2023). Certain aspects of these standards match ESG practices. For example, ISO 14000 assists manufacturers in reducing environmental effects, and ISO 450001 addresses workplace health and security performance. To reduce their carbon footprints, increase resource efficiency, guarantee long-term sustainability, and comply with regulations, manufacturers must integrate ESG practices into their business.

In Southeast Asia, manufacturing companies have shown an increase in the adoption of ESG in their businesses. Clear ESG systems have been established in these countries where sustainability reporting and green finance are essential for the manufacturing industry. For instance, Law no. 40 of 2007 and Government Regulation no. 47 of 2012 concerning "Social and Environmental Responsibility of Limited Liability Companies" in Indonesia, as well as the Climate Change and Principle-Based Taxonomy (CCPT) that exist in Malaysia, are policies that assist firms in controlling their effects to the physical environment and enhancing the well-being of the community. Singapore mandates all publicly listed companies (PLCs) to disclose their sustainability. The Singapore Green Plan 2030 also forces manufacturers to embrace sustainability. Thailand's BCG Economy Model and Vietnam's plans to increase renewable energy investments. Investors interested in the long-term sustainability of their investments prefer to work with companies that comply with ESG standards, which, when integrated into manufacturing companies, helps them meet legal and social requirements regarding disclosure and attract sustainable investment, ultimately enhancing financial performance.

Previous research has also revealed that ESG practices positively correlate with a firm's financial performance. Focusing on environmentally sensitive industries, Naeem et al. (2022) found that ESG performance positively correlates to the financial indicator ROE and Tobin's Q. In Shariah-compliant companies, Lee and Isa (2023) also reveal that firms that enhance their ESG practices tend to improve their financial outcomes and value of the firm. Similarly, Shaikh (2022) found that companies in 17 countries that follow the Global Reporting Initiative (GRI) have better accounting-based (ROA, ROE) and higher market values (Tobin's Q), with the environmental pillar making the biggest difference.

In contrast, some previous research indicates negative or mixed findings regarding specific ESG pillars. Alareeni and Hamdan (2020) report that while overall ESG disclosure positively impacts Tobin's Q, environmental and social disclosures negatively impact ROA and ROE in US S&P 500 firms. Chininga et al. (2024) also highlight that in South Africa, the environmental pillar of ESG had a strong positive effect on both accounting and market performance. However, for social and governance, it was found to have no effect. Buallay (2019) also found that social disclosure negatively affects all performance indicators in the European banking sector, while governance disclosure improves Tobin's Q but negatively impacts ROA and ROE. In the MENAT banking sector, El Khoury et al. (2021) revealed that governance has a positive link with ROA and ROE, the environment positively affects the market performance (Tobin's Q and Stock Return), while social pillar and financial performance have a negative correlation.

In this study, three measures are used to determine firm financial performance: Return on Assets (ROA), Return on Equity (ROE), and Tobin's Q. The selection of these three indicators is based on their ability to provide comprehensive and relevant information regarding the company's profitability, efficiency, and market value. Compared to other indicators, such as Gross Profit Margin, which only focuses on operational profitability, or Current Ratio, which only looks at liquidity, these three indicators offer a broader perspective. By combining these three indicators, the financial performance evaluation becomes more comprehensive for assessing the company's success and potential in the future.

The independent variables in this study are measured based on the Environmental score, Social score, and Governance score of each company, which are available in the Thomson Reuters Eikon database. This research has three control variables, which aim to control and clarify the impact of independent variables on dependent ones. The control variables in this study are firm size, firm leverage, and country variables. Using country variables as a control variable in cross-country research is a common approach to account for country-specific differences such as institutions, economic conditions, and culture, which can affect the study results. This variable helps to separate the influence of the main variables from the factors specific to each country, such as regulations, labor costs, and the level of industrial development. In this study, Thailand is chosen as the baseline for the country dummy variable. The choice of Thailand is based on the stability of its manufacturing sector, which is reflected in its Net Profit

Margins (NPM), which remained steady during the COVID-19 pandemic, unlike the sharp declines seen in other Southeast Asia countries.

