

A Study on Effect of Financial Leverage on Profitability and Risk

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Abstract

A financial leverage is also important in the financial performance of a firm and its level of risk. This paper analyzes how financial leverage influences the profitability and risk in an organization. Financial leverage is the use of the borrowed finances or debt to directly fund business operations and investments, with the hope of making higher returns to shareholders. Although leverage can be used to increase the profitability, it can also escalate the financial risk of the firm as it has fixed interest payments. The primary purpose of the research is to determine the effect of financial leverage on the indicators of profitability including Return on Equity (ROE), Return on Assets (ROA) and Net Profit Margin, and level of risk of financial risk of the company. The research is premised by secondary information obtained through the financial statements of the targeted company within a given duration. The relationship between leverage, profitability, and risk is analyzed with the help of different financial ratios and analytical tools. The study findings are useful in knowing whether an increase in the leverage results in an increase in profitability or an increase in the financial risk of the organization. The study also offers knowledge to managers as well as investors in making sound financial choices on capital structure and debt management. On the whole, the research also shows the significance of a good debt-equity ratio in order to have sustainable financial performance and reduce financial risk.

Keywords: Financial Leverage, Operation Leverage, Compound Leverage, Debt Equity Ratio.

Introduction

The financial management of business organizations is among most significant parts because it assists in the planning, control and practicality of financial resources. The choice of a proper capital structure is one of the critical financial decisions of firms since it defines the amount of debt and equity to be applied to fund the business operations. The financial leverage occurs when a firm uses the debt in the capital structure and hopes to enter the objectives of the excess remuneration to the stockholders. With financial leverage, firms have the opportunity to make higher investments and increase operation without necessarily using only the equity capital. Profitability of a firm directly depends on financial leverage. An effective method of

financing a business through debt would help a company to generate larger earnings since the cost of capital is usually lower than the profit earned through investing in business. Consequently, leverage is capable of improving key profitability ratios that include Return on Equity (ROE), Return on Assets (ROA) and Earnings Per Share (EPS). Leverage is a financial technique that is widely employed by many organizations with an aim of enhancing shareholder value as well as realizing business growth. Nonetheless, financial leverage has brought along financial risk as well. Through debt financing, the firms are subjected to paying interest in lump sums in spite of their financial situation. In case of a decrease in the income of the company or some other economic problems, it is possible that payment of the interest can place strain on the financial resources and make the company suffer. Hence, the overuse of debt has the capacity to experience adverse impacts on the financial stability and the long term sustainability of a firm. The issue of establishing equilibrium between debt and equity best fits is one that is of interest to financial managers in the contemporary world of corporate finance. With proper capital structure, organizations are able to maximize profitability at a minimal financial risk. The level of leverage and the extent to which it influences the financial performance of a firm is normally measured using various financial ratios including the debt equity ratio, asset-debt ratio and interest coverage ratio. This assignment is dedicated to the comparison of the financial leverage effect on the profitability and financial risk. Through the analysis of financial information and ratio analysis, the study will seek to learn how leverage is likely to affect the financial performance of a firm and its risk. The research results obtained after this study will be beneficial to managers, investors, and financial analysts to make superior financial decisions on capital structure and debt management. All in all, the paper has revealed the significance of having an optimal degree of financial leverage to attain sustainable profitability in managing the financial risk.

Background of the Study

Financial leverage can be defined as the use of an availed money or a debt in a business capital structure to fund business and investment activities of a firm. Debt financing has been a common trend in companies aiming to grow their business and generate more profits to their shareholders. Financial leverage has the potential of enhancing the profitability of a firm when the the cost of debt is less than the amount of the return on investment. Nevertheless, the debt factor also augment the financial risk since the company has to pay constant interests irrespective of the financial performance of the company. In case the earnings of the company decline, there is possibility of financial strain due to high debt amounts and this might have an impact on the stability of the company. Thus, the connection between the financial leverage, profitability, and risk is worth studying. This paper can be used to comprehend the effects of leverage on the profitability ratio, including Return on Equity (ROE), Return on Assets (ROA) and the Net Profit Margin, among other impacts on the financial risk of the organization.

Research of Objectives

- To discuss the amount of financial leverage of the firm with the help of such ratios as Debt-Equity Ratio, Debt to Asset Ratio, and Debt to Total Asset Ratio.
- To test the connection between the indicator of financial leverage and profitability including Return of Equity (ROE), Return on Assets (ROA), and Earnings Per Share (EPS).
- To determine the effect of the operating leverage, financial leverage and combined leverage on the financial performance of the company.
- To determine the extent of financial risk undertaken in making use of debt in capital structure of the firm.

