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Financial Leverage, Firm Risk, and Financial Performance: Evidence from Financial Firms

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Abstract: Financial leverage is an important factor used to identify firm risk, returns, and financial performance. It is often used to maximize shareholder returns through debt financing, yet it also raises financial risk due to fixed interest obligations. This paper analyzes the relationship between financial leverage and firm risk using quantitative analysis of financial firms' data. The study analyses the leverage ratios, profitability ratios, and risk measures to establish the relationship between leverage and financial performance and stability. Financial leverage may also increase returns because firms can invest in growth opportunities without diluting ownership, thereby increasing earnings per share and return on equity. Nonetheless, too much leverage increases bankruptcy risk, earnings volatility and financial distress, especially during economic downturns. Optimally levered firms balance risk and payoff to maximize shareholder value while remaining financially stable. The results indicate that moderate leverage positively influences firm turnover, whereas excess leverage is associated with excessive financial risk and lowers firm performance. The results also have significant implications for financial managers, investors, and policymakers seeking to determine optimal capital structures. The research contributes to the financial management literature by providing empirical evidence of the leverage-risk-return relationship and supporting strategic leverage management to enhance firm value, stability and long-term sustainability in the competitive global financial market.

Keywords: Financial Leverage; Firm Risk; Firm Return; Capital Structure; Financial Performance; Earnings Per Share; Return on Equity; Weighted Average Cost of Capital; Corporate Sustainability.

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1. Introduction

Financial leverage is one of the most important strategic financial decisions corporations make because it directly affects profitability, shareholder wealth, risk and long-term sustainability. It is the use of debt financing alongside equity capital in a firm's capital structure to finance business operations, investment opportunities and organisational expansion [19]. The main goal of financial leverage is to enhance shareholder returns by borrowing money that yields a return greater than the cost of debt. Leverage management is an effective way for firms to fund substantial investments without diluting ownership, thereby improving earnings per share (EPS), return on equity (ROE), and overall market valuation [1]. However, financial leverage creates opportunities for value creation but also increases firms' exposure to higher financial obligations, fixed interest expenses and a higher likelihood of financial distress, especially during periods of economic uncertainty and declining profitability [20]. In corporate finance, much

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attention has focused on the relationship between financial leverage and firm performance because leverage is both a source of competitive advantage and a potential source of financial distress. Firms continually seek an optimal mix of debt and equity financing that minimises their weighted average cost of capital (WACC) and maximises firm value. Over-reliance on equity financing may increase the cost of capital because shareholders have higher expectations; conversely, over-reliance on debt financing increases bankruptcy risk and reduces financial flexibility. Choosing the right capital structure is therefore among the most important financial management decisions, as it can affect an organization's competitiveness, sustainability and shareholder returns [2].

Corporate financial managers are always confronted with the trade-off between profitability and financial risk [21]. Debt financing has several advantages, such as the tax deductibility of interest payments, ownership control and greater investment capacity. Unlike equity financing, debt allows firms to raise large amounts of capital without issuing more shares, avoiding ownership dilution and retaining managerial control over strategic decisions [3]. Moderate leverage is also often seen as a sign of management's confidence in future cash flows and business growth, improving investor perception and strengthening market credibility. Furthermore, investors see prudent borrowing as a signal that management expects future investments to generate returns that exceed the cost of borrowing, improving market valuations and financial performance [23]. However, it greatly increases financial risk because debt obligations must be paid regardless of the firm's operating performance. Firms with large debt burdens are often under severe financial pressure during periods of declining revenues, economic recession, inflation, rising interest rates, or market disruption. Fixed interest payments reduce operating flexibility, restrict cash flows, and increase the probability of financial distress, loan defaults, and bankruptcy [4]. Falling credit ratings, declining investor confidence and tougher lending criteria from financial institutions may also cause high-leverage companies to face higher borrowing costs. Leverage amplifies profits as well as losses, so managing the capital structure wisely is important for long-term financial health [22].

