

## Thin Capitalization and Financial Performance of Listed Consumer Goods Companies in Nigeria

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**Abstract:** The study examined the relationship between thin capitalization and financial performance of listed consumer goods companies in Nigeria. The population of the study consists of twenty one quoted consumer goods manufacturing companies in Nigeria. Census sampling was adopted in this study because all the 21 firms in the consumer goods manufacturing sub-sector were used for the study. Secondary data were obtained from the audited annual financial reports of quoted consumer goods manufacturing companies in Nigeria from 2014-2023. Hypotheses formulated were tested using panel least square regression through pooled, fixed effects, and random effect determined by the Hausman test, fixed effect regression was preferred for result interpretation with the aid of E-views 10 econometric statistical software. Findings showed that thin capitalization has significant effect on Tobin's Q and Net Present Margin of quoted manufacturing companies in Nigeria. The study concludes that thin capitalization has significant effect on financial performance of quoted manufacturing companies in Nigeria. The study recommends among others that since thin Capitalization positively influences Tobin's Q, companies might continue leveraging on debt while carefully managing the associated risk.

**Keywords:** Financial Performance, Net Profit Margin, Thin Capitalization, Tobin's Q.

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### INTRODUCTION

The Organization of Economic Cooperation and Development (OECD) defined thin capitalisation as a situation in which a company is financed through relatively high level of debt compared to equity. Blouin, Huizinga, Laeven and Nicodeme (2014) considered thin capitalisation as a tax planning strategy that is used by companies to structure their capital composition in such a way that will enhance the usage of more debt than equity through evaluation of country fiscal policy. According to Webber (as cited in Akabom & Ejabu, 2018), thin capitalisation can be defined as the tactic adopted by multinational companies for usage of direct foreign investment in their capital structure. Highly geared or leveraged firms are referred to a thinly capitalized company. The view of OECD on the position of deductible of interest payable from a company's income in deriving the taxable profit is a valid opinion that higher debt utilization will reduce taxable profit. The general rule of thin capitalisation is to determine the maximum amount of debt that an organization can have in its capital structure.

A company is said to be operating with thin capitalization if the size of the paid-up capital is small or low compared with its debt capital or the size of its operation (Ibiloye, 2013). Thin capitalization refers to a situation whereby an enterprise employs more debt than equity to finance its business activity (highly geared). The effect of thin capitalization on taxation is that enterprises with high debt funding would enjoy tax reliefs on interest charges unlike dividend. This is because interest is tax deductible and paid before the profit of the borrowing company is determined, thereby making debt financing more attractive to associated companies because profit is shifted from one country to another for the purpose of tax avoidance (Gbonjubola, 2013). Thin capitalization brings about tax avoidance practice that affects the level of income tax that accrued to the government. From the perspective of firm's finance strategy, thin capitalization is a financial technique that multinational

companies adopt to avoid tax on their investment portfolio abroad.

The level of debt in the capital mix of a company is a crucial managerial decision since it affects the shareholders return and risk. On one hand, debt or loan as a finance source is considered cheaper than equity because the debt option improves dividend payable to shareholders. Apart from the dilution of earnings, there is also the question of ownership and control associated with the issue of shares (Aziz & Abbas, 2019; Gomis & Khatiwada, 2016; Iqbal & Usman, 2018).

A Company's capitalization method can significantly impact its reported profit for tax purposes. Tax laws typically allow a deduction for interest paid or payable in arriving at the taxable profit. The higher the level of debt in the company, vis-à-vis the interest it pays, the lower its taxable profit. Hence, debt is often a more efficient tax method of financing than equity. A deliberate effort to be highly leveraged is perceived to be a tax planning strategy by most Multinational Companies (MNCs) to minimize group tax liabilities.

Financial performance is a monetary assessment of an organization's financial and economic activities. When evaluating financial performance, cash flow statements, income statements, and financial position are relevant reports, as they are reliable sources of useful information concerning the health of an organization (Mulford, & Comiskey, 2015). It also provides detailed justification to stakeholders, owners, and analysts on changes in a company's cash balances over an accounting period. It is pertinent to note that financial ratios are useful in obtaining information for determining the financial performance of banks. Furthermore, by analysing financial ratios, companies' operating efficiency and financial performance could be assessed. It is imperative to note that commercial banks have been inundated by globalization, macroeconomic distortion, new technology, supervisory challenges, stiff competition, and a highly risky business environment (Sengenberger, 2015).

