CPCU Finance and Accounting for Insurance Professionals

**Introduction to Corporate finance and accounting**

**Part 1 - Explain why it is important for insurance and risk management professionals to study corporate finance and accounting.**

Finance is a discipline concerned with determining value and making decisions about money, banking, credit, investments, and other assets. It provides a structure for analyzing an organization’s own financial status, the financial status of its customers, and that of its competitors. Corporate finance is the area within the discipline of finance that concerns a corporation’s investing and financing decisions. Accounting, an activity that closely related to finance, focuses on accumulating and reporting financial information to support decision making.

**Question:** **Identify the relationship between a corporate finance department and accounting?**

**Responsibilities of a corporate finance department typically include acquiring, investing, and managing the organization’s financial resources, as well as conducting accounting activities**. Accounting information is provided through various internal and external reports, including financial statements, which are designed to provide information that is useful to investors and creditors.

**Question: What types of information can a producer or a risk management professional identify by examining an organization’s financial statements?**

An examination of the organization’s financial statements should be part of a producer’s review of an organization’s application for coverage or a risk management professional’s identification and analysis of an organization’s loss exposures. **Financial statements can identify potential loss exposures or financial liabilities that are neither insured nor adequately addressed by risk management techniques other than insurance. Such exposures deserve further management analysis or even a detailed review of the records underlying the financial statements. Financial statements can also reveal trends in an organization’s financial performance signaling potential problems or growth opportunities**.

Underwriters use financial statements when analyzing an application for insurance or for renewal of coverage. For example, when determining an insurance applicant’s acceptability for coverage, a commercial insurance underwriter assesses the applicant’s financial stability. The underwriter’s opinion about an organization’s financial ability to grow, meet its financial obligations, and make timely premium payments affects acceptability and pricing decisions. A financially distressed applicant might present a moral hazard to the insurer, influencing both the frequency and severity of losses.

Claim representatives can use financial statements during their investigation of a claim to identify the possibility of a moral hazard related to a claim and to calculate the amount of a claim settlement. (

**Part 2 - Goals of Corporate Finance and Accounting**

**Question: Identify the main goals of corporate finance and accounting**

**The main goals of corporate finance and accounting are to maximize shareholder wealth, to provide for transparency in financial reporting, ad to conduct financial operations in an ethical manner.**

The maximization of shareholder wealth must be accomplished to compensate the shareholders for the use of their capital and to maintain a market through which to raise additional capital as needed.

Providing for financial transparency through access to appropriate and accurate financial reporting also helps the corporation maintain a market for its stock and provide a mechanism for raising additional capital when needed. Conducting finance and accounting in an ethical manner not only assists in meeting regulatory requirements, but also is essential to maintain the integrity of the corporate identity and to retaining customers in a highly competitive marketplace.

**Maximization of Shareholder Wealth**

**Question: Identify problems that can result from a business focusing on an overall financial goal of maximizing profits**

**The maximization of shareholder wealth is a generally accepted goal of corporate finance. It should be noted that maximizing wealth is not the same as maximizing profits. Although maximizing profits appears to be a reasonable corporate financial goal, it can result in several problems.**

* **Focusing on current profits to detriment of long-term profitability and growth**
* **Not accounting for the levels of risk associated with different profit scenarios**
* **Electing accounting treatments that make financial statements less useful to potential investors**

The goal of maximizing shareholder wealth refers to maximizing the value of the corporation’s stock. Maximizing wealth requires recognizing the effects of risk, dividends, and growth on the value of the stock; focusing on the best use of corporate financial resources to increase the value of the stock; and clearly identifying the accounting elections used to present the corporation’s financial condition and the results of its operations.

Accordingly, the financial manager makes decisions regarding the acquisition and use of funds that will increase the market value of the corporation’s stock and the wealth of its shareholders. The increase in wealth provides compensation to shareholders for their capital investment and an incentive for them to further invest in the corporation.

**Financial Transparency**

**Question: Explain financial transparency as it relates to a board of directors’ duty to shareholders**

Although the shareholders of a publicly traded corporation own the corporation, they do not manage it. The board of directors, elected by the shareholders, appoints people to key management positions to run the business of the corporation.

**One of the most important ongoing duties of the board of directors is to ensure that management is acting in the best interests of the shareholders. For the board to meet this duty, financial management must create financial transparency for the board and the shareholders by providing access to timely, understandable, informative, and accurate financial reporting that contains full disclosure of key events and accounting methods.**

Other stakeholders (anyone with a financial interest in the corporation) also use the financial statements and reports and rely on their financial transparency.

