

Analysis of the relationship between Financial Structure, Return on Assets, and Return on Equity in Nigeria's Manufacturing Sector

Author(s), ADENIYI, Sarafadeen Diran (Ph.D), KAOJE,
Bello Sani (Ph.D)

Abstract:

The study specifically looked at the relationship between a company's financial success and its financial structure. For the study, twenty-one companies that were listed on the stock exchange throughout this time were chosen. The Pecking Order hypothesis of financial structure served as the foundation for the investigation. Panel data from the Nigerian Stock Exchange Fact-Book was used in the study, which used an ex post facto research approach. Using return on assets (ROA), return on equity (ROE), and profits per share (EPS) as financial indicators, the Ordinary Least Square (OLS) approach was used to assess the link between the businesses' financial structure and financial performance. The hypotheses developed for the study were tested using short-run regression.

Keyword: Finance, Performance, Organization, Return on asset, manufacturing,

EASIJ

Accepted 25 August 2025
Published 30 August 2025
DOI:10.5281/zenodo.17551381



About Author

Author(s):

ADENIYI, Sarafadeen Diran (Ph.D)
Lincoln University College, Malaysia

KAOJE, Bello Sani (Ph.D)
Lincoln University College, Malaysia



Introduction

There are examples of management and ownership being kept apart in modern business structures. One of the most important management decisions is to regulate and guide the flow of corporate resources. The management arranges the organization's cash flow, allocates the funds to various users, sources the funds, and makes efficient use of them in order to optimize the specified business objectives. Selecting the optimal finance mix or financial structure is one of the primary duties of managers. Financial structure decisions, according to Brealey, Myers, and Allen (2006), require determining how much debt and equity will be generated from the appropriate sources at the appropriate periods and at the appropriate costs.

The financial structure of company endeavors is one of the most important aspects taken into account while evaluating and directing them. Rating agencies, who also depend on the company's strategic planning when granting credit facilities, must adjust to the shifting business environment and consider financial structure when selecting financial resources in order to achieve the objective of optimizing shareholder wealth (Drobetz & Fix, 2003). To accomplish this goal, managers must determine the best mix of the company's financial resources.

A company's entire financial performance is impacted by crucial decisions on how to finance its assets from stakeholders and how much debt and equity are required to accomplish so (Okafor, 2014). As a result, selecting the optimal financial structure, together with suitable and enough financing and investments, reduces the cost of capital for the business and enhances its market value, both of which boost shareholder wealth (Modarres & Abdoallahzadeh, 2008).

The theory of financial structure has maintained its appeal throughout time among academics of corporate finance (Mumtaz, Raul, & Noreen, 2013). According to Pandey (2005), it is the most contentious area of study in finance.

Theoretically, the majority of models that deal with a company's financial structure identify the main factors influencing a company's choice of debt and overall performance as tax savings, bankruptcy costs, transaction costs, adverse selection, agency costs, and so on. In actuality, while numerous companies may have different goals, cutting costs while raising income is always the main goal. Creditors and capital market investors are interested in the financing cost of money for businesses listed on the stock exchange (Scott, 2004). Dogra and Gupta (2009) claim that the debt to equity ratio aids creditors in predicting the likelihood of default at various stages of a company's financial structure.

According to Modigliani & Miller's 1958 theory that a firm's financial structure would not affect its value in a world with a perfect capital market and no taxes, investors and stock market traders are also interested in the relative influence of debt on a firm's performance in order to determine the expected returns on their risk-taking activities (Chen, Roll, & Ross, 2004). Investors and traders rank the companies listed on stock exchanges based on their daily performance and decide which companies to invest in based on this ranking and historical stock prices (Mumtaz et al, 2013).

They insisted that a company's value was independent of its financial status. This idea implied that businesses in a specific risk class would not be impacted by the financial system, according to Weston and Copeland (1992). An optimum capital structure can be achieved if tax sheltering benefits are available, claim Brigham & Gujarati (2004). According to their recommendations, managers of a business should be able to identify when the optimal financial structure is achieved and endeavor to maintain it.