Financial leverage is also an important determinant of firm risk. In corporate finance, risk is defined as the uncertainty of future earnings, cash flow and investment returns. Financial leverage raises systematic risk because debt payments are fixed regardless of business performance [24]. The greater the leverage, the larger the percentage change in net income available to shareholders for a given percentage change in operating income [5]. This is often called financial risk amplification, which increases earnings volatility and exposes investors to greater uncertainty. Firms with high leverage ratios tend to have more volatile stock prices, lower credit ratings, and greater sensitivity to macroeconomic shocks. Several capital structure theories explain the relationship between financial leverage, firm performance and financial risk [25]. The Modigliani-Miller propositions originally stated that, under perfect-market assumptions, a firm's capital structure is irrelevant to its value. Subsequent developments, however, incorporated corporate taxes and showed that debt financing provides valuable tax shields, increasing firm value by reducing taxable income. But perfect-market assumptions rarely hold in reality, as firms face bankruptcy costs, agency conflicts, asymmetric information and transaction costs. These practical limitations have led to alternative theoretical perspectives that better explain real-world financing decisions [26]. According to Trade-Off Theory, firms seek an optimal level of debt by balancing the tax benefits of debt with the expected costs of financial distress. In this theory, moderate leverage increases firm value because tax savings outweigh the costs of financial distress [6].

However, an optimal level of debt exists, as additional borrowing decreases firm value by increasing bankruptcy risk, agency costs and reducing investor confidence. So, companies constantly adjust their capital structure to maintain the right balance between risk and return. Another explanation for financing decisions is the Pecking Order Theory. This theory suggests that firms prefer internal financing through retained earnings before external financing. When firms need external financing, they prefer debt to equity because issuing debt sends a less negative signal to investors and does not dilute ownership [7]. Equity financing is generally considered the last choice because investors tend to view a new equity offer as a signal that management believes the firm's shares are overvalued [27]. This pecking order of financing helps explain why profitable companies tend to have moderate debt and rely heavily on internally generated funds. Agency Theory also helps explain the implications of financial leverage by examining conflicts among managers, shareholders and creditors. Debt financing can help mitigate agency problems by limiting managerial discretion over free cash flows and encouraging efficient investment decisions [28]. Managers under debt obligations are more disciplined because they are required to generate sufficient cash flows to satisfy creditors. However, excessive leverage can create conflicts between shareholders and debt holders, as shareholders may prefer more speculative investment strategies that could increase shareholder returns while elevating the risk of default for creditors [8]. Hence, organisational governance, managerial incentives and investment behaviour are influenced by financial leverage. Empirical studies on the relationship between financial leverage and firm performance have yielded mixed findings across industries, countries and economic settings.

Many studies report a positive association between moderate leverage and profitability because debt financing lets firms pursue profitable investment opportunities while lowering the cost of capital through tax benefits. These studies suggest that firms with balanced leverage ratios tend to perform better in terms of ROA, ROE, EPS and market valuation than firms that use only equity financing. On the other hand, empirical studies indicate that high leverage negatively affects financial performance because it increases interest expenses, earnings volatility and reduces financial flexibility [9]. When there is a financial crisis or economic downturn, such firms tend to see larger drops in profitability and market value, as their ability to service debt is hampered by

declining revenues. Such firms often face liquidity constraints, restructuring problems and higher probabilities of bankruptcy [29]. These contradictory results imply that the effect of leverage depends on firm-specific characteristics, industry dynamics, macroeconomic conditions, corporate governance quality and managerial decision-making capabilities. Leverage decisions matter for firm risk because debt financing directly affects financial resilience under uncertainty. Companies in highly volatile industries tend to carry less debt to maintain financial flexibility. In contrast, companies in stable industries with predictable cash flows can often carry more debt without taking on excessive financial risk. Therefore, industry characteristics significantly affect the relationship between leverage and firm performance [10]. As financial markets have become more global, managing leverage effectively has become more important. Rapid technological advancements, evolving investor expectations, growing market competition, fluctuating interest rates, inflationary pressures, and geopolitical uncertainties have increased the financial risks organisations face globally.