As global investors' interest in ESG is increasing, examining the impact of ESG practices on financial performance could prove useful. Based on previous studies, these practices are proven to boost competitiveness, compliance, and sustainability. Despite increasing research on this topic, most focus on developed and developing countries like Europe, Australia, Germany, and America. ESG practices in Southeast Asia still do not get much attention. In addition, six countries in Southeast Asia manufacturing industry are very important to the region's economic growth. The objective of this study is to examine how ESG practices of six countries in Southeast Asia manufacturing companies and their impact on financial performance. Another aim of this study is to address the lack of research on ESG within the non-financial sector, which has mostly been focused on the financial industry (Korwatanasakul and Majoe, 2019). This gap must be closed to enable the six countries in Southeast Asia manufacturing companies to implement ESG better to increase their financial performance and promote sustainable long-term growth.

Based on the phenomena and research gaps that researchers have explained above and also supported by differences in research results obtained from several previous researchers, this is the basis for researchers to continue a study entitled **"The Impact of Environmental, Social, and Governance (ESG) Practices on Firm Financial Performance of Southeast Asia Manufacturing Companies"**.

1.2 Problem Statements

Based on the background described above, the problem statement of this research :

1. What is the impact of environmental practices on the firm financial performance of Southeast Asia manufacturing companies?
2. What is the impact of social practices on the firm financial performance of Southeast Asia manufacturing companies?
3. What is the impact of governance practices on the firm financial performance of Southeast Asia manufacturing companies?

1.3 Objective of the Research

Based on the problem statement above, the objective of this research :

1. To analyze the impact of environmental practices on firm financial performance of Southeast Asia manufacturing companies.
2. To analyze the impact of social practices on firm financial performance of Southeast Asia manufacturing companies.
3. To analyze the impact of governance practices on firm financial performance of Southeast Asia manufacturing companies.

1.4 Contribution of the Research

Some of the contributions of this research are as follows:

1. Theoretical Benefits

    This study explores the impact of ESG practices on manufacturing firms' financial performance in Southeast Asia. It aims to expand our knowledge and offer new perspectives on how sustainability efforts affect business performance in the Southeast Asia manufacturing landscape. The research hopes to close the gap between theory and real-life practice by examining this relationship. The findings could potentially reshape our understanding of sustainable business strategies in this region's rapidly evolving economic environment.

2. Practical Benefits

    a. For researchers or students

        This research is expected to provide additional knowledge and as a reference material for researchers or students related to the factors that influence firm financial performance, especially regarding Environmental, Social, and Governance (ESG) practices of firm financial performance.

    b. For companies

        The results of this study are expected to provide valuable insight for other companies to consider ESG practices in their business, as it can potentially enhance their financial performance.

c. For further researches

This research is useful as a reference for continuing a much broader and deeper study in the future to obtain better results.

d. For investor

This study offers valuable insights for anyone interested in investing in manufacturing companies across the Southeast Asia region. Through this study, investors can better understand the potential risks regarding ESG issues and the benefits of ESG practices. This study provides additional information to help investors decide where to invest their money.

1.5 Scope of the Research

This research is constrained by samples and some variables, intending to prevent ambiguity when discussing the study's findings. Based on the title of this study, namely "The Impact of Environmental, Social, and Governance (ESG) Practices on Firm Financial Performance of Southeast Asia Manufacturing Companies". The independent variables used in this study are environmental practices, social practices, and governance practices. The dependent variable used in this study is firm financial performance. In addition, this study also uses firm size, firm leverage, and country variables as control variables. The sample in this study used six countries in Southeast Asia manufacturing companies listed on their respective country's stock exchanges in 2019-2023.

1.6 Research Systematics

In general, this discussion will be divided into five chapters, with the following systematics:

CHAPTER I INTRODUCTION

This chapter consists of the background of the study, problem statements of the research, the objective and contribution of the research, and research systematics.

CHAPTER II LITERATURE REVIEW

This chapter consists of a theoretical basis, previous research, hypothesis development, and conceptual framework.

CHAPTER III RESEARCH METHOD

This chapter consists of the research design, population and research sample, types and sources of data, definitions of variables operations, data collection methods, and data analysis methods.

CHAPTER IV DATA ANALYSIS AND DISCUSSION

This chapter contains the results of the research and its discussion. In addition, this chapter will explain the analysis of the results and see the comparison of the results of the study with the criteria used to prove the assumptions of the research hypothesis.

CHAPTER V CLOSING

This chapter contains the conclusions of the results of the research conducted, research implications, research limitations, and research suggestions.