



DOI: <https://doi.org>

Journal of Accounting, Finance & Business Insights

Journal homepage: <https://rjsaonline.org/index.php/JAFBI>



Effect of Financial Leverage on Corporate Profitability: The Role of Firm Size and Asset Growth

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ARTICLE INFO

Received:

January 28, 2026

Revised:

February 26, 2026

Accepted:

March 15, 2026

Available Online:

March 24, 2026

Keywords:

monetary leverage, company
Lucreteness, company
length, asset increase, panel
statistics, fixed-consequences
version, go back on property,
Pakistan Stock Exchange,
capital shape, debt ratio.

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ABSTRACT

This paper examines the connection among economic leverage and company profitability, in which the scale of the company and growth of belongings are moderating and manage variables respectively, in a panel version. The trouble of debt and lucrativness has been at the centre of the company finance idea and empirical proof approximately the difficulty has been inconclusive in numerous monetary settings and company attributes. This observe makes use of panel regression evaluation the usage of fixed-results and random-results fashions using secondary information acquired with the aid of using the 2015-2024 annual monetary document of forty non-monetary corporations indexed withinside the Pakistan Stock Exchange to decide the effect of debt financing at the go back on property and the way the connection is moderated with the aid of using organization length and asset boom dynamics. Results suggest that monetary leverage has a sturdy bad effect on company profitability, company length indicates a moderating high quality effect and asset increase indicates a robust wonderful effect. The Hausman check proved the higher version withinside the fixed-outcomes version as compared to the random-outcomes one. The studies suits the modern-day frame of literature at the capital shape and organization overall performance withinside the context of growing economies and presents beneficial recommendation to company monetary managers and policymakers.

Introduction

The correlation of financial leverage and corporate profitability is one of the most widely discussed and empirically argued fields of corporate finance. The overall concept of financial leverage as the degree to which a firm finances its operations using debt as compared to equity in its capital structure has multifaceted effects on firm performance by both creating potential tax shield benefits on interest payments and creating risks due to fixed financial obligations that must be paid regardless of the performance of the operations (Modigliani and Miller, 2008). Leverage and profitability The importance of leverage in determining profitability outcomes is thus a necessary comprehension of corporate financial managers in formulating optimal capital structures but also of investors, creditors and regulators who would want to gauge the financial strength and risk profile of a firm.

Theoretical bases of analyzing leverage-profitability nexus are based on various competing frameworks which provide different forecasts as to the direction and significance of this relationship. According to the trade-off theory, companies set the trade-offs between the tax advantages of debt and the cost of financial distress such that at an optimal level of leverage, further debt may decrease the value and profitability of firms (Frank and Goyal, 2009). According to the pecking order theory, companies tend to finance themselves internally instead of using external funds, and it is only when other firms cannot meet their needs through internal capital that they will issue debts, which means that leverage and profitability are negatively related as more profitable companies will use less debt (Myers and Majluf, 2014). The agency cost theory further adds the element of managerial incentive alignment where moderate leverage is expected to discipline managerial behavior as

well as to alleviate issues of free cash flows and is likely to increase profitability by increasing the efficiency of resource allocation (Jensen, 2006).

Although these theoretical frameworks are rich, empirical studies of leverage-profitability relationship have yielded mixed results in various economic settings, industry setting, and time. Research in developed market economies has typically observed negative leverage-profitability relations, which are in line with the predictions of pecking order; and evidence in emerging and developing economies is more mixed, with institutional factors, market imperfections, and financial system characteristics mediating the relationship in different ways (Rajan and Zingales, 2015). This irregularity highlights the significance of context-dependent empirical research, especially in emerging economies with underdeveloped capital markets, highly concentrated forms of ownership, inaccessible to long-term debt financing.

