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THE EFFECT OF FINANCIAL LEVERAGE ON FIRM PERFORMANCE: EVIDENCE FROM MALAYSIAN LISTED COMPANIES

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Abstract:

Financial leverage is a significant financing decision which affects firms' capital structure and their financial performance. However, the findings from the previous empirical studies are inconsistent on the relationship between financial leverage and firm performance especially in the Malaysian context. Thus, the purpose of this study is to investigate the relationship between financial leverage and firm performance of Malaysian listed companies in the period of COVID-19 and post-COVID-19. The research design of this research is quantitative research, and the data used in this research is secondary data which was obtained from the LSEG Refinitiv database. The sample is 116 Malaysian listed companies, which amounted to 695 firm-year observations in the period of 2020–2025. Panel data regression analysis was used to analyse the relationship between financial leverage and firm performance in terms of return on assets (ROA) and return on equity (ROE). The results indicate that financial leverage has a negative and insignificant relationship with ROA ($\beta = -0.0089$, $p = 0.845$) and a positive and significant relationship with ROE ($\beta = 0.4572$, $p < 0.001$). The results obtained in this paper offer recent Malaysian evidence that the relationship between financial leverage and firm performance varies when adopting different measures of firm performance. The findings can help corporate managers and investors in evaluating their debt

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financing decisions given the distinct relationship between the use of debt financing and asset-based profitability and shareholders' returns.

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Financial Leverage; Firm Performance; Return on Assets; Return on Equity; Malaysian Listed Companies.

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Introduction

Financial leverage is a significant factor that is involved in the capital structure of the company and its financial sustainability (Myers, 1984). It indicates the degree of dependence on debt financing that a company has and is used to fund the day-to-day operations of the business and expansion. Debt can improve firm growth and profitability, but if it exceeds a certain amount then it can result in financial risk and low performance of the firm. Hence, to ensure sustainable financial performance, it is important that financial leverage is kept at an optimum level.

The world has been undergoing significant changes in the last couple of years following the COVID-19 pandemic, rising inflation and increasing interest rates, making the global business environment more uncertain. Businesses are still under financial stress, as borrowing rates stay high in Malaysia. Bank Negara Malaysia (2025) reports that financing conditions continued to be conducive to business needs, as businesses continued to access a stable mix of financing sources. But the central bank also noted that businesses are still operating under difficult conditions due to high costs, geopolitical uncertainties and developments in the international trade policy landscape, which could affect companies' financing decisions and financial performance. These economic conditions make financial leverage an important issue for firms, especially in emerging markets like Malaysia where debt financing is still one of the common sources of capital.

Hence, it is very important for the managers, investors and the policymakers to understand the impact of financial leverage on the firm's performance. Many researchers have explored the effect of financial leverage on company's performance, but results are conflicting. Some studies indicated that financial leverage could improve the company's performance by providing tax benefits, reduced cost of capital, and greater investment opportunities (Zaidi & Abd Kadir, 2024; Qurochman & Putra, 2024). Other studies, however, indicated that high

leverage negatively affects the firm's performance because of high financing costs, financial distress, and bankruptcy risk (Alabdulkarim et al., 2024; Nguyen et al., 2024). The above conflicting results suggest that the linkage between financial leverage and firm performance is still not clear and hence requires further investigation.

Previous research in Malaysia has examined the link between capital structure and firm performance during the pre-pandemic and COVID-19 periods (Shaari & Nik Kamarudin, 2024; Zaidi & Abd Kadir, 2024). Although these studies generate valuable empirical evidence, most were conducted prior to or during the COVID-19 period. In view of the changing economic picture and funding conditions over the past few years, new empirical evidence. To understand if the relationship between financial leverage and firm performance is uniform across Malaysian listed firms, firm-level data is needed.

Therefore, the study will analyse the relationship between financial leverage and firm performance, measured separately by return on assets (ROA) and return on equity (ROE), of Malaysian listed companies for the period of 2020–2025. The findings are expected to be useful and informative to managers, investors and policymakers for financing decisions in the changing economic landscape in Malaysia and to the corporate finance literature as well.

Literature Review

This section reviews the literature on financial leverage and firm performance. Specifically, it covers the theoretical foundation, financial leverage, firm performance, the relationship between financial leverage and firm performance and the development of the research hypothesis.