Osuji and Odita (2012) state that when the cost of capital and finance are reduced, the firm's value and performance improve. A company's choice of financial structure is influenced by its long-term goals and the level of control management want to maintain. The majority of business financial choices in Nigeria are made by managers, much like in several other nations. Equity issues are often chosen over debt, even when debt is a less costly form of capital. When debt is employed, it's usually for short periods of time. This may be due to the manager's inclination to protect his undiversified human capital and avoid the performance pressure that comes with debt commitment. Debts are usually used as a buffer against potential corporate rider problems when they are voluntarily supplied, particularly long-term debt (Ogebe, Ogebe, & Alewi, 2013).

Statement of the problem

According to Jeheel and Olayiwola (2010), business organizations must select the appropriate financial structure in order to endure and get over any financial obstacles they may face. According to Pandey (2010), there are several debates regarding a company's debt and equity mix. According to one school of thought, a company's finance structure shouldn't always be as significant because it has little effect on the company's financial success. A different school of thought emphasizes how a company's financial structure affects its financial performance. A middle ground was found by another school of thought that holds that a specific financial structure gives businesses better returns on their operations.

Financial measures including Return on Equity (ROE), Return on Asset (ROA), Earnings per Share (EPS), and Market values of the firm were the foundation for the study in the majority of studies on the relationship between financial structure and firm financial performance. This served as a more thorough financial performance indicator by comparing the financial performance of the companies to their profitability as determined by profit before taxes. The majority of research (Abor, 2005; Enekwe, Agu, & Eziedo, 2014) that attempted to use profitability as a performance metric are from outside of the country. These research might have clarified how the financial structure of mentioned companies in their different nations impacted their profitability.

Objectives of the study

- i. To ascertain the relationship between financial structure and return on assets of listed consumer goods manufacturing firms in Nigeria;
- ii. To determine the relationship between financial structure and return on equity of listed consumer goods manufacturing firms in Nigeria;

Research hypotheses

H01: There is no significant relationship between financial structure and return on assets of quoted consumer goods manufacturing firms in Nigeria.

H02: There is no significant relationship between financial structure and return on equity of quoted consumer goods manufacturing firms in Nigeria.

Literature Review

Capital

For each person, capital can imply something different. For the accountant, it alludes to capital invested in launching a company. For others, it pertains to the business's long-term finance. It is what a financial professional would see as the entirety of the firm's Statement of Financial Position on the left. Owner funds (the total equity) and loans can make up the capital, or it can come from the owners of the company alone (ordinary shares). The owners' funds consist of money provided in the form of shares and earnings that the company has kept under several headings. The company has many types of loans that it has accrued in order to finance its operations (Olowe, 1997).

The amount of financing a company needs varies depending on its operations and nature. The financial requirements of a heavy duty equipment manufacturing company are probably going to be higher than those of a medium-sized marketing organization. The study examined the financial structure of the enterprises because it encompasses the complete financing of the company. As noted by Muritala (2012), several studies dubbed "capital structure" really addressed the financial structures of the companies under investigation.

Financial Structure

Businesses employ several financing strategies to meet their financial demands (Badar & Saeed, 2013). This involves debt and equity, as noted by Barbosa and Leon (2013). Financial structure, according to Van Horne (2006), is the combination of debt, preferred stock, and common stock equity that make up a company's long-term, permanent finance. Businesses employ a variety of financing combinations, including debt, preferred stock, reserves or retained earnings, and shares. The two main types of finance are debt and equity financing. Financial Structure is the term used to describe the funding structure planned for a firm. Therefore, according to Amadi, (2004), financial structure is the proportion of debt to equity used to fund an organization's operations.

When explaining the financial structure of a company, several writers have utilized capital structure. For example, capital structure was described as an organization's financing mechanism by Muritala (2012). Obviously, this ought to cover the company's entire funding. According to Stickney, Brown, and Wahlen (2007), a company's financial structure is the combination of its total debt and equity. Although Hasan, Ahsan, Rahaman, and Alam (2014) named their study capital structure, they actually examined the financial structure of the companies' operations. The authors claim that while long-term debt and equity are the only topics included in most research on capital structure, their analysis also looked at various short-term funding sources for businesses.