The size of the firm and asset growth are two important firm-level attributes that mediate the leverage-profitability relationship. The size of a firm impacts leverage choices by having different access to capital markets, collateral access, and have economies of scale in the issuance of debt with larger firms usually having a greater ability to withstand costs of financial leverage that are not proportionally reflected in loss of profits (Rajan and Zingales, 2015). Asset growth, which is a factor in the rate at which firms increase their asset base, creates the dynamic aspect into the leverage-profitability relationship, in that, fast growing firms can be in need of more debt financing whilst the pressure of profitability of increased operational commitments (Titman and Wessels, 2008).

A particularly useful empirical setting to this exploration would be the Pakistan Stock Exchange. The PSX being one of the major capital markets in South Asia is a wide-ranging environment that includes a variety of non-financial firms, which are involved in manufacturing, energy, textile, and services and have unique leverage characteristics and profitability dynamics. The 2015-2024 is one of the periods having major macroeconomic events in terms of currency depreciation, inflation, and interest rates fluctuations that have substantially impacted corporate financing choices and profitability performance to be studied in this timeframe in terms of its relevance to the subject of leverage-profitability relationship under different economic conditions.

This research has a number of contributions to the literature. First, it has rigorous empirical evidence of leverage-profitability relationship based on a ten-year panel data that has cross-sectional heterogeneity across firms and variation in financial conditions over time. Second, it directly includes firm size as a moderating variable, following previous studies that have largely assumed size as a control variable. Third, it uses the Hausman specification test to establish the right panel model, which guarantees a methodological rigor of the estimation of the reported coefficients. The rest of this paper is structured in the following way: literature review is the synthesis of theoretical and empirical contributions, the methodology section elucidates the research design and the analytical framework, the data analysis section presents the empirical findings, the discussion section interprets the findings and the conclusion section provides the recommendations and directions to the future research.

Literature Review

Corporate Profitability and Financial Leverage

The educational and empirical proof on how monetary leverage pertains to company profitability isn't always most effective enormous however additionally the realization is arguable in special institutional and monetary settings. The foundational paintings through Modigliani and Miller (2008) decided that capital shape does now no longer have an effect on the price and overall performance of corporations withinside the absence of tax, fee of financial disaster and data asymmetry. Later extensions delivered the prices of taxation and economic misery to derive the idea of change off, which forecasts that companies will select an most fulfilling degree of debt with the intention to maximize internet gain of hobby tax defend with at the least anticipated misery prices (Frank and Goyal, 2009). In this model, a mild stage of leverage can increase profitability with the aid of using saving on taxes, however intense leverage will price it economic misery expenses that undermine profitability.

The exchange-off concept has been examined empirically with blended results. Abor (2005) used the connection among capital shape and profitability of the indexed corporations in Ghana and located that the short-time period debt changed into definitely associated with the go back on fairness while the long-time period debt confirmed bad courting, indicating that the leverage-profitability courting changed into touchy to the composition of the debt maturity. Contrarily, Zeitun and Tian (2007) in comparison Jordanian companies and discovered that leverage measures have poor, statistically full-size relationships with diverse profitability measures, which confirms the pecking order speculation that excessive leverage companies are much less profitable. More recently, Nassar (2016) determined that monetary leverage had a poor effect at the

overall performance of Turkish production companies, and is the reason this impact via way of means of the multiplied price of debt servicing within the surprisingly excessive-hobby price environment.

The connection among leverage and the go back on belongings has been modelled within the literature on company finance extra normally in phrases of the DuPont decomposition framework, which makes an emphasis at the reality that hobby rate decreases the internet income margin aspect of ROA in spite of the opportunity of leverage growing asset utilisation. The panel proof provided via way of means of Dang et al. (2019) suggests that the leverage-ROA dating is constantly terrible while constant impact of companies is taken into consideration, and in addition they document a sizable quantity of cross-sectional heterogeneity within the electricity of the leverage-ROA dating because of the variant within the rights of creditors, the procedure of financial ruin, and the improvement of monetary markets.