Research Problem

Financial leverage is a significant financial technique that companies apply when they need to fund the business activities and investments with the aid of borrowed money. Debts assist the firms in amplifying their ability to invest as well as increase their likelihood of making a profit. In a case where returns on investments made can exceed the cost of debt, the financial leverage can be used to enhancing the returns to shareholders. But the use of the debt also makes a fixed financial commitment like interest payment. In case a company is unable to make enough earnings, the obligations will cause a strain on finances, which will then result in financial risk. A high level of financial leverage could also impair the financial stability, and augment the likelihood of financial distress. Hence, companies have to strike a balance between the application of debt and equity in the capital structure. It can be agreed that many organizations struggle with the issue of establishing the optimal level of financial leverage. The knowledge of leverage impact on profitability and financial risk is significant to making good financial decision-making. In this study, the financial leverage effect on the profitability as well as the risk would be analyzed so as to promote the effective financial management and sustainable business performance.

Literature Review

Ahmad and Abdullah (2021) compared the connection between financial leverage and profitability of selected companies. The analysis was conducted on financial data in terms of leverage ratios including debt-equity ratio, debt ratio and profitability ratios including Return on Assets (ROA) and Return on Equity (ROE). The results revealed that there is a substantial effect of financial leverage on profitability of firms. Intermediate levels of leverage were estimated to enhance financial performance through raising returns to shareholders whereas high levels of leverage enhanced financial risk and lowered financial stability. The paper found that a balanced capital structure should be maintained by the firms to attain sustainable profitability levels and effectively manage their financial risk levels.

Nguyen and Nguyen studied how financial leverage and profitability of firms among manufacturing firms are related to each other. The ratios that were employed in the study in measuring performance included the debt equity ratio, the ratio of the return on the assets (ROA) and the ratio of the return on equity (ROE). The findings showed moderate levels of financial leverage could enhance profitability, yet too much debt would dissuade financial stability increasing the risk of financial situations. The paper has highlighted the need to have optimum capital structure.

Kalaiarasan et al. (2023) Kalaiarasan, et al. measured financial performance and performance of organizations by applying various financial indicators and analytical tools. The paper has emphasized that proper management of financial resources, such as leverage, is significant towards enhancing profitability of the organization and minimizing the risk involved in running the organization. It was also highlighted in the research that financial decision-making also plays a significant role in the long-term sustainability of a firm.

Sharma and Verma examined how financial leverage affects profitability and financial risk of the chosen companies. The researchers discovered that the financial leverage has substantial impact on financial profitability measures including ROA, ROE and earnings per share. Nevertheless, the study also indicated that an increased level of leverage increases the financial risk because it is associated with fixed interest payments. These findings made the authors conclude that debt and equity of capital structure should be carefully balanced by the company.

Kumar and Patel researched the association of the financial leverage, profitability, and risk in corporate firms. The ratio analysis and statistic methods were used in analyzing financial performance in the study. Its results showed that financial leverage has the capacity of boosting the

profitability in cases where it is applied effectively, although high leverage may elevate the financial risk and decrease the long-standing stability of the firm. The study recommended a balanced debt-equity ratio on the part of the managers in order to attain sustainable financial growth..

Case Study Examples

1. Reliance Industries Limited, Financial Leverage and Profitability (2024)

In 2024, Reliance industries limited also illustrated a good application of financial leverage to promote its growth in various fields like telecommunication, retail and energy. The company made use of an equal combination of debt and equity to finance its massive projects and infrastructure investment. Reliance has been in a position to carry out the expansion of its operations by using the strategic debt financing which has ensured that it has high levels of profitability. The financial statements of the company indicated stable profitability ratios like Return on Equity (ROE) and Return on Assets (ROA) which depicted effective use of financial resources. Simultaneously, the company had a controlled Debt Equity ratio and thus the financial risk was under control. This case brings to the fore the significance of an effectively operated capital structure in enabling organizations to rely on financial leverage as a growth instrument without financial instability and investor trust.

2. Tata Motors Limited- Financial Risk and Capital Structure Management (2025)

By 2025, Tata Motors Limited was interested in enhancing its financial stability through strengthening its capital structure, as well as minimizing the financial risk linked to high leverage. The firm had in the past been depending on debt financing to promote growth and investment in electric vehicle technology and internationalization. But as the revenues grew and the company was becoming more efficient in its operations, Tata Motors found itself less reliant on debt financing. This translated to improved financial performance and the improvement in the profitability measures like Earnings Per Share (EPS) and Return on Equity (ROE). The company managed to lower the financial risk through a more balanced Debt Equity Ratio which enhanced investor confidence. As the example of Tata Motors reveals, financial leverage can be effectively used by companies in order to increase their profitability as well as reduce the financial risk in the long run.