Thus, Financial managers are required to continue monitoring leverage ratios, liquidity positions, interest coverage and profitability indicators to ensure long-term organisational resilience. Strategic leverage management is now integral to maximising shareholder wealth and sustainable growth amid increasing economic uncertainty [11]. Similarly, leverage ratios are important financial health indicators that investors consider when evaluating investment opportunities. Creditors use leverage metrics to assess creditworthiness and lending risk. Equity investors look at debt levels to gauge future profitability and financial stability. Credit rating assessments include leverage measures and influence firms' borrowing costs and access to external capital markets. Thus, leverage decisions affect not only internal financial management but also external stakeholders' confidence and the firm's market reputation. Recent advances in corporate sustainability and environmental, social and governance (ESG) reporting have extended discussions on capital structure decisions. Prudent leverage ratios, which encourage long-term resilience rather than short-term maximisation of shareholder returns, are emerging as a key focus of sustainable financial management. Balanced financing strategies are associated with increased resilience to economic shocks, operational continuity, employment protection and long-run strategic investments. Hence, financial leverage is increasingly seen as a determinant of organisational sustainability, rather than merely a financing mechanism [12]. Quantitative financial analysis offers useful methods for evaluating the leverage-risk-return relationship. Researchers can analyse leverage using financial ratios such as debt-to-equity ratio, debt ratio, interest coverage ratio, return on assets, return on equity, earnings per share, operating margin, current ratio, and times interest earned to study its impact on organisational performance.

Empirical investigation of the relationship between leverage, profitability and financial stability is also possible through regression analysis, correlation analysis, panel data estimation and risk modelling [13]. These analytical techniques provide objective evidence to support managerial decision-making and policy formulation. Accordingly, this study investigates the effect of financial leverage on firm risk and financial return using quantitative analytical methods. Specifically, the study aims to determine whether leverage increases profitability while raising financial risk, and whether an optimal balance exists that maximises shareholder value without exposing firms to excessive financial instability. Understanding this relationship is increasingly important because organisations operate in highly competitive and uncertain financial environments, with rapid technological transformation, economic volatility, changing regulatory frameworks and global capital mobility [14]. This research is expected to contribute significantly to the corporate finance literature by providing empirical evidence on the complex relationship between financial leverage, firm risk and financial performance [15]. The findings will help financial managers to formulate optimal capital structures while considering profitability and financial stability. The findings will help investors make informed investment decisions based on leverage-related risk profiles [16]. The findings will help policymakers to formulate regulatory frameworks that promote corporate financial resilience [17]. The study also adds to the growing evidence that strategic leverage management is a critical determinant of sustainable corporate development, long-term shareholder wealth maximisation and organisational competitiveness in current global financial markets [18].

2. Related Works

Financial leverage has been a major subject of corporate finance research because of its significant influence on firms' risk and return, as well as financial stability. Scholars have studied the effects of leverage on profitability, firm value, cost of capital, and financial risk across different economic settings and industries. Boubakri et al. [1] observed that highly leveraged firms experienced increased financial distress during the economic crisis because leverage increased corporate fragility. Their results show that high leverage makes enterprises more vulnerable to financial distress and less stable. Similarly, Ullah et al. found that financial leverage is a significant risk factor that amplifies stock price volatility, implying higher risk for firms.

These results show that leverage increases financial uncertainty and risk exposure. Shapiro [22] studied the cost of capital and capital structure and found that optimal leverage decreases the cost of capital and increases firm value. The research underlined the need to maintain balanced leverage levels to improve financial performance. Tian and Yu [24] concluded that financial leverage significantly increases the probability of bankruptcy, especially when firms experience falling revenues. This indicates the connection between leverage and financial risk. Zeitun and Saleh [25] investigated leverage and firm performance and found that moderate leverage positively affects firm profitability because it helps firms invest in growth opportunities.