Issue of Shares

Shares are investment units that symbolize an investor's ownership interests within a company. Typically, a business will raise money through the sale of shares first (Aborode, 2005). Shares come in various varieties. They can be broadly divided into preference shares and ordinary shares.

There are various categories for each of these.

Shares are a crucial source of funding for businesses in their early stages of development. This is due to the fact that the company will find it difficult to raise funds from the outset through debt instruments. Other funding options become more appealing and accessible to the company as it expands.

Theoretical Framework

Traditional Theory of Financial Structure

This method maintains that the financial structure of a business affects both its cost of capital and its overall valuation. It argues that a company can lower its cost of capital and raise its overall value by using cash wisely, and that there is an ideal capital structure. Better financial performance of businesses may result from an effective mix of debt and equity financing (Pandey, 2010). According to the conventional wisdom, the cost of capital rises if additional debt is used after decreasing within a few reasonable debt boundaries. According to the conventional wisdom, the cost of capital rises if additional debt is used after decreasing within a few reasonable debt boundaries.

The basic tenet of the conventional theory is that a company's cost of capital will decrease as it becomes more highly leveraged if the cost of equity exceeds the cost of debt. But eventually, the percentage of debt will rise to the point where lending more to the company will become extremely dangerous (Van Horne, 2006). Equity holders now face greater risk as a result of this. The assumption that the cost of equity is unaffected by the use of debt up to a reasonable amount is the basis for criticism of this theory. Additionally, it is thought that the risk associated with the company's operations and net operating income determine its worth.

Static trade-off Theory

The static trade-off idea was put forth by Myers (1984) to bolster the decision-making process regarding financial structure. According to this view, businesses have an ideal financial structure and are moving in the right direction. It went on to say that businesses must balance the costs and benefits of bankruptcy because they must make trade-offs between them. The trade-off theory, according to Muritala (2012), is the notion that a business determines how much debt and how much equity financing to employ by weighing the costs and advantages. It says that there are expenses associated with financing with debt (the costs of bankruptcy and the cost of debt during financial hardship), as well as benefits (the tax benefit).

While the marginal cost of taxes rises as debt decreases, the marginal benefits of taxes continue to rise with debt accumulation but eventually begin to diminish. Thus, while

determining the appropriate balance between debt and equity for financing, a company seeking to maximize its overall value will consider this trade-off (Van Horne, 2006).

According to the static trade-off argument, companies that have significant growth potential ought to take on less debt since they are more likely to lose value in a financial crisis. The reason for this is that safe firms—those with higher tangible asset values and greater taxable income to protect—are expected to have high debt ratios according to trade-off theory. A riskier company, one that has more intangible assets whose value will vanish in the event of a liquidation, should, however, depend more on equity funding. According to trade-off theory, more prosperous businesses should be able to service their obligations more fully and have more taxable income to protect; as a result, a larger debt ratio is expected (Chandra, 2008).

Empirical Review

Numerous empirical studies have looked at the connection between a company's financial performance and its financial structure. Some companies utilized market valuation as a performance metric, whereas others chose accounting metrics.

For instance, utilizing a multiple regression approach to estimate the association between leverage level and businesses performance, Jensen (1986) and Umar, Tanveer, Aslam, and Sajid (2012) investigated the impact of financial structure choice on firm performance in Egypt and Pakistan. The years 1997 through 2005 were included in the study. The results showed that, generally speaking, choosing a financial structure had little to no effect on a firm's success when measured using three accounting-based financial performance metrics: return on equity, return on asset, and gross profit margin.

