TAF Journal of Administrative and Business Studies JABS
2023, **9**(1): 32-40

PRIMARY RESEARCH

Thin capitalization and the profitability of consumer goods companies in Nigeria

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Keywords
Thin capitalization
Board size
Age
Profitability
Consumer goods companies

Received: 27 Sep 2022
Accepted: 29 Dec 2022
Published: 11 Feb 2023

Abstract
The study examined how thin capitalization affected the profitability of consumer goods companies in Nigeria. The selected companies' annual reports and financial statements from 2007 to 2022 provided the research's data. A sample of fifteen (15) out of the twenty companies that comprised the population was employed. Regression and correlation analyses were used to analyze the data using descriptive statistics. According to the study, the profitability of consumer goods companies is negatively impacted by thin capitalization. Board size has a negligible and adverse impact on the tested companies' profitability. The companies' ages positively and significantly impacted the profitability of the sampled companies. In order to increase the profitability of the tested Nigerian consumer goods companies, the study recommended that consumer goods companies limit the size of board members and ensure that a minimal amount of thin capitalization is maintained.

INTRODUCTION

Corporate entities aim to improve their financial performance to attract investors and present a favorable image. To achieve this goal, profit generation must be consistent. Profit has a significant influence on the growth and well-being of any given economy, in addition to being a critical component in assessing the effectiveness and performance of an organization (Batra & Kalia, 2016). Profitability is a measure of efficiency, control, and worth of investments to owners, a margin of safety to creditors, employee benefit pools, a measure of taxable capacity, and the basis for government legislative action, according to Weston and Brigham (1968) as cited in (Tanko, 2020) . A country's profitability can be used to measure its citizenry's rising standard of living and its economic growth and advancement rate. According to Abiola and Lateef (2020), the assessment looks at how well a business uses its resources and whether it can generate enough revenue to pay for all necessary, exclusive, and reasonable costs, including taxes, with a tiny leftover for potential future growth. Akintoye, Adegbie, and Onyeka-Iheme (2020) state that while all businesses aspire to be profitable, this is often unattainable because of high taxes and expenses. A company's capitalization strategy usually significantly impacts the reported profitability level for tax purposes (Kayode & Folajinmi, 2020). Utilizing debt and equity allows one to assess a company's financial standing and potential.

In light of the corporate income tax, using debt as a source of financing can be far more advantageous than using equity. When a company's debt is significantly higher than its equity capital, it is considered thinly capitalized. Businesses with a high debt financing level would benefit from tax breaks on interest charges due to thin capitalization (Jackson et al., 2023). As a company's debt load rises, its taxable profit will fall because higher debt loads necessitate higher interest payments (Akabom & Ejabu, 2018). Thus,

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a properly managed thin capitalization can benefit companies' profitability and the government's tax collection.

The study conducted by Jackson et al. (2023) revealed that thin capitalization does not affect profitability, even though it is expected to affect tax liability reduction positively. Few have discussed the implications of thin capitalization for consumer goods companies, despite debates over how much it can reduce tax burdens when fully integrated into many business organizations' strategic plans. In light of the observations above, it is now critically important to research the effects of thin capitalization on the profitability of listed Nigerian consumer goods companies. Thus far, research has not yielded any conclusive empirical evidence regarding the impact of thin capitalization on companies' performance. Otuya and Omoye (2021) found positive insignificant evidence, while Aziz and Abbas (2019) found negative substantial evidence. Research by Osamor et al. (2022) and Fasasi, Ahmad, and Nnejiwuihe (2022) has demonstrated this. Erasmus and Uwikor (2021) and Akintoye et al. (2020) found a weak, negative correlation with profitability. Despite the loans extended to Nigerian enterprises from 2015 to 2022, Nigerian Bottling Company (NBC) management had shut down many production plants, and nine out of 10 indigenous telecom companies would fold up in the next five years (Naradda Gamage et al., 2020; Kinata, 2016; Hor, 2016). The food and beverage division of the economy business climate is deteriorating. It is precisely based on this context that the study finds out how thin capitalization impacts the profitability of consumer product companies in Nigeria (Onwuzurike & Ugwu, 2020; Danladi, 2019; Ugwuanyi, 2016).