Kalash [26] found that leverage positively affects firm performance in emerging economies, although excessive leverage harms profitability. Capelle and Teoh [27] found that leveraged companies are more sensitive to interest-rate fluctuations, increasing financial risk during monetary tightening. Ilyukhin [28] found that leverage plays a significant role in determining firm performance; therefore, firms with optimal leverage are more likely to earn high profits. Bagh et al. [29] found that leverage influences firms' risk-taking behavior, whereby leveraged firms adopt more aggressive investment strategies. Passla et al. [2] found that financial leverage positively affects firm value under management. Abubakar and Anyonje [3] established that leverage increases firm performance by allowing firms to use capital more effectively. Odhiambo et al. [4] found that leverage affects firm performance and financial stability. Akwuobi et al. [5] established that leverage indeed leads to systematic risk and earnings volatility. Mutumanikam and Adelin [6] found that leverage plays a major role in determining firms' profitability and financial risk. Zhou et al. [7] found that corporate governance affects leverage decisions and firm performance. Kijkasiwat et al. [8] concluded that governance mechanisms influence leverage efficiency and firm performance. Chukkapalli [9] found that capital structure choices strongly affect firm profitability. Islam found that leverage dynamics influence long-term firm performance.

Xue et al. [11] found that leverage positively influences firm value when used efficiently. Rahman et al. [13] discovered that leverage enhances profitability, albeit at the expense of exposing an organization to higher financial risk. Clark et al. [14] found that leverage affects the cost of capital and firm valuation. Kijkasiwat et al. [8] found that leverage boosts firm performance in new markets. Dalci [15] found that leverage positively affects profitability in the manufacturing industry. Jermias and Yigit [16] established that leverage affects firms' performance and financial stability. Passla et al. [2] identified that leverage enhances financial performance when managed adequately. Qin and Gong [18] found that leverage affects efficiency in corporate investments. Alarussi and Gao [19] found that leverage affects firms' profitability and financial performance. Saleh [20] found that leverage increases corporate financial risk and earnings volatility. Li [21] found a relationship between leverage and financial stability and risk exposure. Zhang and Gong [23] found that leverage affects firms' risk-return relationships. Overall, existing studies confirm that financial leverage is a key factor in assessing a firm's risk and returns. Optimal leverage enhances profitability and firm value, whereas over-leverage increases financial risk and instability.

3. Methodology

3.1. Research Design

This paper uses a quantitative research design to test the effect of financial leverage on a firm's risk and return. Quantitative research is appropriate because it allows objective assessment of financial relationships through numerical data and statistical methods, and enables empirical measurement of financial variables. Measurable financial indicators of leverage, firm risk, and firm return are derived from financial statements, suggesting that quantitative analysis is the most appropriate study method. Quantitative methods are also applied to guarantee accuracy, objectivity, and reliability in assessing the relationship between leverage and firm performance. The study uses secondary financial data from firms' financial statements, such as balance sheets, income statements, and cash flow statements. Calculating leverage ratios, profitability ratios, and risk indicators requires that these financial documents be relevant and provide essential information. Financial statements are also credible sources of standard financial information and provide consistent, accurate measurements. Secondary data are also used, enabling analysis across multiple firms, industries and timeframes and enhancing the external validity of the research findings.

The research is based on publicly listed companies across the production, services, and financial sectors. Financial information is available for publicly listed firms; hence, the data is reliable and accessible. The sample includes companies with different leverage levels to provide thorough coverage of leverage-risk-return relationships. Including low-, moderate-, and high-leverage firms enables comparisons of financial performance across capital structures. The study evaluates 5 years of financial data to measure changes in financial leverage, profitability, and financial risk. Longitudinal analysis will identify trends and associations between leverage and firm performance. This will improve the precision of the research results by capturing dynamic shifts in financial performance and leverage levels. The research design uses correlational and regression analyses to measure the relationship between financial leverage, firm risk, and firm return. Correlation analysis helps to establish the nature and strength of relationships among leverage and financial performance variables. Regression analysis examines the effect of leverage on firm profitability and financial risk and helps determine cause-and-effect relationships. This aligns with past financial studies that emphasize the need for empirical research to assess capital structure decisions.