Between 1996 and 2005, Cespedes, Gonzalez, and Molina (2010) looked into the connection between ownership and financial structure in seven (7) Latin American nations. A sample of 6,766 companies was chosen for this investigation. They came to the conclusion that leverage and ownership concentration are positively correlated. Furthermore, larger organizations have physical assets, and the research results show a negative association between leverage and profitability and a positive relationship between leverage and growth variables.

Aborode (2005) examined the effect of financial structure on the profitability of twenty-two (22) businesses that were listed between 1998 and 2002 on the Ghana Stock Exchange. The findings demonstrated a strong positive correlation between return on equity (ROE) and capital structure, or the ratio of total debt to total assets. The author also mentioned that profitable businesses rely more on debt financing, with a large percentage (85%) of these businesses' debts being short-term obligations. Sam and Heng (2011) looked at the relationship between the Malaysian construction industry's capital structure and corporate performance between 2005 and 2008. They chose 49 businesses as an example. According to their research, capital structure and company success are significantly correlated.

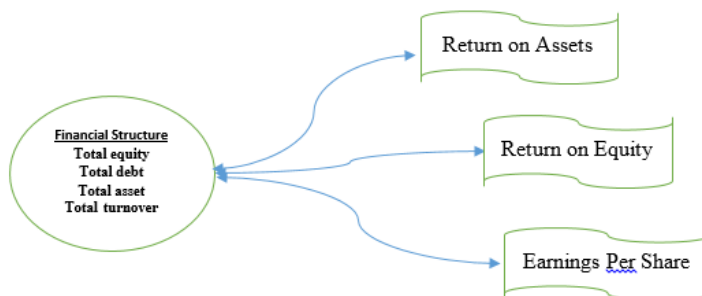
In Aburub's (2012) study, 28 firms were chosen as samples to examine the effect of financial structure on the performance of companies listed on the Palestine Stock Exchange between 2006 and 2010. Five measures of accounting and market performance evaluation were used in the study: return on equity (ROE), return on asset (ROA), earnings per share (EPS), market



value to book value of equity ratio (MVBR), and Tobin Q ratio. Four measures of financial structure were used as dependent variables: short term debt to total asset ratio (SDTA), long term debt to total asset ratio (LDTA), and total debt to total equity ratio (TDTQ). The outcome suggests that capital structure influences company performance evaluation metrics in a favorable way.

Conceptual Framework

The circumstances or traits that the researcher modifies, controls, or records are known as variables. To be more precise, the experimenter manipulates or controls the independent variables in an effort to determine how they relate to phenomena that are observed. On the other hand, the conditions or traits that the experimenter adds, takes away, or modifies are known as the dependent variables (Best, 2007).



Research Methodology

The ex-post facto research design version was used in this study. This is employed due to the correlational nature of the study, which assesses the link between independent and dependent variables. Panel data is also employed. Panel data are a series of surveys conducted over time on a cross-sectional population (Boris & Pamela, 2008 and Bryman & Bell, 2007). The information came from the publicly available financial statements of consumer products manufacturers listed between 2008 and 2023 on the Nigerian Stock Exchange (NSE). These figures include total turnover, total assets, total equity, total debt, profit before tax, profit after tax, and return on equity.

The information was gathered from secondary sources, including the different quantitative data on the activities of consumer goods manufacturing firms that the Nigerian Stock Exchange (NSE) released, which was derived from the financial statements of these firms for each accounting period. The study's primary data sources were releases from the Nigerian Stock Exchange (NSE). The Ordinary Least Square (OLS) technique was used in this study to quantify the association between financial structure and the financial performance of listed consumer products manufacturing firms in Nigeria between 2008 and 2023.

