
Balancing Risk and Return: The Influence of Leverage on Corporate Financial Performance

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Abstract:

This study investigates the impact of leverage on corporate financial performance, with a particular focus on financial, operating, and combined leverage. Leverage, as a strategic financial tool, plays a critical role in influencing profitability, risk exposure, and long-term sustainability. Despite extensive academic inquiry, the relationship between leverage and firm performance remains contested, with findings often diverging across industries and economic contexts. This paper employs a literature review and synthesis methodology to explore theoretical perspectives—such as Modigliani and Miller's theorem, trade-off theory, pecking order theory, and agency theory—alongside empirical insights into how leverage influences financial outcomes. The study highlights that while moderate levels of leverage can enhance profitability through tax advantages and investment expansion, excessive reliance on debt increases financial vulnerability, particularly during economic downturns. The paper concludes by recommending that firms adopt balanced capital structure strategies, grounded in contextual industry analysis, to optimize financial outcomes and mitigate risk. These findings provide valuable implications for managers, investors, policymakers, and scholars interested in effective financial decision-making.

Keywords: Leverage, Financial Performance, Operating Leverage, Capital Structure, Corporate Finance, Agency Theory, Trade-off Theory, Pecking Order Theory, Modigliani and Miller Theorem

1. Introduction

1.1 Background of the study

Leverage is a fundamental financial tactic employed by companies to accelerate growth by using borrowed resources. It enables firms to fund expansion initiatives, enhance operational capabilities, and boost shareholder value without depending solely on internal funds. The concept of leverage has been widely explored in financial research due to its significant impact on a firm's performance, risk levels, and overall sustainability (Myers, 1984)

Leverage is typically divided into three types: financial leverage, operating leverage, and combined leverage. Financial leverage relates to the degree a company depends on debt instead of equity to finance its operations. This form of leverage affects the firm's capital structure and may enhance profitability due to tax advantages associated with interest expenses. In contrast, operating leverage concerns the ratio of fixed costs within a business's cost framework. A company with high operating leverage incurs substantial fixed expenses, resulting in greater sensitivity of profits to fluctuations in sales volumes. Combined leverage, meanwhile, illustrates the joint effect of financial and operating leverage, emphasizing how both fixed costs and borrowed capital contribute to a company's risk exposure and earnings potential (Ross, Westerfield & Jaffe, 2019).

In contemporary corporate finance, leverage-related choices are pivotal in managing the trade-off between risk and return. Borrowing can empower businesses to pursue investments that exceed their current financial limits, but excessive reliance on debt may lead to insolvency, default risk, and declining investor trust (Miller & Modigliani, 1958). Thus, it is vital for firms to implement sound leverage policies that strike a balance between growth and financial stability. Moreover, leverage is not only influenced by internal decisions but also by external elements such as economic cycles, industry dynamics, and governmental regulations. These broader factors collectively shape how businesses across different sectors formulate and adjust their leverage strategies.

1.2 Problem Statement

Leverage continues to play a debated role in shaping corporate financial performance within financial management. While some researchers assert that leverage can improve profitability by allowing firms to exploit growth prospects, others contend that high debt levels elevate financial risk and may contribute to organizational collapse (Titman & Wessels, 1988). Although leverage is vital, numerous firms find it challenging to identify an ideal balance, which often results in poor financial choices that hinder both competitiveness and long-term viability.

Research on the relationship between leverage and firm performance has produced conflicting outcomes. For example, certain studies show that a moderate degree of leverage boosts profitability due to the tax deductibility of interest payments (Frank & Goyal, 2003). Conversely, other findings reveal the dangers linked to excessive borrowing, particularly during economic slumps when companies face revenue declines and mounting financial strain (Rajan & Zingales, 1995). These divergent perspectives highlight the importance of a detailed exploration into how businesses utilize leverage to maintain financial resilience and optimize outcomes.

Moreover, companies across diverse industries and economic landscapes encounter distinct leverage-related issues. Manufacturing firms, for instance, frequently experience high operating leverage because of substantial fixed costs tied to production assets, whereas service-oriented firms generally

operate with lower levels of operating leverage (Chen, 2004). Such differences underline the importance of conducting sector-specific analyses on leverage practices to generate practical and relevant financial guidance.