3.2. Variable Measurement

Firm financial statements are used to measure financial leverage, firm risk and returns using financial ratios. These ratios provide standardized, comparable measures of financial performance and risk. The debt-to-equity ratio measures the relationship between debt and shareholder equity. Higher debt-to-equity ratios indicate more debt funding and higher financial risk. The debt ratio is used to establish the percentage of company assets financed by debt (Table 1).

Table 1: Financial leverage variables

Variable	Measurement	Description
Debt-to-Equity Ratio	Total Debt / Total Equity	Measures financial leverage level
Debt Ratio	Total Debt / Total Assets	Measures proportion of debt financing
Interest Coverage Ratio	EBIT / Interest Expense	Measures ability to meet interest obligations
Financial Leverage Ratio	Total Assets / Equity	Measures overall leverage intensity

Companies with a higher debt ratio carry a higher financial load and face greater financial risk. The interest coverage ratio measures a firm's ability to pay interest as it comes due through operating income. A higher interest coverage ratio indicates a company is financially stable and less likely to suffer financial distress. Banks with low interest coverage ratios are more prone to bankruptcy because they can barely meet their debt obligations. The financial leverage ratio shows the relationship between a firm's assets and shareholder equity. This ratio shows how much firms rely on debt financing to finance asset growth. Higher leverage ratios mean higher financial risk and greater dependence on debt. These leverage ratios are commonly used in financial studies to compare capital structure choices and financial risk exposure (Table 2).

Table 2: Firm risk and return variables

Variable	Measurement	Description
Return on Equity (ROE)	Net Income / Total Equity	Measures shareholder profitability
Return on Assets (ROA)	Net Income / Total Assets	Measures operational efficiency
Earnings Volatility	Standard deviation of earnings	Measures financial risk level
Stock Return	Annual percentage change in stock price	Measures investor return

Return on equity illustrates the investment's profitability for shareholders. Higher ROE indicates improved financial results and more effective use of equity capital. Return on assets measures a firm's profitability based on total assets. Higher ROA implies effective management through efficient asset use and improved performance. Earnings volatility measures changes in firms' earnings over time. Higher earnings volatility reflects greater financial risk and uncertainty. Companies that are highly leveraged tend to have volatility in their earnings because they have constant interest payments. Stock returns measure investor returns and reflect the market's view of firms' performance. An increase in stock returns implies strong investor confidence and valuation of the firm. These variables provide a comprehensive measure of firm risk and returns, allowing accurate analysis of leverage's impact on financial performance.

3.3. Data Collection

The research employs secondary data from financial databases, annual reports and financial statements that have been published publicly. Secondary data is suitably accurate because it provides consistent, acceptable and verifiable financial information. Financial reports published by the state promote transparency and accuracy, enhancing the reliability of the research. The sample will include companies with complete financial information over the five-year study period. Companies that cannot provide financial data are excluded to ensure data integrity. The sample also includes firms from various industries to capture different financial structures and leverage levels. Including firms from other sectors increases the generalizability and accuracy of the research findings. The monetary information obtained will include total debt, total assets, shareholder equity, net income, operating income and stock price information. Ratios that are calculated include leverage ratios, profitability ratios and risk indicators using these financial variables. Data collection will provide reliable measures of financial leverage, firm risk, and company returns. Multi-year financial data can be used to analyze relationships and trends over time. This improves research precision and the quality of statistical analysis. Gathering secondary financial data ensures credibility and impartiality when quantifying financial performance variables.