The results of this study will add to the body of empirical research on thin capitalization and profitability in developing nations. The study's findings would be helpful as reference material for scholars and students who want to conduct related research in this field and library material for researchers. This research will be helpful to the sector's users of accounting information, such as management, shareholders, investors, financial analysts, and other stakeholders, as it will support them in making various judgment calls and investment and financing decisions. In addition, Nigeria has very few consumer goods companies with thin capitalization and profitability. Consequently, this study expands our understanding. Employees, investors, and professional bodies all benefit significantly from this.

LITERATURE REVIEW

This section looks at the concepts of profitability and thin capitalization, which form the basis of the current study.

Concept of Thin Capitalization

Divergent view points exist among academics regarding thin capitalization. It includes the assertion that thin capitalization, as defined by Jackson et al. (2023), is the practice of an organization using a more significant proportion of debt than equity to finance its operations. Thin-cap companies are also referred to as highly geared or highly leveraged. How a company capitalizes often significantly impacts the amount of profit it reports for tax purposes (Kayode & Folajinmi, 2020). Thin capitalization is a strategy businesses use to arrange their financing with a high debt-to-equity ratio (Olamide, Azeez, & Adewale, 2019).

Thin capitalization refers to a situation in which a business is financed primarily through debt rather than equity. This is noteworthy as it influences the amount of profit a company declares for taxation purposes; a business's taxable profit decreases as its debt load increases due to the additional interest payments required (Akabom & Ejabu, 2018). Pratama (2017) states that thin capitalization is financing a business with a relatively high proportion of debt as opposed to equity.

Thin capitalization is defined by the debt-to-equity ratios of the following nations: Australia, Japan, South Africa, Kenya: 2:1; China: Financial Institutions 5:1, Others 2:1; USA, France: 1.5:1; Canada, Ghana: 2:1; Netherlands: 3:1; Germany: deductibility of interest up to 30% of income. Rules with two possible forms—specific regulations and non-specific rules—can be used to create thin-capitalization policies. Specific rules expressly forbid internal debt, but generic rules usually limit debt in general (that is, they do not differentiate between external and internal debt) (Buettner, Overesch, Schreiber, & Wamser, 2012). According to Akintoye et al. (2020), a company is deemed thinly capitalized if debt makes up a more significant percentage of its capital structure than equity. Due to the tax deduction of interest paid on borrowed funds, a company's debt reduces its tax liability, so having more debt benefits it from a corporate tax shield. Thin capitalization is a strategy used by corporate entities with high debt-to-equity ratios to benefit from tax laws that permit interest on debt as an allowable expense. Thin capitalization is the process of a company's capital composition, including a more significant loan capital.

Concept of Profitability

Modigliani and Miller (1963) first put forth the dividend irrelevance argument. According to this argument, a business's success is based solely on its capacity to turn a profit and control risks. To survive and grow over time, a com-

ISSN: 2414-309X
DOI:https://doi.org/10.20474/jabs-9.1.4

pany must be profitable. An analysis of the factors influencing profitability is crucial for all parties involved, but particularly for investors. A conceptual and practical framework for assessing business performance is provided by this principle (Fasasi et al., 2022). Profitability, called Return on Net Operating Assets, is a crucial indicator of a company's capacity to profit from asset management (Sunarto, Widjaja, & Oktaviani, 2021).

Financial ratios are the analytical tools required to evaluate profitability, a crucial aspect of evaluating a company's status. Profitability ratios assess management effectiveness by looking at sales and returns on investment (Bramasta & Budiasih, 2021). Return on Assets evaluates how well a business can increase sales, capital, and assets while controlling costs. This indicator assesses how profitable asset management can be for a company. Profitability measures a company's capacity to generate income from its investments or use resources for output (Chakravarthy, 1986).