Firm's success is explained by its performance over a certain period of time. Measurement of performance can offer significant invaluable information to allow management monitoring of performance, report progress, improve motivation and communication and pinpoint problems (Waggoner, Neely & Kennerley, 2019). Accordingly, it is to the firms' best interest to evaluate its performance. Nevertheless, this is a management area characterized by lack of consistency as to what constitutes organizational performance. Researchers have extended efforts to determine measures for the concept of performance as a crucial notion. Finding a measurement for the performance of the firm enables the comparison of performances over different time periods. Nevertheless, no specific measurement with the ability to measure every performance aspect has been proposed to date (Snow & Hrebiniak, 2018). However, related literatures measures performance using any of these three indicators namely: return on equity, return on asset and profit before tax.

Tobin's Q is widely used proxy for the operating performance in studies of corporate governance. The operating efficiency or performance is defined as the measurement of the management's ability to generate sales revenue and to control cost (Heyman and Vlachos, 2019). The managers create value for the firm through strategic planning and control (Graham and Harvey, 2021). Graham et al. (2022) state that firms have lower normalize valuations than acquiring firms as managers are more focused on their incentives which they receive debt improving EPS (earning per share) and valuation of stock through underinvestment. This behaviour of the managers is due to the managerial entrenchment indicating weak corporate governance, thus improving Tobin's Q for a short while (Core et al., 2019). The valuation of the stock, replacement cost of physical assets and overall net present value of the firm starts declining after some time. Higher cost and operating inefficiency become evident therefore, contradicting the desirable values of Tobin's Q. The decrease in the value of the stock also becomes inevitable in such circumstances, hence shaking the confidence of the shareholders (Hua and Wang, 2015). This diminishes the value of Tobin's Q, and likewise in case of scale and cost disciplines, the implication is that when increasing output to a level where marginal profit gets zero also reduces the Tobin's Q which again questions the eligibility of Tobin's Q as measure of firm performance. When a

project is financed through debt, there would be underinvestment which pushes up Tobin's Q in the short run. And in the long run, Tobin's Q behaves in a reverse manner as operating efficiency declines due to the cost and scale decisions. The presence of endogeneity is likely to affect normalization of the gross profits and operating expenses, resultantly affecting the measurement of firm's operating efficiency (Dybvig and Warachka, 2015). For developing a better understanding, gross profit is the total revenue minus cost of sales divided by total sales revenue. The depreciation and amortization are part of operating expenses, but amortization is an intangible cost difficult to determine. Hence the measure of the gross profits and the operating expenses as a measure of operating efficiency does not sufficiently support the phenomenon of Tobin's Q.

As higher Tobin's Q can be a consequence of underinvestment problem (instead of the better firm performance), underinvest and poorly managed cost discipline in firms due to the weak corporate governance, bearing strong economic implications for achieving strategic objectives of the organization (Bebchuk et al., 2019; Erikson and Whited, 2016; Erikson and Whited, 2012). The management accounting metrics include net profit margin and return on equity, net profit, dividend, shareholder equity, and net assets to judge the performance of the company (Drury, 2012).

Net profit margin is a measure of profitability. Profitability therefore is a strategic objective pursued by economic unity. It reflects the ability of the company to invest the funds it receives from multiple sources and reduce its expenses to the extent that it achieves profits in order to maximize the wealth of the owners and to maintain the survival of the unit and its continuation (Ajanthan, 2013). Profitability represents a large number of policies and decisions. It is a general indicator of the company's profitability performance (Heikal et al., 2014). The aim of these companies is to maximize the wealth of owners by increasing profitability by investing in assets that achieve the greatest possible returns to increase the market value of its shares in the financial market (Ajanthan, 2013).

According to Farris et al, (2010), net profit or net income is "a measure of the profitability of a venture after accounting for all costs". They went further to illustrate the importance of Net Income by showing that in a survey of nearly 200 senior marketing managers, 91 percent responded that they found the 'net profit' metric very useful. In accounting, net profit is equal to the gross profit minus overheads minus interest payable for a given time period usually accounting period (Farris et al, 2010).