Implications of the Study

Managerial Implications

The study provides useful insights for financial managers in making effective capital structure decisions. Managers can use financial leverage carefully to increase profitability while maintaining a balanced debt–equity ratio. Proper monitoring of leverage ratios such as Debt-Equity Ratio and Debt-Asset Ratio can help firms avoid excessive financial risk and maintain financial stability.

Investor Implications

The findings help investors understand how the level of debt in a company affects profitability and financial risk. Investors can evaluate leverage ratios along with profitability indicators such as Return on Equity (ROE) and Return on Assets (ROA) before making investment decisions. Companies with balanced leverage are generally considered financially stable and attractive for long-term investment.

Policy and Financial Planning Implication

It is indicated in the study that an optimal capital structure is essential. To prevent the high financial risk, organizations and financial planners should come up with policies that govern the

utilization of debt financing. Organizations can be assisted with the help of effective financial planning and frequent analysis of leverage ratios in order to grow sustainably.

Implications to Academic and Research

This research paper is an addition to the literature concerning financial leverage, profitability, and financial risk. It helps to gain conceptual knowledge about leverage effect on financial performance. To further improve the relationship between leverage and profitability, future researchers can look at other industries, larger data sets or look at a more sophisticated statistical approach to the problem at hand.

Discussion

Financial leverage high is in estimating the profitability and financial risk of a firm. The money borrowed by firms is used to grow their operations and make investments in large projects that may result in increased returns by the shareholders.

In the event the money borrowed is well utilized, financial leverage may enhance the profitability measures in terms of Return on Equity (ROE), Return on Assets (ROA), and Earnings Per Share (EPS). Nevertheless, an increased debt to equity ratio will result in a greater financial risk since the companies will have to pay a specified interest whether they are making profits or not. These commitments could put financial strains and cause financial stress during low sales or economic downturns.

The research also reveals that operating leverage along with combined leverage affect the earnings and the overall financial performance of a given firm. The financial ratios like the Debt-Equity Ratio and Debt-Asset Ratio are useful in assessing the capital structure of the company along with its reliance on debts. This means that the best way to balance a debt with equity ratio can be established to ensure sustainable profitability and minimal chances of financial riskness.

Main Findings

- The research established that financial leverage plays a major role in determining the profitability and financial risk of a company. Debt financing can assist companies to acquire extra funds to facilitate business activities and investments that can flow in performance of finances and shareholders returns.
- The analysis Half of the indicators of profitability related to financial leverage include Return on Equity (ROE), Return on Assets (ROA) and Earnings Per Share (EPS). Leverage has the potential to increase profitability when the borrowed money goes to good use. Nevertheless, the advantages are subject to the capacity of the firm to control its debts and generate enough revenues to settle its interest payments.
- The research shows that moderate leverage can promote the growth of businesses, whereas high leverage leads to the financial liabilities and the risk. Financial ratios include Debt-Equity ratio and Debt-Asset ratio which are used to assess the use of capital structure and debt in the firm.
- In general, the results indicate that it is necessary to keep the capital structure balanced between debt and equity. Having the right financial leverage will lead to better profitability and long-term expansion and too much Debt will result in financial instability and increase financial risk.

Future Implications

The research recommends that companies ought to embrace newer financial analytics and computerized financial management systems in order to gain better insight into leverage, pattern

in profitability and financial risk. The firms are encouraged to concentrate on coming up with efficient approaches in capital structure maintaining a balanced proportion of debt and equity and periodically reexamining the leverage ratios in view of the market conditions and fluctuations in the interest rates. Transparency can be enhanced through the introduction of technology like financial management applications, ERP solutions, and real time monitoring solutions to aid in making improved financial decisions. Secondly, companies need to focus on the long-term financial growth in investments, and not short-term returns through debt utilization. Research in the future may also seek to establish how financial leverage is interconnected with profitability and financial risk in various industries with different economic realities to establish more knowledge of successful financial management behaviours.

Conclusion

The financial leverage is a factor that is significant in the profitability and financial risk of a company. Debt financing can be used to grow the business hence give firms more investment opportunities and better returns to shareholders. The researchers discovered that financial leverage is positively correlated to measures of profitability, including Return on Equity (ROE), Return on Assets (ROA), and Earnings Per Share (EPS) in the event that the borrowed funds have been utilised effectively in productive investments. Nonetheless, high use of debt is risky in finances as firms are bound to pay interest in a fixed amount whether they are doing well or not. The leverage ratio analysis including Debt Asset Ratio and Debt Equity Ratio reveals that moderate leverage firms have a better financial performance and stay afloat. As such, the ideal capital composition of organizations between debt capital and equity capital should be balanced in its aspect to reduce financial risk and ensure a sustainable long-run growth.

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