Trade-off Theory

One of the most widely accepted theories for the capital structure decision of the firms is the Trade-off Theory. The theory suggests that companies have an optimal amount of debt such that the advantages of debt financing are offset by the costs of debt financing. The main benefit of debt financing is the tax shield from the interest paid, which may lower the overall cost of capital for a firm, and increase the value of the firm. However, excessive borrowing can create financial distress costs, agency costs, and a risk of bankruptcy, which could hurt performance (Myers, 1984).

The theory presumes that the firm will have an optimal capital structure in which the marginal benefit and the marginal cost of debt are equal. Debt financing can enhance firm performance at lower levels of leverage due to the availability of extra financial resources for investment and expansion. However, if leverage is used above the optimal level, the additional financing costs and financial risks may outweigh its benefits, leading to a decline in profitability. Thus, Trade-off Theory can theoretically account for the positive and negative relationship of financial leverage and the firm's performance found in previous empirical studies.

Financial Leverage

Financial leverage is a measure of the amount of debt financing a firm uses to carry on its business or investment activities. It is most often expressed through the debt-to-total-assets ratio that indicates the percentage of a firm's assets financed through debt. Financial leverage

helps businesses to access more capital without giving up equity, thus supporting growth and enhancing efficiency. In addition, debt financing can provide certain tax advantages as interest is a deductible expense and can lead to higher shareholders' returns.

Although there are many benefits to financial leverage, the levels of leverage can be so high that they present the firm with increased financial risk. An increase in debt could lead to higher interest costs and debt servicing obligations, which can reduce profitability and weaken financial flexibility in times of economic uncertainty. Therefore, it is crucial to maintain financial leverage at the optimal level so as to ensure sustainable financial performance and avoid the risk of experiencing financial distress (Myers, 1984).

Firm Performance

Firm performance is an indication of a firm's effectiveness in using its resources to produce profits and increase the wealth of shareholders. The typical measures of financial performance include accounting-based measures like Return on Assets (ROA) and Return on Equity (ROE). ROA measures management's efficiency in using total assets to generate earnings, while ROE compares the return earned on shareholders' equity.

ROA and ROE have become popular measures in corporate finance research because they provide comprehensive indicators of the efficiency and profitability of a company. Financial leverage has a direct effect on financing costs and interest expenses and influences capital structure decisions, and therefore its impact is expected to be reflected in both ROA and ROE. Thus, in this study, these two indicators are used for measuring firm performance.

Financial Leverage and Firm Performance

The empirical results have been mixed concerning the effect of financial leverage on the firm performance. Financial leverage has been found to have a positive effect on the performance of the firms in several studies. For example, Arhinful and Radmehr (2023) conducted a study on the impact of financial leverage on the financial performance of non-financial corporations listed on the Tokyo Stock Exchange in Japan and discovered that financial leverage significantly improved their financial performance. Likewise, Ima et al. (2024) found that an optimal level of leverage boosted the profitability of Bangladeshi firms by improving financing efficiency. Similarly, Zaidi and Abd Kadir (2024) reported that there is a positive association between financial leverage and firm performance for Malaysian pharmaceutical firms. More recently, Ong et al. (2025) concluded that leverage had a positive relationship with both ROA and ROE of Malaysian technology companies, providing further evidence that the leverage-performance relationship may vary across industries and performance measures. Similar findings were also reported by Qurochman and Putra (2024) and Mutumanikam and Adelin (2024), indicating that debt financing can be beneficial for firm profitability if it is managed efficiently.

However, other studies showed that high financial leverage adversely affects the performance of a firm. Alabdulkarim et al. (2024) concluded that high leverage had a negative impact on firm performance among Saudi Arabian firms due to increased financial distress and financing costs. In addition, Nguyen Le Hoa Tuyet and Le Khuong Ninh (2024) documented that the over-leveraging of firms negatively affected the performance of firms in Vietnam. Khan et al. (2024), Morais et al. (2024) and Monday and Dopemu (2024) also reported similar evidence,

concluding that high debt financing is associated with high financial risk and reduces the profitability of firms.