The term is also used as a general measure of a firm's overall financial health over a given period of time and can be used to compare similar firms across the same industry or to compare industries or sectors in aggression (Stewart, 2019). Company performance is very essential to management as it is an outcome which has been achieved by an individual or a group of individuals in an organization related to its authority and responsibility in achieving the goal legally, and conforming to the morale and ethics. Company's performance is evaluated in three dimensions. The first dimension is company's productivity, or processing inputs into outputs efficiently. The second is profitability dimension, or the level of which company's earnings are bigger than its costs. The third dimension is market premium, or the level of which company's market value is exceeding its book value (Corrode, 2017).

## **STATEMENT OF THE PROBLEM**

Thin capitalization is a technique used mostly to avoid tax by MNC and many other company. From empirical review, it has become necessary to conclude that the debate for or against thin capitalization as a measure used to avoid or evade tax is far from being agreed upon since divergent opinions exist as to or against its adoption. These conflicting results show that thin capitalization and financial performance are still inconclusive. Hence, this study investigates the review of thin capitalization and financial performance of quoted consumer goods companies in Nigeria.

## **Research Questions**

What is the relationship between thin capitalization and Tobin's Q of quoted consumer goods

manufacturing companies in Nigeria?

What is the relationship between thin capitalization and net present value of quoted consumer goods manufacturing companies in Nigeria?

Research Hypotheses

There is no significant relationship between thin capitalization and Tobin's Q of quoted consumer goods manufacturing companies in Nigeria.

There is no significant relationship between thin capitalization and net present value of quoted consumer goods manufacturing companies in Nigeria.

## LITERATURE REVIEW

Kasim and Saad (2019) analyzed the factors that determined the strategies of multinational corporations with respect to tax avoidance. The study used a panel data secondarily sourced from Malaysia Inland Revenue Board consisting for 830 firm-year observations. The dependent variable was effective tax rate (ETR) which represents tax avoidance while the independent variables were profitability (PTI), capital intensity (CAPINT), foreign operations (FO), leverage (LEV) and firm size (SIZE). The results pointed out that PTI, FO and LEV significantly and negatively influenced ETR; SIZE influence on ETR was positively significant while CAPINT was not significant.

Oeta et al. (2019) studied that if tax planning has had any influence on firms' financial performance in Kenya. A panel of secondarily sourced data of elected listed manufacturing firms on the floor of the Nairobi Securities Exchange from 2010 to 2017 was used. Firms' performance (ROA) was used as the dependent variable while capital intensity (CAPINT), research and development expenditure R&D), debt- equity ratio (DER) and company size (SIZE) were the independent variables. The results revealed that while CAPINT, R&D and SIZE relationship with ROA was insignificantly positive, that of DER was insignificantly negative.

Fagbemi et al. (2019) carried out an empirical investigation whether tax planning have any impact on the financial performance firms in Nigeria. A panel of secondary data of 8 listed systemically important banks (SIBs) on the floor of the Nigerian Exchange Group (NXG) was used. Firms' performance (PERF) was used as the dependent variable while effective tax rate (ETR) which proxied tax planning is measured as income tax expense scaled by pre-tax profits; capital intensity (CAPINT); thin capitalization (TINCAP) measured total debts to total assets ratio; LOPT represents lease arrangement options and SIZE were the independent variables. The pooled OLS regression results revealed that ETR relationship with PERF was negatively significant; TINCAP had a positive and significant relationship with PERF while other variables were insignificant.

Herianti and Chairina (2019) examined if there was any relation between transfer pricing and tax avoidance, transfer pricing and financial reporting aggressiveness as well as tax avoidance and financial reporting aggressiveness. A panel of secondary data of 61 listed manufacturing firms on the floor of the Indonesian Stock Exchange over the period 2013 to 2017 was used in this study. Tax avoidance was used as the dependent variable while aggressiveness of financial reporting and transfer pricing were the independent variables. The regression results revealed that the relationship between tax avoidance and transfer pricing was positively significant. Again, tax avoidance and financial reporting aggressiveness had a positive and significant relationship.