Consequently, profitability ratios assess a company's potential for income, revenue, or profit growth (Olurankinse & Mamidu, 2021). A corporation can accomplish this by raising operational standards, satisfying client needs, expanding into new markets, thwarting competition from competitors in the same industry, and leveraging economies of scale to reduce production costs (Adejumo & Sanyaolu, 2020; JAM, SING, & NG, 2016). According to (Nguyen, 2020), businesses can effectively predict their future performance by utilizing profitability as a valuable tool. One ratio used to measure profitability is a company's capacity for profit. This ratio also shows how well a company's management does its job (Sari, Wardani, & Lestari, 2021; Jam, Kaur, & Kwee, 2016).

Consequently, a company's profitability is determined using Return on Capital Employed (ROCE) after deducting net tax income. According to Kayode and Folajinmi (2020), ROCE is an accounting ratio that displays an organization's profit for a given accounting period as a percentage of the capital spent. After accounting for capital expenditures, it is used to evaluate the relative profitability of businesses (Batchimeg, 2017). Therefore, the state of being lucrative is called profitability.

THEORETICAL FRAMEWORK

Modigliani and Miller (1963) static trade-off theory claimed that companies' tax deductions for debt payments are based on the lower risk of favoring debt over equity. Obtaining debt financing is more cost-effective and favorable than financing through equity. It means that rather than lowering the cost of capital, a corporation that uses a more significant percentage of debt in its capital structure will face greater risk from its investors and achieve a high return on its investment. Additionally, support capital raising in the following order: debt, equity, and internally generated money (retained earnings), per pecking order theory. Pecking order theory's capital ranking suggests that debt is the best funding source. Thus, using this theory as a framework, this study assesses the impact of thin on the profitability of consumer product companies in Nigeria.

Thin Capitalisation and Profitability

Companies' financial performance and profitability have been interchangeably proxied in empirical studies on thin capitalization. However, the research produced conflicting results, which are listed below:

Jackson et al. (2023) examined the relationship between the financial performance of listed health companies in Nigeria and their thin capitalization. Ex-post-facto and correlational research designs were used in the study. Seven pharmaceutical (healthcare) companies listed on the Nigeria Exchange Group between 2006 and 2020 comprised the study's population and sample size. Descriptive statistics were used to analyze the secondary data used as instrumentation for the research questions. Using E-view (10), the Ordinary Least Square (OLS) Model regression analysis was used to test the hypotheses. The study's conclusions indicated no discernible link between listed pharmaceutical companies in Nigeria's profit after taxes and their thin capitalization. Thin capitalization and earnings per share of listed Nigerian pharmaceutical companies do not significantly correlate.

Furthermore, it was demonstrated by Fasasi et al. (2022) that the profitability of listed agricultural companies in Nigeria is significantly impacted positively by short-term debt and negatively by long-term debt. The Nigerian Stock Exchange (NSE) listed agricultural companies were sampled for the study. The study utilized secondary data from listed agricultural firms' annual reports. Multivariate regression analysis was employed to analyze the data.

Similar findings were made by Osamor et al. (2022), who discovered that low capitalization affected the financial performance of Nigerian multinational and local businesses. Replaced by the debt-to-equity ratio as a stand-in for thin capitalization, return on invested capital served as a stand-in for the financial performance of the firms. The analysis used the unit root test, panel data regression, cointegration, descriptive statistics, and annual reports of the companies from 2006 to 2020. Put, return on investment is used in the study to gauge financial success. A variety of

ISSN: 2414-309X
DOI:https://doi.org/10.20474/jabs-9.1.4

proxies for financial performance can be used in comparison studies.