3.4. Data Analysis Techniques

One analysis technique used in the study is statistical analysis to compare the relationship between financial leverage, firm risk and firm return. Statistical analysis objectively quantifies financial relationships using empirical data. Financial variables such as leverage ratios, profitability ratios and risk are summarized using descriptive statistics. Descriptive statistics provide measures such as the mean, standard deviation and minimum and maximum values. These tools provide information on financial performance and the distribution of leverage among companies. The effect of financial leverage on firm risk and return is tested using regression analysis. Regression analysis estimates the relationship between leverage ratios and profitability indices (ROE and ROA). Regression analysis also gauges the effect of leverage on financial risk, as indicated by earnings volatility.

4. Findings and Discussions

Firms with medium leverage show the highest profitability, with a profit ratio of 14% and a profitability ratio of 10% compared with low-leverage and high-leverage firms. This proves the efficiency of leverage in increasing the firm's return. Financial leverage enables companies to invest in opportunities that yield good returns without raising more equity, thereby enhancing shareholder returns. Moderate leverage increases profitability because firms can use borrowed funds to expand operations, increase production capacity and invest in lucrative opportunities. These investments generate higher earnings, increasing ROE and ROA. Leverage also offers tax benefits through interest tax shields, which reduce total tax liability and increase net income. This enhances firm return and shareholder value. However, leverage reduces profitability, with ROE falling to 9% and ROA to 5%. This depreciation is brought about by the fact that too much debt raises the cost of interest; hence, it lowers the net income and general profitability (Figure 1).

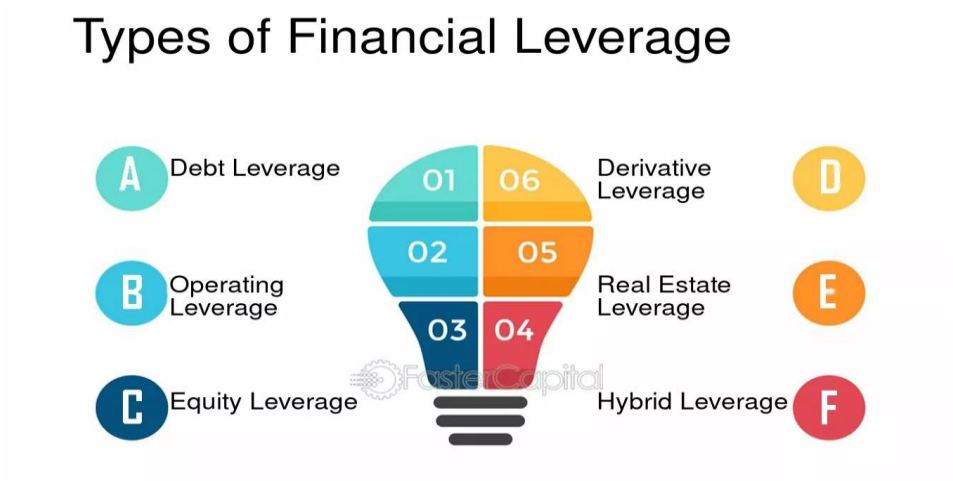


Figure 1: Financial leverage

It also restricts financial flexibility, meaning that at high leverage it becomes hard to respond to market dynamics. Specifically, excessive leverage strains finances and lowers firm performance by increasing debt-servicing costs. Low-leverage firms also show low profitability because they depend on equity financing and can hardly finance new growth opportunities.

4.1. Impact of Leverage on Firm Risk

The results indicate that financial leverage greatly amplifies a firm's risk, both in earnings volatility and bankruptcy risk. Highly leveraged firms have higher earnings volatility and higher bankruptcy risk than low-leveraged and moderately leveraged firms (Table 3).

Table 3: Leverage and financial risk

Leverage Level	Earnings Volatility	Bankruptcy Risk
Low	Low	Low
Moderate	Moderate	Moderate
High	High	High

This is because highly leveraged firms have fixed interest payments regardless of financial performance. Even weak earnings strain firms' earnings and increase the threat of financial distress and bankruptcy. High leverage increases earnings volatility because interest payments dilute net income when revenues decline. This makes finances more volatile and firms less resilient during an economic recession.

