

STUDY SESSION

11

Corporate Finance (2)

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

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| Reading 34 | Measures of Leverage by Pamela Peterson Drake, PhD, CFA, Raj Aggarwal, PhD, CFA, Cynthia Harrington, CFA, and Adam Kobor, PhD, CFA |
| Reading 35 | Working Capital Management by Edgar A. Norton, Jr., PhD, CFA, Kenneth L. Parkinson, MBA, CCM, and Pamela Peterson Drake, PhD, CFA |

LEARNING OUTCOMES

READING 34. 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 35. 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.