

# STUDY SESSION

# 11

## Corporate Finance

### Leverage and Working Capital Management

**T**his study session covers how companies make use of leverage and manage their working capital to meet short-term operational needs. The various types of leverage (operating, financial, total), measures of leverage, and how leverage affects a company's earnings and financial ratios are examined. A discussion then follows on the different types of working capital and the management issues associated with each. The session concludes with techniques for assessing the effectiveness of working capital management.

#### READING ASSIGNMENTS

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|-------------------|--|
| <b>Reading 37</b> | Measures of Leverage<br>by Pamela Peterson Drake, PhD, CFA, Raj Aggarwal, PhD, CFA, Cynthia Harrington, and Adam Kobor, PhD, CFA     |
| <b>Reading 38</b> | Working Capital Management<br>by Edgar A. Norton, Jr., PhD, CFA, Kenneth L. Parkinson, MBA, CCM, and Pamela Peterson Drake, PhD, CFA |

#### LEARNING OUTCOMES

##### READING 37. MEASURES OF LEVERAGE

The candidate should be able to:

- a** define and explain leverage, business risk, sales risk, operating risk, and financial risk and classify a risk;
- b** calculate and interpret the degree of operating leverage, the degree of financial leverage, and the degree of total leverage;

- c analyze the effect of financial leverage on a company's net income and return on equity;
- d calculate the breakeven quantity of sales and determine the company's net income at various sales levels;
- e calculate and interpret the operating breakeven quantity of sales.

### **READING 38. WORKING CAPITAL MANAGEMENT**

The candidate should be able to:

- a describe primary and secondary sources of liquidity and factors that influence a company's liquidity position;
- b compare a company's liquidity measures with those of peer companies;
- c evaluate working capital effectiveness of a company based on its operating and cash conversion cycles and compare the company's effectiveness with that of peer companies;
- d describe how different types of cash flows affect a company's net daily cash position;
- e calculate and interpret comparable yields on various securities, compare portfolio returns against a standard benchmark, and evaluate a company's short-term investment policy guidelines;
- f evaluate a company's management of accounts receivable, inventory, and accounts payable over time and compared to peer companies;
- g evaluate the choices of short-term funding available to a company and recommend a financing method.