Data Presentation

This pertains to the display of time series data gathered from the statistical bulletin of the Nigerian Stock Exchange (NSE) on the variables under investigation. Here is how they are displayed:

Table 1: Trends in the Ratio Data of 21 Quoted Consumer Goods Manufacturing Firms in Nigeria, 2008- 2023

YEARS	Return on Assets(ROA)	Return on Equity(ROE)
2008	0.2645	0.2664
2009	0.3241	0.3344
2010	0.2654	0.3328
2011	0.2433	0.2974
2012	0.2112	0.3073
2013	0.2133	0.2584
2014	0.2979	0.3078
2015	0.3131	0.3848
2016	0.2747	0.3522
2017	0.2882	0.1318
2018	0.2334	0.3113
2019	0.1912	0.2501
2020	0.1696	0.2431
2021	0.2711	0.2048
2022	0.2364	0.1673
2023	0.4321	0.1540

Source: Nigerian Stock Exchange Fact-book



Unit Root Test

In order to ascertain whether the time series data collected on the various variables of study were stationary or not, the study carried out a unit root test using Philip-Perron (PP) test. The results are as follows:

Table 2: PP Unit Root Test

Variables	PP Statistic	1% Critical Value	5% Critical Value	Order of Integration
ROA	-3.986439	-4.057910	-3.119910	1(1)
ROE	-9.814078	-4.057910	-3.119910	1(1)
EPS	-3.311553	-4.004425	-3.098896	1(0)
TEQ	-13.35054	-4.057910	-3.119910	1(1)
TDBT	-3.711777	-4.057910	-3.119910	1(1)
TAS	-3.552030	-4.121990	-3.144920	1(2)
TOT	-6.535997	-4.121990	-3.144920	1(2)

Source: E-Views (9.5) Data Analysis

From the results in table 2 where the unit root test was carried out to establish the stationarity of the variables, return on assets (ROA), return on equity (ROE), total equity (TEQ) and total debt (TDBT) are integrated of order one 1(1) at 1% and 5% levels of significance. The results also indicate that earnings per share (EPS) is integrated of order zero 1(0) at 5% level of significance. The results also indicated that total assets (TAS) and firm size (TOT) are integrated of order two 1(2) at 1% and 5% levels of significance. This means that the time series data are stationary.

Short Run Regression Analysis

The various models that established relationship between financial structure and financial performance of quoted consumer goods manufacturing firms in Nigeria were estimated as follows

Table 3: Short Run Regression Estimates for Return on Assets (ROA) Model

Dependent Variable: D(ROA)

Method: Least Squares

Date: 10/01/2024 Time: 16:03

Sample (adjusted): 2008 2023

Included observations: 15 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
	t			
C	0.033015	0.023178	1.424371	0.1848
D(TAS)	-4.13E-09	9.64E-10	-	0.00

			4.28094	16
			5	
D(TEQ)	-7.01E-12	7.72E-11	-	0.92
			0.09085	94
			9	
D(TOT)	3.96E-09	8.65E-10	4.5772	0.00
			49	10
D(TDBT)	-4.47E-10	1.05E-10	-	0.00
			4.25540	17
			5	
R-squared	0.696623	Mean dependent var	0.01117	3
Adjusted R-squared	0.575272	S.D. dependent var	0.07108	8
S.E. of regression	0.046329	Akaike info criterion	-	3.04490
			6	
Sum squared resid	0.021464	Schwarz criterion	-	2.80888
			9	
Log likelihood	27.83679	Hannan-Quinn criter.	-	3.04742
			0	
F-statistic	5.740566	Durbin-Watson stat	1.52394	7
Prob(F-statistic)	0.011521			

Source: E-Views(9.5) Data Analysis

The modified (Adjusted R^2) from the data in Table 3 is 0.575272. This suggests that changes in the explanatory variables of total equity (TEQ), total debt (TDBT), total assets (TAS), and firm size as measured by turnover (TOT) account for roughly 57.5 percent (%) of the variation in the dependent variable, return on assets (ROA). The factors that are left out of the model could be responsible for the remaining 42.5% (%). 5.740566's F-statistic and at five percent (%), the whole model is statistically significant, according to the probability (F-statistic) of 0.011521. The DW-statistic of 1.523947 indicates that the error term's autocorrelation is absent. This indicates that the OLS-based estimates are reliable. It indicates that the analysis's findings can be trusted to make predictions.