Firm Size as a Moderator Variable

The length of corporations takes a primary degree within the literature of company finance as a determinant of capital shape selections and as a moderator of the leverage-profitability dating. It is hypothesized that large corporations have higher get entry to to capital markets, asset diversification, and much less data asymmetry among managers and creditors, which decrease the fee of outside finance and alleviate the destructive profitability outcomes of leverage (Rajan and Zingales, 2015). Empirical research have continually recorded a nice affiliation among organization length and profitability with large companies taking part in economies of scale, marketplace energy and extra flexibility in operations which buffer the consequences of debt servicing value on internet profitability.

Fama and French (2012) confirmed that the destructive effect of leverage on profitability is lots decrease in massive corporations as in comparison to small corporations, that is in step with the speculation that scale results lower the marginal price of leverage of big companies. Likewise, Berk and DeMarzo (2017) reasoned that larger corporations are related to decrease predicted monetary misery prices at a particular stage of leverage due to the fact they may be greater different of their belongings, this means that that length acts as a moderating variable, reducing the probabilities and charges of monetary misery. All those findings make contributions to the addition of organization length as a moderating variable within the fashions that check out the connection among leverage and profitability.

Le and Phan (2017) used constant-consequences panel fashions to Vietnamese indexed groups and discovered that smaller agencies had a more potent terrible leverage impact on profitability, which without delay empirically confirmed the scale moderation speculation. Equally, of their observe of PSX-traded businesses, Ahmed and Bhuyan (2020) stated a disproportionately poor loss in profitability within the smaller corporations that turned into connected to improved leverage, because of their loss of capacity to renegotiate their debt phrases and extra value of resolving monetary misery in a placing with poorly evolved creditor safety institutions.

The Development of Assets and Its correlation with Profitability

The increase of belongings in phrases of proportional extrade in general belongings among or greater consecutive intervals shows the quantity of funding and increase sample of a corporation which has giant implications to the connection among leverage and profitability. Theoretically, the leverage ratios of swiftly developing corporations are speculated to be better due to the fact they name at the outside debt to finance the purchase of property and on the equal time, due to the fact they may be beneathneath the strain of profitability because of the prices of integration of operations and the transition hazard that includes the speedy increase (Titman and Wessels, 2008). The typical effect of asset increase on profitability is as a result theoretically uncertain, in that the productiveness will increase of asset boom exceed the fee of debt-financed boom.

Empirical studies has proven a fine courting in addition to poor dating among asset boom and profitability. Myers (2014) suggested that excessive increase corporations in evolved markets have decrease modern profitability however more destiny profits potential, which means that the connection among boom and profitability is temporal. Nguyen and Nguyen (2020) hooked up that asset increase has a high-quality effect at the modern-day profitability of Vietnamese indexed agencies and that they characteristic this to the productiveness profits because of asset modernization. Such conflicting consequences spotlight the want to look at the asset increase in a multi-variable panel version that captures leverage interactions and organization-unique heterogeneity.

Capital Structure Research: Panel Data

The technique of panel information has won extensive recognition within the studies of company finance due to the analytical advantages that they offer over cross-sectional studies or time-collection studies in isolation. The panel statistics fashions allow the researcher to control the unknown organization-stage heterogeneity with corporation constant consequences probably main to the reduced overlooked variable bias in estimating leverage-profitability relationships

(Baltagi, 2013). The Hausman specification check measures the affiliation of the unobserved corporation particular consequences with the regressors with a massive stage of take a look at statistic in assist of constant outcomes estimation in comparison to random results estimation.

Recent panel regression research of capital shape research have proven the usefulness of constant-results fashions to apprehend the within-company dynamics of leverage selections and their implications approximately profitability. Using a massive international dataset, Dang et al. (2019) applied the constant-consequences panel regression version and determined robust terrible leverage-profitability results that remained tremendous in exceptional version specifications. Similar empirical blessings had been proven through Khan (2012), who confirmed the empirical advantages of panel strategies in separating the leverage impact in Pakistani fabric corporations, as cross-sectional strategies overstate the leverage-profitability correlation because of time-invariant corporation traits that mutually decide each the financing choice and the profitability outcome.

