This 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**

**Reading 36**
Measures of Leverage  
by Pamela Peterson Drake, PhD, CFA, Raj Aggarwal, PhD, CFA, Cynthia Harrington, CFA, and Adam Kobor, PhD, CFA

**Reading 37**
Working Capital Management  
by Edgar A. Norton, Jr., PhD, CFA, Kenneth L. Parkinson, MBA, CCM, and Pamela Peterson Drake, PhD, CFA

**LEARNING OUTCOMES**

**READING 36. 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 37. 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.