Total asset (TAS), total equity (TEQ), and total debt (TDBT) all demonstrated negative relationships with return on assets (ROA) based on the coefficient values (table 3). However, the proxy for company size, total turnover (TOT), revealed a positive correlation. This

indicates that while total debt and turnover complied with the study's apriori criteria, total equity and total asset did not.

Table 4: Short Run Regression Estimates for Return on Equity (ROE) Model

Dependent Variable: D(ROE)

Method: Least Squares

Date: 10/01/2024 Time: 16:03

Sample (adjusted): 2008 2023

Included observations: 15 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.023652	0.021883	1.080844	0.3051
D(TAS)	-7.32E-10	9.10E-10	-0.804936	0.4396
D(TEQ)	-4.77E-10	7.29E-11	-6.546151	0.0001
D(TOT)	5.64E-10	8.16E-10	0.690601	0.5055
D(TDBT)	-7.57E-11	9.91E-11	-0.764407	0.4623
R-squared	0.817094	Mean dependent var	-0.007493	
Adjusted R-squared	0.743932	S.D. dependent var	0.086437	
S.E. of regression	0.043740	Akaike info criterion	-3.159905	
Sum squared resid	0.019132	Schwarz criterion	-2.923888	
Log likelihood	28.69928	Hannan-Quinn criter.	-3.162419	
F-statistic	11.16823	Durbin-Watson stat	1.814247	
Prob(F-statistic)	0.001041			

Source: E-Views (9.5) Data Analysis

Adjusted R^2 is 0.743932 based on table 4 data. It may be inferred that fluctuations in the explanatory variables, namely total equity (TEQ), total debt (TDBT), total assets (TAS), and (TOT), account for approximately 74.4 percent (%) of the variation in the dependent variable ROE. The variables that are not accounted for in the model could be the cause of the remaining 25.6%. The whole model is statistically significant at 5 percent (%), according to the F-statistic of 11.16823. The error term's autocorrelation is absent, as indicated by the DW-statistic of 1.814247. Thus, the estimates derived from OLS are not erroneous. Total debt (TDBT), total assets (TAS), and total equity (TEQ) all shown negative relationships with

return on assets (ROE) based on the coefficient values (table 4). This indicates that neither total equity nor total assets met the study's apriori criteria. Return on equity (ROE) and total turnover (TOT), a measure of firm size, were found to be positively correlated.

Conclusion

Financial structure and the factors included in this study did not share a similar link, according to the results of the t-test analysis, which examined the hypotheses. For instance, return on assets demonstrated a negative correlation with total debt, total equity, and total assets but a positive correlation with total turnover. However, considering return on equity, return on assets, and equity, and the entire model showed a substantial positive association between the firms' financial success and their financial structure. The total model showed a positive correlation between the financial performance metrics examined for the study and financial structure. All four of the tested hypotheses passed muster.

Recommendations

In accordance with the results and conclusion of this investigation, the subsequent suggestions are proposed:

- i. Businesses should continue to take into account the ratio of debt to equity needed to fund their operations. This is because the research showed that financial structure affects organizations' financial performance.
- ii. Since the firm's size has a major impact on its financial success, management should work to increase it. This is so that the company can benefit from economies of scale brought about by its size, which promote equity investment and careful evaluation of credit facilities.
- iii. The Nigerian capital market should be reinforced because it is anticipated to contribute positively to the growth of the country's economy. This may be done by maintaining the policy direction for the financial sector's reform.

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Cite this article:

Author(s), ADENIYI, Sarafadeen Diran (Ph.D), KAOJE, Bello Sani (Ph.D) , (2025). “Analysis of the relationship between Financial Structure, Return on Assets, and Return on Equity in Nigeria’s Manufacturing Sector”, **Name of the Journal**: Euro Afro Studies International Journal, (EASIJ.COM), P, 1-15. DOI: [www.doi.org/10.5281/zenodo.17551381](https://doi.org/10.5281/zenodo.17551381) , Issue: 8, Vol.: 7, Article: 1, Month: August, Year: 2025. Retrieved from <https://www.easij.com/all-issues/>

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