Methodology

Research Design

The gift have a look at changed into primarily based totally at the quantitative studies layout premised at the positivist philosophical way of life that specializes in the utility of empirical information and using statistical techniques to check theoretically formulated hypotheses approximately the connection among measurable phenomena (Creswell, 2014). The panel statistics technique turned into used to seize the blessings of evaluation among-company variations in leverage and profitability and within-corporation version withinside the given variables over the 10 years span of the observe among 2015 and 2024.

Population and Sample

The goal populace covered all of the non-monetary groups indexed withinside the Pakistan Stock Exchange at the start of the examine duration. Firms withinside the economic sector, along with banks, coverage businesses and funding corporations had been now no longer blanketed as they've essentially one-of-a-kind capital systems and determinants of profitability as do non-economic companies, and feature specific regulatory capital necessities that might complicate leverage comparisons. The pattern length changed into forty businesses selected the usage of a purposive sampling approach and had all of the recorded monetary facts over the 10 years of the studies duration which turned into whole and constantly mentioned to attain a balanced panel dataset of four hundred company-12 months observations. The sampled organizations represented a extensive variety of industries consisting of textiles, cement, energy, chemicals, meals and liquids and engineering and furnished a big sectoral variety withinside the pattern.

Data Collection

The audited annual monetary reviews of the forty sampled corporations had been searched to extract secondary statistics and had been obtained withinside the legit Pakistan Stock Exchange facts portal and the State Bank of Pakistan monetary statements database. Data objects that have been extracted have been general property, overall debt, internet profits, and 12 months-on-12 months asset values that had been acquired the usage of which increase fees have been calculated. All economic facts have been transformed into Pakistani Rupees and transformed the usage of ratio and herbal logarithm calculations earlier than evaluation to assure cross-company comparison and decrease the results of scale versions on regression residuals.

Variable Operationalization and Measurement

A precis of the variables of the have a look at, their size proxies, function withinside the evaluation model, and facts reassets are supplied in Table 1. The structured variable, that is the company profitability, became decided with the aid of using the Return on Assets this is calculated because the ratio of internet profits to general property that is typically taken into consideration as an ordinary indicator of profitability that isn't always deceptive because of the variations in financing structure (Zeitun and Tian, 2007). The unbiased variable changed into economic leverage, which became operationalized through the debt ratio this is general debt/overall belongings, which might replicate the ratio of the asset financing that might be attributed to the debt obligations. The herbal logarithm of general property turned into used to degree corporation length to standardize the distribution of asset values and decrease heteroscedasticity. Asset increase turned into calculated as the share alternate in general belongings on a 12 months on yr basis, which displays the dynamic investments sample of each company.

Table 1: Variable Definitions, Measurement Proxies, and Sources

Variable	Measurement Proxy	Role	Source
Financial Leverage	Debt Ratio = Total Debt / Total Assets	Independent	PSX Annual Reports
Corporate Profitability	ROA = Net Income / Total Assets	Dependent	PSX Annual Reports
Firm Size	Natural Logarithm of Total Assets	Moderating	PSX Annual Reports
Asset Growth	(Assets _t - Assets _{t-1}) / Assets _{t-1}	Control	PSX Annual Reports

Note. PSX = Pakistan Stock Exchange. ROA = Return on Assets. All data sourced from audited annual financial reports.

