GAAP Financial Statements

**Part 1 - Purpose of Financial Statements**

Financial statements can be used by management and other interested parties to make informed business decisions about their areas of responsibility. The can be useful to insurance professionals in many aspects of their work. For example, the financial statements can help agents and brokers assess coverage needs. Help underwriters assess acceptability for coverage, and help claim representatives calculate the amount of a claim settlement.

**Question: Identify activities that are presented quantitatively on an organization’s financial statement**

**A Financial statement is a document that quantitatively presents and organization’s financial activities or status. Such activities include sales, purchases, borrowings, repayments, and investments.** When a financial activity occurs, the information regarding that activity is forwarded to the accounting department. Initially, the activity is recorded using a process known as bookkeeping. Once the information is recorded, it goes through the accounting process.

Accounting: The classification, analysis and determination of the appropriate method of reporting the effects of the bookkeeping records in an organization’s financial statements.

**Question: Describe how financial information typically flows within an organization from the occurrence of financial activity to the reporting on financial statements**

**Financial information typically flows this way within an organization:**

* **Financial activity occurs**
* **Information regarding the activity is forwarded to the accounting department**
  + **The activity is recorded using the bookkeeping process**
  + **The information is classified and analyzed, and the appropriate method of reporting the effects of the bookkeeping records in the financial statements through the accounting process is determined**
  + **Financial statements are prepared using standardized accounting concepts and principles.**

**Question: Identify the purpose of financial statements**

**The purpose of financial statements is to communicate information about an organizations financial activities, and the results of those activities, to individuals who need to make informed financial decisions about the organization**.

**Question: List individuals who might use information contained in financial statements to make informed financial decisions regarding an organization**

**Such individuals can include management, investors, insurers, and employees**.

There are four primary financial statements: The balance sheet, the income statement, the statement of changes in shareholder’s equity, and the statement of cash flows. Individually, each of these statements provide valuable information, but because they are interrelated, they provide a more complete picture when viewed together. When considered together, they present the organization’s financial condition, including resources, liabilities, and investment decisions. These statements are prepared using standardized accounting concepts and principles.

**Part 2 - Balance Sheet**

**A balance sheet indicates the financial position of an organization**.

Financial analysts, investors and insurance underwriters evaluate an organization’s financial strength by examining its balance sheet.

The balance sheet is a listing of everything than an organization owns and everything that is owes at a particular moment in time. It is a snapshot of the company’s financial position as of that date. The accounting equation ties together the balance sheet’s main components, which are assets, liabilities, and shareholder’s equity.

**Need to know Definitions**:

**Balance sheet**: the financial statement that reports the assets, liabilities, and owner’s equity of an organization as of a specific date.

**Current assets**: A balance sheet asset classification that includes cash and other assets that are expected to be converted into cash, sold, or exchanged within the business’s normal operating cycle, usually one year.

**Marketable securities**: An asset classification that includes temporary investments that can easily be converted into cash.

**Receivables**: An asset classification that consists of the amounts owed to a company by customers and other outsiders.

**Inventory**: An asset classification that consists of goods available for sale to customer: for a manufacturing company, it includes raw materials and finished goods.

**Prepaid expenses**: An asset classification that represents the amount that has already been paid for services that have not been received or used.

**Current liabilities**: A balance sheet liability classification that includes obligations whose payments are reasonably expected to require the use of cash or the creation of other liabilities within one year.

**Retained earnings**: The cumulative net income that an organization has retained, after payment of dividends, for reinvestment in the organization’s operations.

**The accounting Equation**

**Question: Explain why shareholder’s equity is shown as a liability on the balance sheet**

The balance sheet illustrates the accounting equation (also known as the balance sheet equation), which relates assets to liabilities and shareholder’s equity. The difference between assets and liabilities in a for-profit business is called shareholder’s equity (also known as owner’ equity, net worth, or book value). **Shareholder’s equity is shown on the liabilities side of the balance sheet because a business does not own its net worth. It “owes” its net worth to its owners. The balance sheet must always balance because assets equal liabilities plus shareholder’s equity, even if shareholders’ equity must be a negative number for balance to occur**.

Assets – Liabilities = Shareholder’s equity (owner’s equity)

**Assets = Liabilities + Net Worth**

**Assets**

**Question: Describe noncurrent assets**

Assets are the resources an organization owns or uses to operate its business. Assets are grouped into current assets and noncurrent assets. Current assets can include cash, marketable securities, receivables (accounts and notes), inventories, and prepaid expenses. **Noncurrent assets are those assets that will be used over a period greater than one year, and they are grouped into tangible assets (such as land, buildings, and equipment) and intangible assets. Intangible assets include all assets that cannot be seen or touched, such as leaseholds, patents, and trademarks, and they are often categorized as intellectual property.** “Goodwill” – whenever the acquiring organization pays more than the book value for the acquired organization, the difference between the price paid for the organization and the book value can be listed as goodwill on the balance sheet.