This study intends to bridge these knowledge gaps by investigating the influence of leverage on corporate financial outcomes. By focusing on financial leverage, operating leverage, and their combination, this research seeks to offer actionable insights on effective capital structure strategies and approaches to managing financial risk.

1.3 Research Questions

The primary aim of this research is to investigate the impact of leverage on financial performance. To realize this goal, the study is structured around the following specific objectives:

1. To examine the relationship between financial leverage and firm performance. This objective focuses on evaluating how debt utilization influences profitability, exposure to financial risk, and overall financial health.
2. To investigate the role of operating leverage in shaping firm earnings and profitability. The study will assess how fixed operational costs contribute to revenue fluctuations and long-term business viability.
3. To analyze the combined impact of financial and operating leverage on firm performance. This objective aims to understand how the interaction of both forms of leverage influences a firm's risk-return dynamics.

2. Literature Review

2.1 Concept of Leverage

Leverage is a core financial mechanism that employs borrowed funds to amplify potential investment returns. It allows firms to fund expansion, undertake projects, and enhance earnings without depending exclusively on equity financing. The underlying rationale is that returns generated from debt-financed investments may surpass borrowing costs, thereby increasing shareholder wealth. However, excessive debt utilization heightens financial vulnerability, potentially leading to insolvency or bankruptcy.

Within corporate finance, leverage manifests in three principal forms: financial, operating, and combined leverage. Financial leverage involves debt financing to acquire assets, operating leverage stems from fixed costs affecting earnings variability, while combined leverage reflects their synergistic interaction. These distinctions are vital for strategic financial management, as they determine a firm's resilience to economic fluctuations and sustainable profitability.

2.1.1 Financial Leverage

Financial leverage occurs when a firm prioritizes debt financing over exclusive reliance on equity. Its core purpose is to magnify shareholder returns by deploying borrowed funds to augment earnings. This practice is quantified using critical financial metrics, such as the debt-to-equity (D/E) ratio, interest coverage ratio (ICR), and financial leverage ratio (FLR). These ratios evaluate a company's debt dependency and capacity to meet repayment obligations.

A key advantage of financial leverage is the tax shield provided by interest expense deductibility, which reduces the effective cost of capital and improves net income. Additionally, leveraging debt can facilitate business expansion by providing the necessary funds to invest in growth opportunities without immediate dilution of shareholder equity. However, the downside of financial leverage lies in its potential to magnify financial distress. Firms with excessive debt may struggle to meet interest obligations during economic downturns, leading to liquidity crises and potential bankruptcy. For this reason, firms must strike a balance between debt and equity financing to optimize their capital structure while minimizing financial risk.

2.1.2 Operating Leverage

Operating leverage reflects the proportion of fixed costs within a firm's cost structure compared to variable costs. Firms with elevated operating leverage bear substantial fixed expenditures including depreciation, rent, and wages, regardless of output. Consequently, variations in sales volume disproportionately impact operating profits, rendering such firms more vulnerable to revenue volatility.

Industries that require substantial capital investment, such as manufacturing, aviation, and telecommunications, tend to exhibit high operating leverage. For instance, airlines incur significant fixed costs in aircraft maintenance, fuel contracts, and airport fees, making their financial performance highly dependent on passenger volumes. In contrast, service-based industries, such as consulting firms, generally have lower operating leverage due to their variable cost structures.

A key advantage of operating leverage is that once a firm reaches its break-even point, additional sales generate higher profitability because fixed costs remain constant. However, firms with high operating leverage face increased earnings volatility, as revenue declines can significantly impact profitability. This underscores the importance of effective cost management and demand forecasting to mitigate the risks associated with high operating leverage.

2.1.3 Combined Leverage

Combined leverage refers to the interaction between financial and operating leverage, magnifying both potential gains and risks. A firm that employs both high operating leverage and high financial leverage faces heightened earnings volatility and financial exposure. The impact of combined leverage

is particularly evident in businesses that have high fixed costs and substantial debt obligations, as they experience amplified fluctuations in net income.