Model Specification

The empirical model was specified as a panel regression equation incorporating both direct effects and a firm size interaction term to capture the moderating role of size in the leverage-profitability relationship. The panel regression model was specified as follows:

$$ROA_{it} = \beta_0 + \beta_1(DR_{it}) + \beta_2(FS_{it}) + \beta_3(AG_{it}) + \beta_4(DR_{it} \times FS_{it}) + \mu_i + \varepsilon_{it}$$

where ROA_{it} denotes return on assets for firm *i* at time *t*; DR_{it} represents the debt ratio; FS_{it} denotes firm size as the natural log of total assets; AG_{it} represents asset growth; DR_{it} × FS_{it} is the interaction term capturing the moderating effect of firm size; μ_{*i*} represents unobserved firm-specific fixed effects; and ε_{*it*} is the idiosyncratic error term assumed to be independently and identically distributed.

Estimation Strategy and Diagnostic Tests

Three panel estimators were used which include pooled ordinary least squares, fixed-effects, and random-effects models. The Hausman test was performed to identify which specification (fixed-effects or random-effects) to use at the beginning, and the statistically significant test value supported the conclusion that there is a correlation between unobserved firm-specific effects and the regressors and thus the fixed-effects estimator is used (Hausman, 1978). The Huber-White sandwich estimator was used to compute heteroscedasticity-robust standard errors of all models. Variance inflation factors were also analyzed to check whether there is multicollinearity and all VIF values were confirmed to be below 10. To verify the occurrence of panel effects, the Breusch-Pagan Lagrange Multiplier test was used. EViews 12 and STATA 17 software were used to perform statistical analysis.

Data Analysis

Descriptive Statistics

Table 2 presents the descriptive statistics of the four important variables in the 400 firm-years. A mean of 0.082 means that average profitability there is moderate between the sampled firms, and the range of 0.291 to -0.134 standard deviation of 0.061 indicates that there is a lot of variation in the outcomes of profitability across firms and years. The negative minimum ROA suggests that some of firms experienced net losses in at least one year of the research period which is in line with the macroeconomic pressures on corporate performance in the 2015 to 2024 period.

The average debt ratio of 0.491 means that the sampled firms used debt to finance about 49 percent of total assets on average that portrays a moderate leverage profile that is largely in line with non-financial firms in the emerging market economies. The standard deviation of 0.174 and the range of 0.084 to 0.879 show that leverage ratios are quite different, whereby there are firms with equity-based financing and highly leveraged balance sheets. The mean natural log of firm size was 22.314 with a standard deviation of 1.643; this indicates significant heterogeneity of firm sizes in the sample. The average growth of assets was 0.114/yr, which implies that on average growth in asset bases was about 11%, but the standard deviation of 0.183 indicates that there was a lot of variance in growth rates among firms and over time.

Table 2: Descriptive Statistics for Study Variables (N = 400 firm-year observations)

Variable	N	Mean	Std. Dev.	Min	Max	Skewness
ROA	400	0.082	0.061	-0.134	0.291	-0.312
Debt Ratio	400	0.491	0.174	0.084	0.879	0.218
Firm Size (ln)	400	22.314	1.643	18.762	25.891	0.104
Asset Growth	400	0.114	0.183	-0.212	0.743	0.891

Note. ROA = Return on Assets. Debt Ratio = Total Debt / Total Assets. Firm Size = ln(Total Assets). Asset Growth = (Assets_t - Assets_{t-1}) / Assets_{t-1}.

Correlation Analysis

Table 3 shows the Pearson correlation of the key variables of the study. The debt ratio showed a strong negative relationship with the return on assets ($r = -.483, p < 0.01$) which is the preliminary bivariate data supporting the prediction of the pecking order hypothesis that the higher leverage is the lower the profitability. The size of the firm was found to have a significant positive relationship with the returns on assets ($r = 0.371, p < 0.01$), which is in line with scale and market power benefits of a larger firm. The fact that the correlation between the size of firms and debt ratio is negative ($r = -0.218, p < 0.01$) indicates that larger firms may have not needed as much debt financing because they had easier access to equity markets and were able to generate internal cash.