This increases overall firm risk and uncertainty. Moderate financial risk is reflected in moderate earnings volatility and bankruptcy risk among firms with moderate leverage. These companies use leverage while remaining financially stable. Middle-range leverage enables companies to earn higher returns without exposing them to too much financial risk. Low-leverage companies have the least financial risk because they have little debt. These firms have high financial flexibility and low bankruptcy risk. However, they may also face reduced profitability because of limited investment capacity (Figure 2).

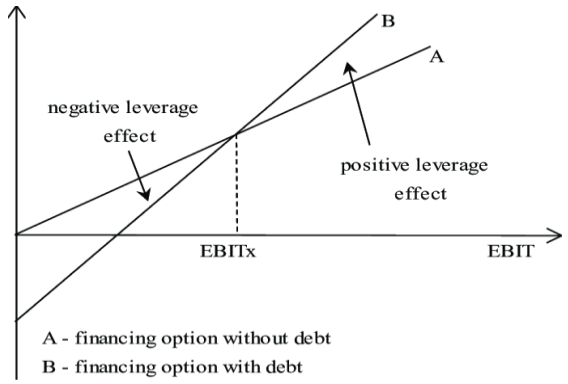


Figure 2: Positive and negative financial leverage effect

This shows that leverage raises risk for firms, but an optimal level of leverage offers an excellent balance between risk and reward (Figure 3).

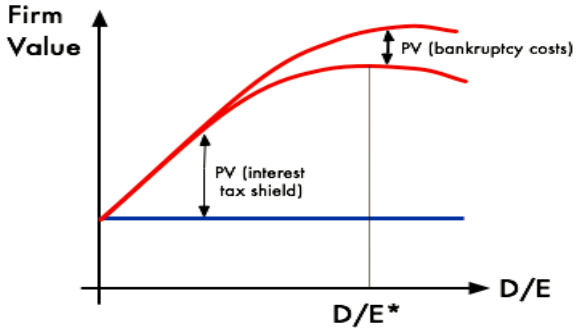


Figure 3: Thinking about financial leverage

4.2. Leverage and Firm Value

The findings show that financial leverage plays a substantial role in firm value. Moderately leveraged firms show maximum firm value, while overleveraged firms show diminishing firm value (Figure 4).



Figure 4: Risk and return in financial management

This shows that optimal leverage enhances firm valuation by increasing profitability and improving capital efficiency. Moderate leverage enhances firm value by increasing profitability (Table 4).

Table 4: Leverage and firm value

Leverage Level	Firm Value
Low	Moderate

Moderate	High
High	Low

Companies with optimal leverage can invest in high-return projects, improve productivity and boost shareholder payouts. These factors raise firm valuation and investor trust. Financial leverage also indicates optimism about the firm's growth, which improves how investors view the firm and how the market values it.

5. Conclusion

Financial leverage is a significant factor in determining a company's risk, return, and financial success. This paper aimed to quantitatively analyse the link between financial leverage and firm risk and return to assess the company's financial information. Based on the findings, it can be concluded that leverage has a considerable influence on profitability, financial risk, and firm value. As corporations invest in growth projects, moderate leverage contributes to increased profitability, shareholder wealth, and overall firm value over time. High leverage, on the other hand, increases the risk of financial trouble, earnings instability, and bankruptcy. Overleveraged companies have been linked to lower earnings and greater vulnerability to financial shocks. According to the paper's findings, achieving financial stability and maintaining optimal leverage are two of the most important factors in maximising shareholder value. Financial managers manage leverage and financial risk to establish the best possible capital structure. When making investment decisions, investors should consider the company's leverage. Generally, financial leverage is a significant factor in both a company's risk and return. Effective leverage management can improve a company's performance, financial stability and long-term sustainability.

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