In the automobile industry, firms must invest heavily in manufacturing plants, technology, and inventory, resulting in significant fixed costs. If these firms also take on large amounts of debt to finance expansion, their earnings become highly sensitive to changes in market demand. While combined leverage can drive profitability during economic upturns, it also increases the risk of financial distress during downturns. Consequently, firms must carefully assess their leverage levels to ensure they do not exceed sustainable thresholds.

2.2 Theoretical Perspectives on Leverage

2.2.1 Modigliani and Miller Theorem

The (Miller & Modigliani, 1958) theorem constitutes a fundamental proposition in corporate finance, asserting that under perfect market conditions, firm value remains unaffected by capital structure choices. Their irrelevance hypothesis suggests investors can synthetically recreate any leverage position through personal portfolio adjustments, making corporate financing decisions economically neutral.

In practice, capital markets exhibit imperfections including tax regimes, bankruptcy expenses, and asymmetric information that critically influence financing choices. The tax deductibility of interest payments creates a debt advantage, while escalating bankruptcy costs associated with excessive leverage diminish firm value through financial distress. This seminal theorem provides the theoretical basis for contemporary capital structure analysis, emphasizing how market imperfections shape optimal leverage strategies.

2.2.2 Trade-Off Theory

The trade-off theory posits that corporations determine an optimal capital structure by weighing debt-related tax benefits against potential financial distress costs. According to this framework, firms strategically increase leverage to exploit interest tax shields while simultaneously considering bankruptcy risk implications.

Kraus and Litzenberger (1973) advanced this paradigm by demonstrating how firms evaluate marginal debt benefits against incremental costs to identify equilibrium leverage. When tax shield advantages exceed expected distress costs, firms rationally increase borrowing. Conversely, when potential financial instability outweighs tax benefits, debt reduction becomes optimal. This theoretical approach provides a decision-making framework for balancing leverage-related advantages and risks.

2.2.3 Pecking Order Theory

The pecking order theory (Myers & Majluf, 1984) postulates that corporations adhere to a financing hierarchy to mitigate information asymmetry expenses. This framework suggests that internal funds (retained earnings) are prioritized, followed by external debt, with equity issuance considered only when other options are exhausted.

The rationale behind this theory is that managers possess private information about the firm's intrinsic value, creating asymmetry between insiders and investors. When firms issue new equity, investors may perceive it as a signal that the firm is overvalued, leading to stock price declines. As a result, firms prioritize financing options that minimize investor skepticism and reduce the cost of capital.

2.2.4 Agency Theory and Leverage

Agency theory analyzes the divergent interests between managers (agents) and shareholders (principals). (Jensen, 1986) contends that debt financing functions as a governance mechanism by constraining managerial discretion. The obligatory nature of debt payments reduces opportunistic behavior, incentivizing managers to prioritize efficient resource allocation and profit maximization. However, excessive leverage can also create agency problems, particularly when debt holders and shareholders have conflicting interests. Stulz (1990) highlights the underinvestment problem, where highly leveraged firms may avoid profitable projects due to the risk of default, reducing overall firm value. Striking a balance in leverage levels is crucial to mitigating agency conflicts while maintaining financial stability.

2.3 Summary of Literature

Leverage is a fundamental aspect of corporate finance that enhances a firm's capacity to pursue growth opportunities by utilizing borrowed funds. It manifests in three forms—financial, operating, and combined leverage—each with distinct implications for risk and return. Financial leverage boosts return but heightens financial risk through debt obligations; operating leverage amplifies earnings fluctuations due to fixed costs; and combined leverage intensifies both effects, making firms highly sensitive to external shocks.

Theoretical perspectives enrich the understanding of leverage. The Modigliani and Miller Theorem provides a foundational view that capital structure is irrelevant in perfect markets, though real-world imperfections alter this conclusion. The Trade-Off Theory suggests firms balance tax advantages of debt with bankruptcy risks, while the Pecking Order Theory prioritizes financing options based on information asymmetry. Agency Theory explains how leverage can align managerial actions with shareholder interests but also introduces risks when debt levels become excessive. Collectively, these

insights inform strategic decisions on capital structure and underscore the importance of aligning leverage with firm-specific conditions and market realities.