Both the resulting return on assets ($r = 0.244, p < 0.01$) and debt ratio ($r = 0.132, p < 0.05$) were found to correlate positively with asset growth, as increasing firms were more likely to be profitable and yet be more leveraged, which was consonant with the growth-financing nexus hypothesized in the literature. The absolute value of all correlation coefficients was less than 0.60 and the variance inflation factors were 1.14 to 2.37, much lower than the critical value of 10, which proved that there was no problematic multicollinearity in the regression models.

Table 3: Pearson Correlation Matrix

Variable	(1)	(2)	(3)	(4)
(1) ROA	1.000			
(2) Debt Ratio	-0.483**	1.000		
(3) Firm Size	0.371**	-0.218**	1.000	
(4) Asset Growth	0.244**	0.132*	0.198**	1.000

Note. * $p < 0.05$; ** $p < 0.01$ (two-tailed). N = 400 firm-year observations.

Table 4 provides the results of the pooled OLS, fixed-effects and random-effects panel models and the Hausman test result. In all the specifications, financial leverage had a high negative impact on the return on assets where the fixed-effects estimate was that a one-unit change in debt ratio had a negative impact of 0.163 on the ROA ($= -0.163, p = 0.001$). This observation holds well in both pooled OLS and random-effects specifications, and is thus strong evidence that the negative leverage-profitability correlation is not a results of the estimation procedure.

The size of firms showed a good positive influence on the return on their assets in the fixed-effects model ($= 0.091, p < 0.001$), which agrees with the scale and market power benefits of large firms. There was also a significant positive effect on asset growth ($= 0.073, p < 0.001$) which posits that expansion in asset base has a positive influence on profitability, as is the case with productivity gains with capacity expansion. The correlation between the debt ratio and the firm size was found to be positive and significant ($0.051, p < 0.01$), which proves that the negative leverage effect is reduced in larger firms, which supports the moderating effect of size hypothesis.

The Hausman test value was very high ($p = 0.003$) and it rejected the null hypothesis of zero correlation between firm-specific effects and the regressors and affirmed the fixed-effects estimator as valid. The within R-squared value of 0.447 means that the explanatory variables explain about 45 percent of within-firm variation in profitability, which is a satisfactory fit to such a panel model (Baltagi, 2013).

Table 4: Panel Regression Results: Dependent Variable = Return on Assets (ROA)

Variable	Pooled OLS	Fixed Effects	Random Effects	FE (Selected)
Debt Ratio (DR)	-0.147*** (0.031)	-0.163*** (0.028)	-0.158*** (0.029)	-0.163*** (0.028)
Firm Size (FS)	0.084*** (0.019)	0.091*** (0.017)	0.088*** (0.018)	0.091*** (0.017)
Asset Growth (AG)	0.061** (0.024)	0.073*** (0.021)	0.068** (0.023)	0.073*** (0.021)
DR × Firm Size	0.042* (0.022)	0.051** (0.019)	0.047* (0.021)	0.051** (0.019)
Constant	0.034* (0.018)	0.029* (0.016)	0.031* (0.017)	0.029* (0.016)

R-squared	0.381	0.447	0.429	0.447
F-statistic	31.24***	38.91***	35.47***	38.91***
Observations	400	400	400	400
Hausman p-value	—	—	—	0.003

Note. Standard errors in parentheses. * $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$. Hausman test significant ($p = 0.003$) confirms fixed-effects model is preferred. $N = 400$ firm-year observations from 40 firms over 10 years.

Robustness Checks

Table 5 shows robustness tests in terms of sequential fixed-effects model construction. The negative and substantial impact of debt ratio on ROA was present in all three models and the coefficient of the debt ratio on ROA became more negative with the full interaction model (-0.171) than it was in the base model (-0.152), showing that it is not sensitive to changes in the model specifications. Within R-squared increased to 0.463 in the full model, as compared to 0.284 in the base model, and this fact confirms that the addition of firm size, and asset growth, and the interaction of the two, with leverage, do provide significant explanatory power. These robustness findings support the confidence in the main findings of the fixed-effects specification, which are presented in Table 4.