Empirical evidence is also inconclusive in the Malaysian context. Mohd Shaari and Nik Kamarudin (2024) discovered that the impact of the capital structure on firm performance differed during the COVID-19 period, implying that shifts in economic conditions may affect firm's financing decisions. In contrast, Zaidi and Abd Kadir (2024) reported that the financial leverage of Malaysian pharmaceutical companies was positively linked to the company's performance. Previous Malaysian findings were also inconclusive. Jee et al. (2021), for instance, with Malaysian listed plantation companies, investigated the relationship between capital structure and both ROA and ROE, and their findings revealed that the relationship between each of them varied across different debt measures and performance indicators. The mixed results indicate that the effect of financial leverage could be different based on industry, firm characteristics and economic conditions.

Thus, it is concluded that, despite the increasing number of publications, the relationship between financial leverage and firm performance in Malaysia remains inconclusive. Given existing Malaysian evidence, the relationship could vary from industry to industry, measure to measure, and economic climate to economic climate. Furthermore, many of the prior studies used pre-pandemic data, or data for the COVID-19 period; there is limited evidence in the literature that uses more recent firm-level data. Besides, it is also questionable whether the impact of financial leverage is the same for asset-based performance (ROA) and shareholder-based performance (ROE) for Malaysian listed companies. To fill this gap, this study examines the relationship between financial leverage and ROA and ROE separately and analyses them based on data from 2020–2025.

Hypothesis Development

According to Trade-off Theory, an optimal level of financial leverage enables firms to maximise firm value by balancing the tax benefits of debt financing against the costs of financial distress (Myers, 1984). However, the results of earlier empirical studies have been inconsistent on the relationship between financial leverage and firm performance. Some researchers reported that there is a positive relationship, while others reported that over-leveraging has a negative effect on profitability. In view of these mixed results and the evolving financing environment in Malaysia, this paper revisits the link between financial leverage and firm performance of Malaysian listed companies.

H1a: Financial leverage has a significant relationship with return on assets (ROA) among Malaysian listed companies.

H1b: Financial leverage has a significant relationship with return on equity (ROE) among Malaysian listed companies.

Methodology

Research Design

This study takes a quantitative research approach in studying the relationship between financial leverage and firm performance for Malaysian listed companies. Secondary data were used

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because they offer objective, reliable and publicly available financial data to be used in an empirical analysis. The data were collected from the LSEG Refinitiv database as the database is known to provide comprehensive data on financial information and is known to be consistent and widely used in accounting and corporate finance research. The data used in the study were panel data from 2020 to 2025 in order to observe the firm-level observations on a temporal basis.

Sample Selection

The population of this study comprises public listed companies in Malaysia listed on Bursa Malaysia. Purposive sampling is used which is based on availability of complete information on financial leverage, ROA, ROE, firm size, firm age and liquidity ratio throughout the study period. The sample comprises listed companies in Malaysia and includes all available industries without excluding any industry from the analysis. In the sample, companies that did not have complete information about the variables needed were not included. After screening and data cleaning, the final sample size comprised 116 Malaysian listed firms, with 695 firm-year observations.

Variable Measurement

Firm performance is used as the dependent variable in this study, which is proxied by return on assets (ROA) and return on equity (ROE). Financial leverage is the independent variable and is calculated by dividing total debt by total assets. Furthermore, firm size, firm age and liquidity ratio are also added as control variables since they have been used in many previous studies on firm performance. Table 1 summarises the measurement of all variables used in this study.

Table 1: Measurement of Variables

Variable	Type	Measurement	Source
ROA	Dependent	Net income / Total assets	Refinitiv
ROE	Dependent	Net income / Shareholders' equity	Refinitiv
Leverage	Independent	Total debt / Total assets	Refinitiv
Firm Size	Control	Natural logarithm of total assets	Refinitiv
Firm Age	Control	Number of years since incorporation	Refinitiv
Liquidity Ratio	Control	Current assets / Current liabilities	Refinitiv

Source: Authors' own compilation based on LSEG Refinitiv database and previous literature.

Result and Discussion

Correlation Analysis

Table 3 reports the Pearson correlation coefficients among the study variables.