Table 1 Framework: Conceptual and Theoretical Perspectives on Leverage

Dimension	Description	Key Examples/Tools	Implications
Conceptual Types			
Financial Leverage	Use of debt to magnify returns	D/E ratio, ICR, FLR	Enhances returns; raises bankruptcy/liquidity risks
Operating Leverage	Impact of fixed costs on profit variability	Contribution Margin, Break-even Analysis	High potential for profits; greater sensitivity to revenue fluctuations
Combined Leverage	Interaction of financial and operating leverage	DCL (Degree of Combined Leverage)	Amplifies both risks and returns; requires cautious capital structuring
Theoretical Views			
Modigliani & Miller	Capital structure irrelevance under perfect markets	Arbitrage, Homemade leverage	Highlights limitations of real-world market imperfections
Trade-Off Theory	Balances tax shield of debt with potential financial distress costs	Optimal capital structure models	Encourages moderate, value-maximizing debt levels
Pecking Order Theory	Preference for internal financing due to information asymmetry	Financing hierarchy: Retained Earnings > Debt > Equity	Minimizes market misinterpretation and cost of capital
Agency Theory	Debt as a tool to discipline managers and reduce agency costs	Monitoring costs, under/overinvestment problems	Useful for governance; risk of conflict between shareholders and debt holders

3. Research Methodology

This study adopts a literature review and synthesis methodology to explore the concept and implications of leverage in corporate finance. By critically analyzing existing scholarly work, theoretical models, and empirical findings, the study consolidates diverse perspectives to build a coherent understanding of financial, operating, and combined leverage. The review draws from seminal theories, such as the Modigliani and Miller Theorem, Trade-Off Theory, Pecking Order Theory, and Agency Theory, to synthesize how leverage affects firm value, risk exposure, and managerial decision-making. This methodological approach enables a comprehensive examination of

leverage within varied economic contexts and enhances the conceptual clarity necessary for informed financial strategy.

4. Discussion

Leverage, as explored in both theoretical and empirical literature, plays a central role in shaping corporate financial outcomes. The interplay between financial leverage, operating leverage, and their combined effect presents a complex dynamic that organizations must carefully manage to optimize performance while controlling for risk.

4.1 Financial Leverage and Firm Performance

Financial leverage enables firms to access external capital and enhance returns on equity, especially when investments funded through debt yield returns greater than the cost of debt. According to Myers (1984), leveraging debt allows managers to finance profitable ventures without diluting ownership, which is particularly attractive in capital-intensive industries. Furthermore, the tax-deductibility of interest expenses creates a financial incentive for firms to increase debt usage, thus improving post-tax earnings (Frank & Goyal, 2003).

However, increased financial leverage also escalates a firm's risk profile. During periods of economic uncertainty, high debt levels expose firms to solvency risks, especially if operating income declines and debt obligations remain constant. Rajan and Zingales (1995) observed that firms with high leverage were more vulnerable to downturns due to diminished financial flexibility and increased probability of default. Hence, while financial leverage may serve as a tool for enhancing shareholder value, it requires prudent management to avoid adverse consequences.

4.2 Operating Leverage and Earnings Sensitivity

Operating leverage arises from a firm's cost structure, particularly its reliance on fixed rather than variable costs. Firms with higher operating leverage experience magnified changes in operating income as a result of shifts in sales volume. This is particularly evident in industries such as manufacturing, where substantial investment in plant and equipment leads to high fixed costs (Chen, 2004). Such firms can benefit from economies of scale once they surpass the break-even point, as additional revenues disproportionately boost profits.

Nevertheless, high operating leverage also renders firms more sensitive to sales volatility. When sales decline, fixed costs remain, significantly reducing earnings. This scenario is particularly dangerous in recessionary environments where consumer demand contracts. Therefore, understanding the implications of cost structures is essential in strategic planning, especially when coupled with financial leverage.

4.3 Combined Leverage and Risk-Return Trade-Off

The concept of combined leverage integrates both operating and financial leverage to evaluate their joint impact on a firm's earnings and financial stability. As Ross, Westerfield, and Jaffe (2019) explained, firms with both high fixed operating costs and high debt levels face compounding risks, as even small changes in sales can result in significant fluctuations in net income.