Also, Erasmus and Uwikor (2021) discovered in another study that thin capitalization has a negligible and unfavorable effect on the return on equity of Nigerian quoted banks. Twelve banks were chosen using judgmental sampling techniques to determine the appropriate sample size for the study. From 2006 to 2019, audited annual financial reports of Nigerian quoted banks provided secondary data. The study used descriptive statistics for univariate analysis, and E-view 10 econometric statistical software was utilized to test hypotheses using the ordinary least squares regression statistical tool. The variability of the variables is denied by using ordinary least square regression. A similar study could be carried out with different data analysis methods.

Otuya and Omoye (2021), however, suggested that thin capitalization has a marginally positive correlation with the financial performance of MNCs. The research design used in the study was ex post facto, and pertinent data from the financial statements of the MNCs in the sample were obtained between 2014 and 2018. Regression, correlation, and descriptive analysis are the analytical methods. Too little time was spent on the analysis to demonstrate how thin capitalization affects profitability.

However, Merlo, Riedel, and Wamser (2020) analysis revealed that more stringent thin capitalization regulations adversely impact MNC location decisions—the effect of thin capitalization regulations on foreign affiliate locations of multinational corporations. The study offers several novel and intriguing insights into how thin capitalization rules impact where foreign entities are located, using data on almost all new foreign investments of German MNCs. Furthermore, according to Ehi-Oshio, Adeyemi, and Enofe (2013), debt has a statistically significant negative impact on corporate profitability.

On the other hand, Akintoye et al. (2020) examined the impact of Tax Planning (TP) Strategies on the Profitability of Manufacturing Firms in Nigeria for the period of 2008 – 2017 and found that thin capitalization has a negative and negligible effect of TP on Return on Assets (ROA). The variables used are return on assets (the dependent variable) and thin capitalization, capital intensity, and research and development as independent variables. The annual reports of the selected companies provided the study's data—design of ex post facto research. The study's sole proxy for profitability was ROA. You can perform a similar study with a different profitability proxy. Even though ROCE, a strategic variable used to measure profitability, was not included in the variables used, the data analysis technique is still appropriate.

In a similar line, Aziz and Abbas (2019) discovered that debt financing significantly and negatively affects the company's performance. The study looked at how various forms of debt financing related to the performance of businesses in 14 different Pakistani sectors. From 2006 to 2014, secondary data was gathered from the Pakistan Stock Exchange's fourteen distinct sectors for nine years. While the study was conducted in Pakistan, similar research could be carried out in Nigeria because the two nations have different economic backgrounds, even though the data used are easily obtained and understood.

According to research by Akabom and Ejabu (2018), thin capitalization is a revenue-stripping strategy that impacts the performance of multinational corporations in Nigeria. Seventeen sampled multinational corporations listed on the Nigerian stock exchange between 2012 and 2016 provided the study's data. Multiple regression analysis was employed for data analysis. Although the methodology and variables are sufficient and thorough, more than the period employed is needed to evaluate the noteworthy influence of thin capitalization on profitability. This study aims to contribute to this debate by testing the following hypothesis:

H1: Nigerian consumer goods companies' profitability is positively impacted by thin capitalization.

METHODOLOGY

The study's methodology encompassed consumer products companies listed on the Nigerian Stock Exchange in 2022 as its population. The data for this study was obtained from annual reports and accounts of the sampled companies from 2007 to 2022. The sample of fifteen consumer goods companies is provided in Table 1 below. Only fifteen of the twenty consumer goods companies listed on the Nigerian stock exchange had all their data available for the study.

ISSN: 2414-309X
DOI:https://doi.org/10.20474/jabs-9.1.4

TABLE 1. Sample size

S/N	Companies	Year of Listing
1	Cadbury Nigeria PLC	1976
2	Champion Breweries PLC	1983
3	Dangote Sugar PLC	2007
4	Flour Mills PLC	1979
5	Guinness Nig. PLC	1965
6	International Breweries PLC	1995
7	Northern Nigeria Flour Mills	1978
8	Nascon Allied Industries PLC	1992
9	Nestle Nigeria PLC	1979
10	Nigerian Breweries PLC	1973
11	Nigerian Enamelware PLC	1079
12	P.Z Cussons Nigeria PLC	1972
13	Unilever Nigeria PLC	1973
14	Union Dicon Salt	1993
15	Vita Foam Nigeria PLC	1978

The following linear regression equation has been adopted for this study with modifications from the subsequent studies: (Adejumo & Sanyaolu, 2020; Olamide et al., 2019; Gayatri & Wayan, 2021; Junaidu & Saidu, 2018; Michael, 2020; Oeta, Kiai, & Muchiri, 2019; Salawu, Ogundipe, & Yeye, 2017).