Zhu et al. (2019) studied the impact of tax avoidance on the profitability of firms in Ghana. The researchers used panel secondary data sourced from selected firms listed on the Ghanaian Stock Exchange. The dependent variable used was return on assets (ROA) while the independent variables were tax avoidance represented by effective tax rate (ETR) which is the ratios of tax expense to profit before tax; profitability, firm size, inventory intensity, leverage, board independence and capital intensity. The results of the OLS showed that profitability and inventory intensity were positively and significantly related with ROA; firm size and leverage were negatively and significantly related with ROA while board independence and capital intensity were not significant at all in explaining ROA. Anasta

(2019) attempted a study to empirically assess the impact of tax avoidance on firm value. The researchers used secondary data sourced from 45 manufacturing firms listed on the Indonesian Stock Exchange covering the period 2013-2017. Two Dependent variables, financial performance or firm value represented by Tobin's Q and earnings management represented by discretionary accruals (DA) were used. The independent variables were return on assets (ROA) and tax avoidance represented by book tax difference (BTD). The regression results showed that while ROA and BTD were positively significant with Tobin's Q, only ROA was positively significant with DA.

Thanjunpong and Awirothananon (2019) attempted to analyze the association between tax planning and financial performance. The researchers used secondary data sourced from 58 firms listed on the Thailand Stock Exchange covering the period 2014-2016. The dependent variable was financial performance (FP) otherwise known as return on equity which is measured as net income to total equity. The independent variables were tax planning (TP) otherwise known as effective tax rate (ETR) measured as tax expenses to total assets ratio, firm size (SIZE), financial leverage (LEV), return on assets (ROA), capital intensity (CAP) which is measured as property, plant and equipment divided by total assets as a proxy for firms' working capital management. Rani et al. (2018) conducted a research study to examine the relationship between tax avoidance and firms' characteristics with earnings management as a moderating variable. A panel data made up of 49 listed manufacturing firms on the floor of the Indonesian Stock Exchange covering the period 2012 to 2016 was used. ETR which means effective tax rate, used as proxy for tax avoidance (Tax/PBT), was the dependent variable while firm size (SIZE), profitability (ROA) and debt-equity ratio (DER) were the independent variables with discretionary accruals (DA) as moderator variable (ROA\*DA, DER\*DA, SIZE\*DA). The results of the random effect model (REM) showed that ROA, SIZE and DER\*DA significantly but negatively influenced ETR; DER and ROA\*DA positively and significantly influenced ETR while DA and SIZE\*DA influence on ETR was not significant at all.

Kurawa and Saidu (2018) investigated if there was any relationship between corporate tax and financial performance of 16 selected consumers' goods firms listed on the floor of the Nigerian Exchange Group (NXG). The researchers used panel secondary data sourced from those firms which covered the period from 2006 to 2016. ROA which stands for return on assets as a proxy for financial performance was the dependent variable while the independent variables were the effective tax rate (ETR), firm size (SIZE), age (AGE) and risk (RISK). Results revealed that ETR, AGE and RISK had insignificant relationships with ROA but SIZE significantly explains variations in ROA. Fitriana and Islami (2018) carried out a study to ascertain if there was any relationship between some Board and firms' characteristics vis-a-vis earnings quality. The study made use of secondary unbalanced panel data obtained from the Indonesian Stock Exchange on manufacturing company over the periods 2013-2014. The dependent variable was earnings quality while the independent variables were tax aggressiveness, firm size and CEO ability. The regression results indicated that firm size was negatively significant with earnings quality but tax aggressiveness and CEO ability insignificantly explained earnings quality. Ifurueze et al. (2018) empirically analyzed the impact which corporate strategic tax aggressiveness has had on the growth of firms in Nigeria. The study used panel data obtained from consumers' goods firms of the manufacturing sector over the period of 2007 to 2016. FMGRTH which stands for profit after tax was the dependent variable while leverage (LEV) and effective tax rate (ETR) was the independent variables. The Pooled OLS results indicated that both LEV and ETR were not statistically significant in explaining variations in FMGRTH. Irianto et al. (2017) studied the influence of certain factors in explaining the variation in tax avoidance in Indonesia. A panel of secondarily sourced data of 36 listed manufacturing firms on the floor of the Indonesian Stock Exchange from 2013 to 2015 was used. Tax avoidance known as effective tax rate was used as the dependent variable while capital intensity, firm size, profitability and leverage were the independent variables. The results revealed that while

capital intensity, profitability and leverage relationship with tax avoidance was insignificantly positive, that of firm size was significantly positive.