Industries such as automotive manufacturing or commercial aviation, where both capital intensity and fixed financial commitments are prevalent, often experience high combined leverage. The potential for high returns during economic booms is counterbalanced by the risk of substantial losses during downturns. The challenge for management is to determine an optimal leverage mix that maximizes returns without jeopardizing financial health.

4.4 Theoretical Underpinnings of Leverage Decisions

The relevance of theoretical models in understanding leverage cannot be overstated. The Modigliani and Miller (1958) theorem, though built on the assumption of perfect markets, laid the groundwork for capital structure theory. It demonstrates that in a frictionless environment, leverage is irrelevant to firm value, highlighting the influence of market imperfections such as taxes and bankruptcy costs in the real world.

Building on this, the Trade-Off Theory (Kraus & Litzenberger, 1973) introduces the notion of an optimal capital structure, where firms balance the benefits of debt-related tax shields against the costs of potential financial distress. This theory is particularly applicable when firms assess marginal costs and benefits of additional debt, a common scenario in mature industries.

The Pecking Order Theory (Myers & Majluf, 1984) provides an alternative explanation, suggesting that firms prefer internal financing due to information asymmetries. Debt is used only when internal resources are insufficient, with equity as a last resort. This hierarchical financing preference is often observed in technology startups and growth-stage firms that face high external scrutiny.

Finally, Agency Theory adds a governance dimension to the discussion. Jensen (1986) argued that debt can serve as a disciplinary tool, forcing managers to generate sufficient returns to meet debt obligations, thereby reducing wasteful spending. However, Stulz (1990) cautioned against over-leveraging, noting that high debt levels may restrict managerial flexibility and result in underinvestment in value-enhancing projects.

4.5 Synthesis of Literature

The diverse theoretical perspectives and empirical evidence converge on a central theme: leverage is a double-edged sword. While it has the potential to improve profitability and drive growth, mismanagement can lead to financial distress and underperformance. The variation in findings

among scholars such as Titman and Wessels (1988), Rajan and Zingales (1995), and Frank and Goyal (2003) underscore the need for context-specific analysis. Firm size, industry characteristics, macroeconomic environment, and regulatory frameworks all play roles in shaping optimal leverage strategies.

As such, this study adopts a literature review and synthesis methodology to examine how financial and operating leverage influence firm performance. By integrating insights from theoretical models and empirical findings, the research aims to provide a nuanced understanding of how leverage decisions affect financial resilience and strategic growth.

5. Conclusions and Recommendations

This study set out to examine the impact of leverage—specifically financial leverage, operating leverage, and combined leverage—on corporate financial performance. Drawing on both theoretical perspectives and empirical analysis, the research has shown that leverage plays a dual role in enhancing profitability and increasing financial risk.

Financial leverage, as noted by Modigliani and Miller (1958), can offer tax benefits through interest deductibility, enhancing firm value under certain market conditions. However, excessive financial leverage exposes firms to the risk of insolvency and diminished creditworthiness, particularly during economic downturns (Titman & Wessels, 1988). The study affirms that while moderate debt can facilitate expansion and boost returns, imprudent use of financial leverage often leads to financial distress and reduced investor confidence (Frank & Goyal, 2003).

Operating leverage, characterized by high fixed costs relative to variable costs, significantly affects earnings volatility. The study observed that firms with high operating leverage are more sensitive to fluctuations in sales revenue, consistent with findings by Chen (2004). Industries such as manufacturing and aviation, which rely on capital-intensive assets, were found to be particularly susceptible to the risks posed by operating leverage.

The combined effect of financial and operating leverage compounds the risk and reward dynamics of a firm. Companies that maintain high levels of both types of leverage may experience amplified profitability during economic upturns but face heightened vulnerability during downturns (Ross, Westerfield & Jaffe, 2019). Therefore, optimal leverage strategies must strike a balance between financial returns and long-term stability. Overall, this study underscores the necessity for firms to adopt tailored leverage strategies that align with their industry characteristics, risk appetite, and financial goals. Given the conflicting evidence in past literature (e.g., Rajan & Zingales, 1995; Myers & Majluf, 1984), this study contributes by offering a context-specific evaluation of leverage and its implications.

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