$ROCE_{it} = \alpha + \beta_1 TC_{it} + \beta_2 BS_{it} + \beta_3 AGE_{it} + e_{it}$

Where:

α = The constant

β = The coefficient

it = Random error term where i is cross-sectional and t time identifier

ROCE= Return on Capital Employed

TC= Thin Capitalization

BS= Board Size

AGE= Age of the Company

TABLE 2. Variables measurement

Variables	Proxies	Measurement	Source
Independent	Thin Capitalization (TC)	Total Debt/Total Assets	(Robinson, Xue, & Zhang, 2012)
Dependent/ Profitability	Return on Capital Employed (ROCE)	EBIT divided Total Assets minus Current Liabilities	(Kayode & Folajinmi, 2020)
Control Variables	Board Size	Number of members on a board	(Katmon, Mohamad, Norwani, & Farooque, 2019)
		Year of research minus year of listing	
	Age		(Ibrahim & Yahaya, 2023)

Source: Developed by the researcher

RESULTS AND DISCUSSION

The results of this study are presented and discussed using descriptive statistics, correlation, and regression analysis. According to Table 3, the average profit made by the sampled listed consumer goods companies in Nigeria is 19%, with a maximum profit of approximately 80% of their total assets and a maximum loss of 62%. The sampled companies' mean, min, and max ROCE are, respectively, 0.19, -0.62, and 0.80. The low standard deviation of 0.16 from the mean suggests that the profitability level of the Nigerian consumer goods companies in the sample is somewhat variable. Similarly, the sampled consumer goods companies'

ISSN: 2414-309X
DOI:https://doi.org/10.20474/jabs-9.1.4

average profitability is indicated by the mean value of TC, which stands at 54%. It is implied that TC helps save at least 0.02 and up to 99% of the total amount. The 19% standard deviation is less than the mean, suggesting little variation in the percentage of TC among the consumer goods companies in the sample.

TABLE 3. Descriptive statistic

Variable	Obs	Mean	Std. Dev	Min	Max
ROCE	240	.193952	.161929	-.6243	.8028
TC	240	.5395608	.185507	.0209	.9995
BS	240	35.24583	12.6319	7	54
AGE	240	9.900001	3.545772	.4332	17

Source: Generated from the data collected through the annual report data of the sampled companies.

The average Board Size (BS) of the sampled listed consumer goods companies in Nigeria is 35, while the minimum and maximum values are 7 and 54, respectively. They indicate that there are, on average, 35 members on the board, with a minimum of 7 and a maximum of 54. The sampled listed companies' boards have a low variation, as indicated by the lower-than-mean standard deviation of 12. Nigeria's sampled consumer goods companies range from 9 to 17 years on average. A low variation in the years of the sampled listed companies is implied by the three-year standard deviation, which is smaller than the mean.

TABLE 4. Validity and reliability test

	ROCE	TC	BS	AGE	VIF
ROCE	1				
TC	-0.2885	1			1.01
BS	0.125	-0.0501	1		1.64
AGE	0.2447	0.0543	0.619	1	1.64

Source: Generated from the data collected through the annual report data of the sampled companies.

The relationship between the independent variables (TC), control variables (BS & AGE), and dependent variables (ROCE) is represented by the correlation coefficients in Table 4. Intervals between -1 and 1 illustrate the correlation coefficient's values. More significant correlation coefficient absolute values indicate stronger relationships, while the correlation coefficient's sign indicates positive or negative relationships. Each variable exhibits a perfect positive linear relationship with itself, as evidenced by the correlation coefficients on the main diagonal of 1.0.