**Question: Describe the purpose and the major provisions of the Sarbanes-Oxley Act of 2002 regarding financial reporting of United States Corporations**

**The stated purpose of Sarbanes-Oxley is to protect investors by improving the accuracy and reliability of corporate disclosures. Its major provisions include these:**

* **Creation of an oversight board to regulate public accounting firms that audit publicly traded corporations**
* **Enhanced financial disclosure requirements**
* **Increased criminal penalties for corporate fraud and white-collar crime**
* **New requirements for certifying the accuracy of financial information**

One of Sarbanes-Oxley’s specific requirements is that the principal executive officer(s) and the principal financial officer(s) or persons performing similar functions must certify quarterly that they have reviewed the report, that is contains to untrue statement of material fact or omission of material fact that makes the report misleading, the information is fairly present, signing officers have evaluated the effectiveness of the internal controls as of a date ninety days prior to the report and have included their conclusion about the effectiveness of the controls in the report.

Corporate officers are subject to criminal penalties, including fines and prison sentences, for failing to fulfill these requirements.

**Ethical Conduct**

Certain ethical conduct requirements are governed by laws and regulations. For example, Sarbanes-Oxley requires a corporation to disclose in its financial statements whether it has adopted a code of ethics that applies to the corporation’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions.

Beyond complying with laws and regulations, a code of ethics provides a means of actively managing ethics in the workplace. The code identifies and prioritizes the corporation’s values to help guide employee conduct. Ethical behavior is essential for maintaining the integrity of the corporate identity, retaining customers, and attracting investors.

**Question: List several questions that help determine whether a business decision is ethical**

Many experts suggest that the best method of determining whether a decision is ethical is to answer these questions:

* Does my decision fall within the guidance of the corporation’s code of ethics?
* Am I willing to have my decision and reasoning reported on the front page of the newspaper and as the lead story on the evening television news report?
* Will the people with whom I have significant personal relationships (spouse, family members, and friends) approve of my decision?

**Part 3 – Corporate Finance Departments**

**Question: Describe the responsibilities of corporate finance departments**

**Although corporate finance departments are structured in different ways according to each organization’s requirements, responsibilities of the corporate finance department include acquiring, investing and managing the organization’s financial resources and providing financial information internal and external stakeholders need to make informed decisions**.

There is no one specific model that all businesses use to organize their corporate finance department. However, these descriptions of the activities of corporate finance departments can apply, in varying particulars to most organizations:

* Working capital management focuses on a corporation’s short-term needs for cash and other resources. By maintaining an adequate amount of working capital, a corporation can meet its day-to-day financial obligations and operate its business efficiently by being able to provide needed resources without delay.
* Capital structure management focuses on raising capital through borrowing or selling stock as well as specific financial vehicles that will be used. Two decisions 1) how much capital will be financed by borrowing, and how much will be raised through the sale of stock in the corporation? 2) What specific financial vehicles will be used to raise capital?
* Capital budgeting is the planning and managing of a corporation’s long-term investments, which can be for tangible or intangible assets.
* Accounting activities encompass financial accounting, taxation, and financial reporting.

**Organization**

The financial manager makes investment and financing decisions for the organization. In large corporations, the financial manager is typically the chief financial officer (CFO) – a senior executive whose main responsibility is setting the corporations overall financial strategy.

The CFO is also responsible for coordinating activities of both the treasurer and the controller. The treasurer’s responsibilities include working capital management, capital structure management, and capital budgeting. The controller is typically responsible for accounting functions, taxes, and financial reporting.

**Key Activities of Corporate Finance Departments**

The broad categories of corporate finance activities usually performed by the corporate finance department-working capital management, capital structure decisions, capital budgeting and accounting-affect departments throughout an organization.

**Working Capital Management**

A liquidity measure that is calculated by subtracting current liabilities from current assets. It is used to determine a company’s ability to finance immediate operations (to buy inventory, finance growth, and obtain credit).

Working capital management focuses on a corporation’s short-term needs for cash and other resources. The working capital of a corporation is its current assets minus its current liabilities

Current assets include cash, accounts receivable from customers, marketable securities, and inventory. Current liabilities include amounts owed to suppliers and employees, and the current portion of any loans payable (that is, the amount due within one year).

**Question: Explain working capital management and its importance to a corporation**

**By maintaining an adequate amount of working capital, a corporation can meet its day-to-day financial obligations and operate its business efficiently by being able to provide needed resources without delay.**

The activities involved in working capital management mainly involve the receipt and disbursement of cash.

**Capital Structure Management**

A corporation’s mix of long-term debt and equity.

Capital structure decision making focuses on what resources the corporation needs to meet its long-term goals and how these resources should be obtained.

**Question: Describe the two major decisions that a financial manager must make regarding capital structure**

**The two major decisions that a financial manager needs to make in its regard are these:**

* **How much capital will be financed by borrowing, and how much will be raised through the sale of stock in the corporation?**
* **What specific financial vehicles will be used to raise capital?**

A Corporation’s capital structure directly affects both the value to the owners of the corporation’s stock and the financial risk to which the owners are exposed. A corporation’s total value remains the same under different capital structures. However, the amount of the corporation’s cash flow that goes to the creditors(lenders) in the form of interest, and the amount that goes to the shareholders (owners) in the form of dividends, changes as the capital mix changes. In other words, the size of the pie does not change, but the size of the slice does. The corporate finance department determines the mix.