Salawu et al. (2017) attempted, in their study, to establish if there as a relationship between tax planning and the value of firms in Nigeria. A panel data of 50 nonfinancial firms listed on the Nigerian Exchange Group (NXG) spanning the period 2004 to 2014 was used in this study. The result of the pairwise VAR Granger Causality test showed no directional relationship between tax planning represented by effective tax rate (ETR) and firm value which stands Tobin Q. This mean that the two endogenous variables did not granger cause each other.

Santa et al. (2016) sought to analyze the factors that could determine the relationship, if any, between tax avoidance and the values of Brazilian firms. The study used a panel of secondarily sourced data from Brazilian Stock Exchange consisting of 1,704 firm-year observations, that is, 323 firms over a period of 2006 to 2012. The dependent variable was Tobin’s Q which represents firm value while the independent variables were total book-tax differences (BTD) representing tax avoidance, total accruals (TA), net income (NI), long term debt (LTD) and net sales (SALES). The results pointed out that BTD significantly and negatively influenced Tobin’s Q; NI influence on ETR was positively significant while TA, LTD and SALES were not significant in explaining variations in Tobin’s Q.

Zemzem and Ftouhi (2013) embarked on a research study to investigate if there were board characteristics that spurred tax aggressiveness in Tunisia. The study used cross sectional time-series research design where a panel of data obtained from 73 French firms for the period 2006 to 2010. The dependent variable used, ETR is the effective tax rate and a proxy for tax aggressiveness, while the independent variables were boards size (BSIZE), firm size (FSIZE), boards Duality (DIJA), firm performance (ROA), independent directors (INDEP) and board diversity (DIV). The results revealed that ROA and FSIZE were statistically and positively significant with ETR, BSIZE was statistically and negatively significant while DUA, DIV and INDEP were insignificant.

Abubakar, Sulaiman and Haruna, (2018) examined the effect of firms age on the financial Performance of listed Insurance Companies in Nigeria. They made use of the ex-post facto research design. Their study covered a period 10 ten years 2007 through 2016. The results of the study revealed that Age has significant negative impact on financial performance of insurance companies it Nigeria. They recommended that companies are to convert significant part of their cash and cash equivalent into productive assets that can improve their financial performance.

**METHODOLOGY**

The design used for the study was the ex post facto approach, it was used because it improves validity and is appropriate for the historical and econometric character of the data and analysis respectively, it is also an independent way of gathering and compiling the data that was used. The study used secondary data collection method which was sourced from the financial reports and accounts of the quoted consumer goods manufacturing companies in Nigeria. The annual panel data which relates to the 21 consumer goods manufacturing companies in Nigeria for a ten year period (2014 to 2023) collected from the factsheet of the Nigeria Exchange Group (2023). In this study, a collection of econometric techniques was used (with the aid of E-Views 10) to analyze the data. These include panel regression models, co-integration analysis (preceded by unit root test) and granger causality lest. The usefulness of the tool was to establish direction and strength of the relationship that exist between thin capitalization and financial performance.

**Results**

**Thin Capitalization and Tobin’s Q**

Correlation

Probability

Observations	TC	TC	TQ
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TC	Correlation Coefficient	1.000	0.0121
	Sig (2-tailed)		0.000
	N		0.0075
	Correlation Coefficient	0.0121	1.000
TQ	Sig (2-tailed)	0.00	
	N	0.0075	

Source: E-view 10, 2024

HO1 There is no significant relationship between thin capitalization and Tobin's Q of quoted consumer goods manufacturing companies in Nigeria.

The table also indicates that there is positive and significant relationship between thin capitalization and Tobin's Q of quoted manufacturing companies in Nigeria. The result shows correlation coefficient of  $r=0.0121$  and probability value of 0.0075 which is less than 0.05 significance level. The result of the correlation coefficient revealed that there is linear relationship between thin capitalization and Tobin's Q of quoted consumer goods manufacturing companies in Nigeria. Based on this result, we reject hypothesis and accept the alternate hypothesis and conclude that thin capitalization have a positive and significant relationship with Tobin s Q of quoted consumer goods manufacturing companies in Nigeria.

