

STUDY SESSION

11

Corporate Finance

Leverage, Dividends and Share Repurchases, and Working Capital Management

This study session covers how companies measure leverage, distribute earnings, and manage working capital. The first reading discusses the various forms and measures of leverage and how leverage affects a company's earnings and financial ratios. The second reading provides an introduction to earnings distribution policies, including dividends and share repurchases. The final reading discusses short-term liquidity and working capital management.

READING ASSIGNMENTS

Reading 37	Measures of Leverage by Pamela Peterson Drake, PhD, CFA, Raj Aggarwal, PhD, CFA, Cynthia Harrington, CFA, and Adam Kobor, CFA
Reading 38	Dividends and Share Repurchases: Basics by George H. Troughton, PhD, CFA, and Gregory Noronha, PhD, CFA
Reading 39	Working Capital Management 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. DIVIDENDS AND SHARE REPURCHASES: BASICS

The candidate should be able to:

- a** describe regular cash dividends, extra dividends, liquidating dividends, stock dividends, stock splits, and reverse stock splits, including their expected effect on shareholders' wealth and a company's financial ratios;
- b** describe dividend payment chronology, including the significance of declaration, holder-of-record, ex-dividend, and payment dates;
- c** compare share repurchase methods;
- d** calculate and compare the effect of a share repurchase on earnings per share when 1) the repurchase is financed with the company's excess cash and 2) the company uses debt to finance the repurchase;
- e** calculate the effect of a share repurchase on book value per share;
- f** explain why a cash dividend and a share repurchase of the same amount are equivalent in terms of the effect on shareholders' wealth, all else being equal.

READING 39. 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.