Alternatives must be carefully evaluated to ensure the corporation has the capital structure that, considering the potential risks and rewards, will provide the capital the corporation needs and maximize the benefits to the owners.

**Capital Budgeting**

**Question: Describe the two categories of assets financial managers invest in when performing capital budgeting, and give examples of each**

**Capital budgeting is the planning and managing of a corporation’s long-term investments. These investments can be for tangible assets (such as machinery, offices, or computer equipment), or they can be for intangible assets (such as technical expertise, patents, advertising, or insurance writing capacity).**

In capital budgeting, the financial manager tries to identify investment opportunities that provide more benefit to the corporation than they cost. This is normally done by determining whether the value of the cash inflows generated by the investment will exceed the value of the cash outflows.

**Accounting**

**Question: Explain how a corporate finance department can use both internal and external financial reports**

**Financial reports can be internal reports based on a corporation’s own information that are used, for example, by the corporate finance department to determine capital needs. Alternatively, financial reports can be external reports based on another corporation’s information, use in evaluating investment opportunities**. In many cases, financial decisions require the use of both internal and external financial reports.

For example, the underwriting decision about whether to insure an account requires understanding of the amount of capital the insurer can commit to an account (internal report) and an analysis of the potential insured’s financial statements (external report) to determine the appropriateness of the type and amount of coverage being requested. The ability to make timely premium payments.

**Part 4 - GAAP Accounting**

Useful financial statements must accurately and consistently convey an organization’s financial condition and performance.

Generally accepted accounting principles (GAAP) are a common set of accounting standards and procedures used in the preparation of financial statement to ensure consistency of presentation and reported results. In the United States, under the auspices of the Securities and Exchange Commission (SEC), private-sector organizations have established the concepts and principles of GAAP accounting. This is often referred to as US GAAP to distinguish it from GAAP adopted by other countries

**GAAP Accounting and FASB**

Under the Securities Exchange Act of 1934 the SEC was granted authority to promulgate financial accounting standards for publicly held companies. However, the SEC has looked to the private sector to establish these standards. Within the private sector the FASB is the organization designated for establishing financial accounting standards.

FASB standards for preparation of financial statements are recognized by the SEC and American Institutes of Certified Public Accountants (AICPA). The FASB notes that its standards are important to the economy because “investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information.”

**Question: Explain the role of the Financial Accounting Standards Board (FASB)**

**The FASB is the organization designated by the Securities and Exchange Commission (SEC) for establishing financial accounting standards. These standards create a credible, transparent resource for individuals and businesses that compare financial information among different organizations.**

**GAAP Accounting Principles and Concepts**

GAAP creates the general framework for determining what information to include in financial statements and how that information should be presented. In the US, most nongovernmental organizations are required to produce their financial statements in accordance with GAAP.

GAAP encompasses the basic objective of financial reporting, several broad concepts and principles, and many detailed rules

**Going concern Concept**

**Question: Explain the going concern concept and how it affects financial statements**

**The going concern concept is an accounting assumption that a business entity will continue to operate indefinitely. The assumption affects the values that an organization assigns to assets recorded in its financial statements**. For example, if an organization were about to cease operations, then users of the financial statements would want to know the current market or liquidation value of the organization’s assets. However, if it can be assumed that the organization will continue to operate indefinitely, it is more appropriate to record expenditures that will benefit multiple accounting periods as assets, and expense them as they are used in the operations of the organization.

**Question: Describe each of these GAAP principles**

**Cost Principle**

**The cost principle requires an organization’s assets to be recorded at their purchase price or production price; therefore, financial statements simply record the historical cost of the assets.**

**Revenue Recognition Principle**

**The revenue recognition principle requires revenues to be recognized and recorded at the time services are rendered or goods are sold to customers**.

**Matching Principle**

**The matching principle requires expenses incurred in generating revenues to be matched against those revenues. As a result, the profitability of the organization’s activity can be accurately measured**.

**Accrual Versus Cash Basis Accounting**

The accounting basis under which revenues and expenses are recorded as they are incurred, rather than when cash is received or paid, is called accrual basis accounting. Accrual basis accounting is used to accomplish the matching of revenues and expenses.

In contrast, the less frequently used cash basis accounting is an accounting basis under which transactions are recorded only as cash is received or paid.

**Question: Explain the conflict that arises in following the matching principle when cash basis accounting is used instead of accrual accounting**

**Financial statements prepared using cash basis accounting may not adhere to the matching principle because the timing of payments received for sales transactions can differ from the timing of the payment for the purchases of material and services needed to produce the goods sold**.