#### Thin Capitalization and Net Profit Margin

Correlation

Probability

Observations	TC	TC	NPM
TC	Correlation Coefficient	1.000	0.0093
	Sig (2-tailed)		0.000
	N		0.0441
	Correlation Coefficient	0.0093	1.000
NPM	Sig (2-tailed)	0.00	
	N	0.0441	

Source: E-view 10, 2024

HO2 There is no significant relationship between thin capitalization and net profit margin of quoted consumer goods manufacturing companies in Nigeria.

The table indicates that there is positive and significant relationship between thin capitalization and net profit margin of quoted consumer goods manufacturing companies in Nigeria. The result shows correlation coefficient of  $r 0.0093$  and probability value of 0.0441 which is less than 0.05 significance level. The result of the correlation coefficient revealed that there is linear relationship between thin capitalization and net profit margin of quoted manufacturing companies in Nigeria. Based on this result, we reject the null hypothesis and accept the alternate hypothesis and conclude that thin capitalization has a positive and significant relationship with net profit margin of quoted consumer goods manufacturing companies in Nigeria hypothesis and conclude that thin capitalization had a negative and insignificant impact on return on equity of quoted consumer goods manufacturing companies in Nigeria.

#### DISCUSSION OF FINDINGS

The findings of the study relating to thin capitalization and Tobin's Q of quoted consumer goods manufacturing companies in Nigeria indicate that the estimated panel least square regression results shows that thin capitalization had positive and significant effect on Tobin's Q of quoted consumer goods manufacturing companies in Nigeria. The result was confirmed by a positive coefficient of 6.93 1907 and probability value of 0.0295 which is less than 0.05 significance levels. The positive and significant effect of thin capitalization and

Tobin's Q of quoted consumer goods manufacturing companies in Nigeria was not in agreement with our a priori expectation of negative relationship. The result also indicates that there is a long run relationship between thin capitalization and Tobin's Q of quoted consumer goods manufacturing companies in Nigeria. The result also revealed that thin capitalization does not granger cause Tobin's Q of quoted consumer goods manufacturing companies in Nigeria. The findings of this study is in line with Kurawa and Saidu (2018) who investigated if there was any relationship between corporate tax and financial performance of 16 selected consumers' goods firms listed on the floor of the Nigerian Exchange Group. The results revealed that ETR, AGE and RISK had insignificant relationships with ROA but SIZE significantly explains variations in ROA.

The findings of the study thin capitalization and net profit margin of quoted consumer goods manufacturing companies in Nigeria indicate that the estimated panel least square regression results shows that thin capitalization had positive and significant effect on net profit margin of quoted consumer goods manufacturing companies in Nigeria. The result was confirmed by a positive coefficient of 5.451307 and probability value of 0.01 19 which is less than 0.05 significance levels. The positive and significant effect of thin capitalization and net profit margin of quoted consumer goods manufacturing companies in Nigeria was not in agreement with our a priori expectation of negative relationship. The result also indicates that there is a long run relationship between thin capitalization and net profit margin of quoted consumer goods manufacturing companies in Nigeria. Our result also revealed that thin capitalization does not granger cause net profit margin of quoted consumer goods manufacturing companies in Nigeria. The study is in consonant with the study of Olanium, Jimoh, Shuaibu and Ibrahim (2022), who studied the effect of tax aggressiveness on the financial performance of listed industrial goods firms in Nigeria. The findings of the study revealed that GAAP effective tax rate has significant positive effect on return on assets.

## CONCLUSION AND RECOMMENDATIONS

The study sought to investigate thin capitalization and financial performance of listed consumer goods companies in Nigeria. The study concludes that tin capitalization had negative and insignificant effect on return on equity of quoted consumer goods manufacturing companies in Nigeria. Thin capitalization had positive and significant effect on Tobin's Q of quoted consumer goods manufacturing companies in Nigeria. Thin capitalization had positive and significant effect on net profit margin of quoted consumer goods manufacturing companies in Nigeria.

Based on the findings of the study, the following recommendations were made:

Companies should review their capital structure to ensure that they are not overly reliant on debt, especially when it has a negligible or adverse effect on equity returns.

Firms should focus on maintaining an optimal capital structure that balances the benefits of debt against the risks. Since thin capitalization positively influences Tobin's Q, companies might continue leveraging debt while carefully managing the associated risks.

Companies should keep an eye on the cost of debt to ensure that interest expenses do not outweigh the benefits. Firms should seek the most favourable borrowing terms to maintain the positive impact on profit margins.

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