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Table 3: Pearson Correlation Matrix

Variable	ROA	ROE	Leverage	Firm Age	ln (Firm Size)	Liquidity Ratio
ROA	1.000					
ROE	0.772***	1.000				
Leverage	-0.070	0.274***	1.000			
Firm Age	0.033	0.086**	0.025	1.000		
Ln (Firm Size)	-0.217***	-0.162***	0.216***	0.213***	1.000	
Liquidity Ratio	0.075**	-0.107***	-0.628***	-0.074	-0.235***	1.000

Note: *** $p < 0.01$; ** $p < 0.05$
Mean VIF = 1.38
Source: Authors' computation using Stata 17.

Financial leverage is negatively related to ROA as presented in Table 3 but is positively related to ROE. The results in Table 3 show that financial leverage is negatively related to ROA and positively related to ROE. Leverage and liquidity ratio showed a relatively strong negative correlation (r = -0.628) while the mean VIF value was 1.38 which showed no evidence of multicollinearity in the present study. Thus, all the independent variables are kept for the next regression analysis.

Hausman Test

Table 4 presents the results of the Hausman specification test.

Table 4: Hausman Test Results

Dependent Variable	Chi-square	Prob > Chi-square	Selected Model
ROA	60.53	0.0000	Fixed Effects
ROE	8.85	0.0649	Random Effects

Source: Authors' computation using Stata 17.

Results of the Hausman test suggest the Fixed Effects model is the best model for the ROA model ($p < 0.001$) and the Random Effects model is the best model for the ROE model ($p = 0.0649$). Thus, the Fixed Effects estimator is used for ROA, and the Random Effects estimator is used for ROE.

Regression Results

Table 5 presents the regression results for the ROA model.

Table 5: Fixed Effects Regression Results (Dependent Variable: ROA)

Variable	Coefficient	Std. Error	t-value	p-value
Leverage	-0.0089	0.0454	-0.20	0.845
Ln (Firm Size)	0.0664***	0.0166	3.99	0.000
Firm Age	-0.0069***	0.0017	-4.00	0.000

Liquidity Ratio	-0.0178***	0.0035	-5.04	0.000
Constant	-1.1698***	0.3419	-3.42	0.001

Model Statistics	**Value**
Observations	695
Number of Firms	116
R^2 (Within)	0.0898
F-statistic	14.19***

*** $p < 0.01$

Source: Authors' computation using Stata 17.

The results of the fixed effects regression analysis of the relationship between financial leverage and return on assets (ROA) are shown in Table 5. The results of the fixed effects regressions for the ROA model are reported in Table 5. The findings show that although financial leverage is negatively associated with ROA, it is not significant (β = -0.0089, p = 0.845). Thus, Hypothesis H1a is not supported as financial leverage does not seem to have a significant effect on the operational performance of the firms.

The control variables indicate that firm size is positive and statistically significant for ROA (β = 0.0664, $p < 0.01$), imply that larger firms tend to use their assets more efficiently to generate profit. Conversely, firm age ($\beta = -0.0069$, $p < 0.01$) and liquidity ratio ($\beta = -0.0178$, $p < 0.01$) exhibit significant negative relationships with ROA. The results suggest that firms with higher liquidity and older firms may use their assets less efficiently. In addition, the overall model is statistically significant ($F = 14.19$, $p < 0.001$), which means that the overall group of explanatory variables explains the variation in firms' return on assets.

Table 6 presents the regression results for the ROE model.

Table 6: Random Effects Regression Results (Dependent Variable: ROE)

Variable	**Coefficient**	**Std. Error**	**z-value**	**p-value**
Leverage	0.4572***	0.0749	6.10	0.000
Ln (Firm Size)	-0.0504***	0.0115	-4.36	0.000
Firm Age	0.0015	0.0009	1.59	0.112
Liquidity Ratio	-0.0016	0.0070	-0.22	0.824
Constant	1.0201***	0.2530	4.03	0.000

Model Statistics	**Value**
Observations	695
Number of Firms	116
Wald χ^2	62.43***

*** $p < 0.01$

Source: Authors' computation using Stata 17.

The results of the random effects regression for return on equity (ROE) are reported in Table 6. The results show that financial leverage has a positive and statistically significant effect on ROE ($\beta = 0.4572$, $p < 0.001$). This suggests that companies that are more highly leveraged tend to have higher ROEs. Hence, Hypothesis H1b is supported.