Table 4 illustrates a weak negative correlation between TC and ROCE, as evidenced by the correlation coefficient of -0.2885, which is not close to 1. Additionally, table 4's correlation results show that the explained and control variables, AGE and BS, correlate positively. A Variance Inflation Factor (VIF) test was used to identify whether the Colinearity problem was present. Whose outcomes demonstrate that Colinearity is not present. This is due to the VIF test's results, which vary from a minimum of 1.01 to a maximum of 1.64. Therefore, the relationship has no negative impact on the independent variables' ability to predict.

ISSN: 2414-309X
DOI:https://doi.org/10.20474/jabs-9.1.4

TABLE 5. Regression results on thin capitalisation and the profitability

Dependent Variable: ROCE		
Independent Variable	*p*>/*t*/estimates (and coefficient)	
		OLS Robust
TC		0.000(-.2704798)
BS		0.269 (-.0010888)
AGE		0.000(.0143469)
R^2		0.15
Prov. F		0.0000

Source: Author's computation using STATA on the data obtained from annual reports and accounts of sampled companies (2022).

The profitability of Thin Capitalization (TC) is negatively and significantly impacted, as demonstrated by the coefficient (-.2704798) and *prob. F* (0.000) in table 5 This suggests that a considerable decline in profitability results from a unit increase in thin capitalization. Additionally, it indicates that the likelihood of the sampled consumer goods companies in Nigeria will be considerably lower with an increase in thin capitalization while maintaining the same levels of other independent variables. The outcome concurs with the research conducted by (Merlo et al., 2020; Erasmus & Uwikor, 2021; Akintoye et al., 2020). This outcome defies tax planning theory, which predicts a positive correlation with profitability, possibly because Nigerian businesses are not allowed to relocate.

Board Size (BS), as shown by the coefficient (-.0010888) and prob. *F* (0.269) has a negative and significant impact on profitability. According to this, an increase in BS will only marginally reduce the tested enterprises' profitability when all other variables stay the same. The conclusion is in line with the decision of (Ibrahim & Yahaya, 2023). The outcome might indicate that members are receiving larger allowances in light of their numbers. Therefore, allowances decrease, and profitability declines with the number of boards.

Furthermore, the results show that AGE significantly and favorably affects profitability, as indicated by the coefficient (.0159355) and prob. *F* (0.000). This demonstrates that the profitability of the assessed businesses will rise favorably and significantly with age, provided that all other variables stay the same. This indicates that more well-thought-out and successful projects are developed over time. The outcomes concur with the findings of (Ibrahim & Yahaya, 2023).

CONCLUSION AND RECOMMENDATION

Increased thin capitalization had a detrimental effect on the sampled companies' profitability. The older companies in the sample are more profitable, and board size had a notable and adverse impact on profitability. The study advises businesses to keep a small amount of their capital as thin capitalization will make them more profitable, allowing the government to increase taxes, employees to receive higher salaries, and society to benefit from corporate social responsibility. The profitability of the sampled companies will increase with higher capital investments in older businesses and fewer board members. Future research should consider using short and long-term debt as separate proxies of thin capitalization to identify the most effective in terms of yielding the desired profit.

Implications of the Findings

They offer significant insights for key stakeholders, such as regulators, policymakers, investors, shareholders, professional associations, academics, and scholars. Despite the body of research on thin capitalization and profitability, this study has broadened its focus to include the Nigerian context. The results of this study cast doubt on the sampled companies' use of thin capitalization as a source of funding. The results defy the Pecking Order Theory, indicating that thin capitalization has a negligible and unfavorable effect on the profitability of Nigerian consumer goods companies.

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ISSN: 2414-309X
DOI:https://doi.org/10.20474/jabs-9.1.4