**Question: Describe each of these GAAP principles**

**Materiality Principle**

Not all transactions that an organization conducts involve significant items or amounts. Following accounting principles for these transactions strictly may involve a disproportionate amount of work or cost. **The materiality principle allows accountants to ignore generally accepted accounting principles when recording items that are not material if to do so is less expensive and more convenient**.

**Consistency Principle**

**The consistency principle requires an organization to use the same accounting principles and reporting practices in every accounting period. This principle prevents an organization from selecting alternative accounting methods from one period to the next for the purpose of presenting a more favorable financial position or manipulating earnings**.

**Conservatism Principle**

**The conservatism principle requires transactions to be recorded in a manner such that assets and earnings are not overstated. A conservative accounting approach is to anticipate losses and to not anticipate gains**. For example, the recorded value of many assets must be reduced if they are currently worth less than book value and unlikely to recover.

**Part 5 – International Financial Reporting Standards (IFRS)**

It is important to understand the nature of International Financial Reporting Standards (IFRS) and their influence on the financial reporting by property-casualty insurers. The increasing globalization of world economies is accelerating the need for convergence of Unites States generally accepted accounting principles GAAP) and IFRS.

International Financial Reporting Standards (IFRS) financial standards developed by the International Accounting Standards Board (IASB).

Publicly traded US property-casualty insurers report under both GAP and Statutory accounting principles (SAP), which are the accounting principles prescribed by US insurance regulators. SAP are based on GAAP and are reviewed for changes whenever changes are made to GAAP.

Statutory Accounting Principles (SAP) the accounting principles that are prescribed or permitted by an insurer’s domiciliary state and that insurers must follow.

**Comparison of GAAP and IFRS**

GAAP are the established standards of financial accounting in the US. The Financial Accounting Standards Board (FASB) is recognized by the Securities and Exchange Commission SEC as the private sector authority charge with establishing and maintaining these standards. FASB, through GAAP standards, determines the minimum required content of financial statements of US public companies.

**Question: Explain how IFRS standards are broader than GAAP standards**

The International Accounting Standards Board (IASB) is the independent standard-setting body of the International Accounting Standards Committee Foundation. Similar to FASB’s responsibility for GAAP, IASB members are responsible for the development and publication of the IFRS. **Because of their global approach, IFRS standards are broader than their GAAP counterparts.** **The stricter regulatory and legal environments in the US market results in more rules-based approach, with comprehensive guidance and industry-specific interpretations of GAAP standards. IFRS maintain a more principles-based approach to the reporting organizations.**

Therefore, they contain elements of accounting standards from various countries.

**Question: Contrast the GAAP definition of fair value with the IFRS Definition of fair value**

GAAP and IFRS are similar in that they use fair value reporting for many assets, such as intangible assets and financial instruments, including derivatives, equities, and debt securities. However, a significant difference in the reported value of property, plant and equipment assets still exists, with GAAP using historical cost and IFRS allowing for fair value.

**GAAP Defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Under IFRS, fair value represents the amount for which an asset could be exchanged or for which a liability could be settled between knowledgeable, willing parties in an arm’s-length transaction**.

The movement toward fair value alters the traditional concepts of accounting income and accounting net worth. Accounting income and accounting net worth do not recognize unrealized gains or losses on the income statement or the balance sheet when historical cost accounting is used. When fair value is used, changes in asset or liability values (realized and unrealized gains or losses) are recognized both on the income statement and on the balance sheet. This leads to reported values that are consistent with the concepts of economic income and economic net worth, which are based on market valuations.

**Convergence of GAAP and IFRS**

To promote the international convergence of accounting standards, FASB has been working with its international counterpart, the IASB, FASB and IASB declared their commitment to convergence of their respective accounting standards at the Norwalk Agreement in 2002. Convergence of GAAP and IFRS.

**Importance to Property-Casualty Insurer Financial Reporting**

All publicly traded property-casualty insurers are required to file GAAP financial statements. In addition, many other insurers choose to file GAAP financial statement to share financial information with customers, regulators, and the general public. All licensed property-casualty insurers are required to file annual statements with the National Association of Insurance Commissioners (NAIC) using SAP.

**Question: Explain why international convergence of accounting standards will likely change SAP reporting requirements**

While GAAP and IFRS value many insurer assets in a similar fashion, a controversial difference between the two is the manner in which they value insurer liabilities. Another difference is the premium allocation approach used, including eligibility criteria and the modeling method. Additionally, the accounting for certain reinsurance transactions differs. FASB and IASB continue to meet and work on reconciling these differences. **Any Changes to GAAP also need to be made to SAP because GAAP is the basis for SAP. The convergence of GAAP and IFRS will likely change SAP reporting requirements because SAP standards are based on GAAP standards**.