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Turning to the control variables, firm size is statistically significant and has a negative relationship with ROE ($\beta = -0.0504$, $p < 0.01$), which implies that larger firms are likely to earn a relatively lower return on shareholders' equity. On the other hand, firm age and liquidity ratio are not statistically significant, implying that these variables do not have a significant effect on ROE of the sampled firms. Overall, the model is statistically significant (Wald $\chi^2 = 62.43$, $p < 0.001$), indicating that the independent and control variables selected in this study account for the differences in firms' ROE.

Discussion

Results indicate that financial leverage has mixed relationships with firm's performance based on the performance indicator used. It was found that financial leverage has no significant relationship with ROA which implies that the debt financing is not necessarily associated with the improvement of firms' operational efficiency in generating returns from assets. This may be due to the increased cost of financing as well as the increased interest liability that outweighs the benefit of financing via the use of debt. This means that increased borrowing does not necessarily lead to an improvement in profitability as measured by ROA. The results align with Alabdulkarim et al. (2024), who noted that excessive leverage does not necessarily improve firms' operational performance as it is accompanied by higher financing costs and financial distress.

On the other hand, there is a positive and statistically significant relationship between financial leverage and ROE. This indicates that the companies with higher financial leverage are more likely to have higher ROE which might be due to tax benefits and utilisation of capital. The result is in keeping with the Trade-off Theory (Myers, 1984) which states that firms can maximise firm value by maintaining an optimal level of debt. This is also in line with the results of Arhinful and Radmehr (2023), Ima et al. (2024), and Zaidi and Abd Kadir (2024) who also showed that the use of appropriate leverage enhances the return to the shareholders.

The results show that the relationship between financial leverage and firm performance varies with the indicator of firm performance used. The result of the hypothesis testing in this study is summarised in Table 7.

Table 7: Summary of Hypothesis Results

Hypothesis	Decision
H1a: Financial leverage has a significant relationship with ROA	Not Supported
H1b: Financial leverage has a significant relationship with ROE	Supported

Conclusion

This research examined the relationship between financial leverage and the firm performance of Malaysian listed companies based on financial leverage data for 116 companies in the period of 2020–2025. The results obtained from the use of panel regression analysis show that financial leverage is not significantly related to return on assets (ROA) while it is positively and significantly related to return on equity (ROE). This result indicates that there is no significant relationship between the financial leverage and operational efficiency (ROA), but there is a significant relationship between financial leverage and shareholders' return (ROE).

The results also show that firm size, firm age and liquidity ratio influence firm performance, although their effects differ across performance measures. This study makes two contributions to the corporate finance literature in Malaysia. First, it offers new firm-level evidence for the period 2020–2025, which includes the COVID-19 pandemic and the post-pandemic adjustment. Second, the study examines ROA and ROE separately and shows that the relationship between financial leverage and firm performance differs depending on the performance measure that is used. Financial leverage is not significantly related to asset-based profitability but is positively related to shareholder-based returns.

Practically, corporate managers can apply these results in analysing the trade-off between debt financing and firm performance. Financial leverage has a positive relationship with ROE, which means that higher leverage may be linked to higher ROE, while the relationship between financial leverage and ROA is not significant, which means that there is no clear relationship between the increase in financial leverage and the increase in ROA. Investors can thus consider financial leverage along with both ROA and ROE in assessing the financial performance of firms. The results give policymakers fresh insights into the relationship between firm financing decisions and various aspects of firm performance in Malaysia.

However, there are some limitations of this study. First, this study is limited to Malaysian listed companies only, and the findings may not be applicable to companies in other countries or private companies. Second, firm performance is only measured using accounting-based measures, namely ROA and ROE. Future research can be conducted using market-based performance measures such as Tobin's Q or market value and including more firm-specific or macroeconomic variables to gain a fuller picture of the link between financial leverage and firm performance.

The overall results suggest that firms need to maintain an appropriate level of financial leverage in relation to firm performance, while financial risk should be minimised during heightened uncertainty in the economic environment.

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Author Contribution Statement: All authors contributed to the conception and design of the study. The manuscript was prepared collaboratively, with all authors providing intellectual input, reviewing the manuscript critically, and approving the final version for publication.

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