Table 5: Robustness Check: Sequential Fixed-Effects Panel Models

Variable	Model 1 (Base)	Model 2 (+Controls)	Model 3 (Interaction)
Debt Ratio	-0.152^{***}	-0.163^{***}	-0.171^{***}
Firm Size	—	0.091^{***}	0.094^{***}
Asset Growth	—	0.073^{***}	0.069^{**}
DR \times Firm Size	—	—	0.051^{**}
Within R-squared	0.284	0.447	0.463
Observations	400	400	400

Note. * $p < 0.05$; ** $p < 0.01$; *** $p < 0.001$. All models estimated using fixed-effects with Huber-White robust standard errors. $N = 400$ firm-year observations.

Discussion

The results of this research have strong and consistent empirical evidence to support the hypothesis that financial leverage has a strong negative impact on corporate profitability. The fact that the effect of the debt ratio on the return on assets is estimated to be -0.163 is consistent with the expectations of the pecking order theory, according to which more profitable firms use less external debt financing, and the views of agency costs that focus on the drag in profitability caused by excessive debt servicing requirements (Myers and Majluf, 2014; Jensen, 2006). These results are consistent with previous research within an emerging market context, such as Ahmed and Bhuyan (2020) and Zeitun and Tian (2007), which supports the notion of the universal applicability of the negative leverage-profitability relationship to the context of the developing economy.

The important positive moderating role of firm size ($\beta = 0.051$, $p < 0.01$ of the interaction term) contributes to the existing body of empirical literature by showing that larger firms have better chances to cope with the negative profitability implications of high leverage, in line with Fama and French (2012) and Rajan and Zingales (2015). This observation means that leveraging management policies should be adjusted to the size of the firm, where smaller firms are more cautious with debt accumulation because it is more susceptible to costs of financial distress. The positive and substantial impact of the expansion of assets on profitability ($= 0.073$) is in line with the literature which reports the profitability gains of asset expansion in emerging markets, and indicates that growth-oriented investment policies may raise profitability even in situations of high leverage. These results, combined with others, lead to a more subtle understanding of the leverage-profitability relationship whereby the adverse effect of debt financing is actual but highly moderated by firm attributes that managers can moderate via strategic decisions in capital structure and investment choices.

Conclusion and Recommendations

This paper investigated the impact of financial leverage on corporate profitability based on a balanced panel sample of 400 firm-years of 40 non-financial Pakistani listed companies in the Pakistan Stock Exchange in 2015 to 2024. The panel regression results of the fixed-effects showed that financial leverage has a large negative impact on the return on assets, firm

size positively moderates the impact of the leverage, and the growth of assets has a positive impact on profitability. The stability of these findings was checked using robustness checks with three model specifications.

Theoretically, the research contributes to the literature on capital structure as it validates the pecking order theory using a panel-based study in the context of a developing economy and also proves that firm size can moderate the negative leverage effect. In practice, the findings suggest that corporate financial managers, especially those of smaller organizations should pursue low leverage policies that restrict the amount of debt to levels that are sustainable based on operating cash flows. The larger companies can also use their scale advantages to obtain inexpensive debt with less relative profitability cost, so long as it is invested in productive assets.

Financial market development initiatives that increase access to equity financing by smaller firms through higher equity financing should be taken into account by policymakers and regulators to minimize the use of expensive short-term debt. Further moderating variables like industry concentration, interest rate cycles and macroeconomic phase and dynamic panel estimators like generalized method of moments should be considered in future studies to overcome the possibility of endogeneity of capital structure decisions. It would be interesting to extend the framework to cross-country comparisons to the South Asian emerging markets to better understand the institutional factors conditioning the leverage-profitability nexus.

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