Noncurrent assets, by definition, are used over multiple years. The value of many noncurrent assets, such as machinery, declines over time due to a variety of factors including usage, wear and tear, and obsolescence. Depreciation is an accounting term used to describe the allocation of the value of a noncurrent tangible asset over its useful life. Methods of depreciating assets: Straight line, declining balance depreciation.

Reflected on the balance sheet with net value of the asset (historical cost – accumulated depreciation).

**Liabilities**

Liabilities are the debts and obligations that represent claims against an organization’s assets. As with assets, liabilities are categorized as current or noncurrent. Current liabilities can include accounts payable, short-term debt, or the current position of a long-term debt. Noncurrent liabilities are those that will be paid or satisfied more than one year after the balance sheet date, such as long-term notes payable.

**Shareholder’s Equity**

**Question: describe the components of shareholder’s equity**

**Shareholder’s equity (owner’s equity) is the amount of assets after deducting and organization’s debts and obligations (liabilities). It includes the capital contributed by owners and the accumulation of earnings retained by the organization (retained earnings) since it was started. Also, for specific assets and liabilities, it includes cumulative changes in value that were not used to calculate cumulative earnings.** On the balance sheet of a not-for-profit organization, shareholder’s equity is often called “surplus”.

If some or all of the assets on the balance sheet are listed at the price paid for them (historical cost) rather than at current fair market value, net worth would not reflect the market value of the assets.

Shareholder’s equity is negative whenever liabilities exceed assets. A business with negative shareholder’s equity may be close to bankruptcy.

**Part 3 – Income Statement**

**Revenue**: The inflow of assets, usually cash or accounts receivable resulting from the sale of products or the rendering of services to customers.

**Gross Profit**: An income statement value that represents sales or operating revenue minus the cost of goods sold.

**Gross Margin (gross profit margin**): The percentage of sales remaining after deducting the cost of goods sold from sales, calculated by dividing gross profit by sales.

**Operating Income**: An income statement value that reflects income that results from the normal operations of the business during the period covered by the statement. Calculated as the gross profit less selling, general, and administrative expenses.

**Comprehensive Income**: A measure of income that goes beyond that reported on the income statement by including items such as unrealized gains and losses.

An income statement provides stakeholders with information regarding the profitability of an organization over a given period of time. Risk and insurance professionals can gain a better understanding of an organization and its insurance needs by reading and interpreting its income statement.

An income statement shows and organization’s profit or loss for a stated period. It is created by comparing the revenue generated with the expenses incurred to produce those revenues, and then adding any gains and subtracting any losses during the reported period.

The income statement describes the organization’s experience over time, whereas a balance sheet lists the organization’s assets and liabilities as a given moment.

**Revenue**

An organization generates revenue from sales of its products or services. For a nonprofit organization, revenue might come from dues, memberships, or contributions. Revenue does not include gains from the sale of property, plan, or equipment.

**Expenses**

**Question: Describe the expenses directly related to sales shown on an organization’s income statement.**

Expenses are measured by the assets relinquished or consumed in the process of delivering goods or rendering services to customers. The nature of these expenses depends on the nature of the organization. Every operating expense can be categorized as either a general operating expense or an expense directly related to sales. **An expense directly related to sales is one that increases or decreases in direct relationship to sales, such as the cost of goods sold, commissions, or the cost of materials used to ship goods that have been sold. A general operating expense is one that is necessary to run the business but bears no direct relationship to the volume of sales, such as cost for heating and air conditioning its place of business.**

**Question: Explain why the income statements of most service operations do not include a cost of goods sold category**

The cost of goods sold is an expense that deserves special note. Although the term “cost of goods sold” applies to any business, the type of business dictates the expenses that are included. In retail operations, the cost of goods sold is usually the business’s cost to purchase its merchandise and for shipping. In manufacturing operations, the cost of goods sold includes the cost of the materials to make the product**. In a service operation, such as an insurance agency, the cost of goods sold is minimal or nonexistent because no physical product is being sold**.

The cost of goods sold expense that appears on the income statement is calculated according to this formula:

Beginning Inventory

+ Additions to inventory

= amount that could have been sold

– ending inventory

= cost of goods sold

**Question: An accountant wishes to recognize as an expense the cost of purchasing inventory. Explain how the accountant would do so**

**In order to recognize as an expense the cost of purchasing inventory, an accountant would use the costs of goods sold formula to recognize the expense of acquiring goods to sell and coordinate it directly with sales on the income statement. If there are no sales, the ending inventory is equal to the sum of the beginning inventory plus any additions to it. Once an item of inventory has been sold, its cost appears as an expense on the income statement by operation of the cost of goods sold formula**.

**Gross Profit**

The cost of goods sold expense, which is shown separately from other expenses, it is subtracted from sales on the income statement to arrive at the gross profit.

Gross profit expressed as a percentage of gross sales is sometimes called gross margin. Similarly, the gross profit expressed as a percentage of the cost of goods sole is sometimes called mark-up.

**Operating Income**

General operating expenses are deducted from gross profit to arrive at an operating income amount.

Not all money a business spends is counted as operating expenses. To be recorded as operating expenses, expenses must be incurred in the business’s ordinary operations. For this reason, capital expenditures appear on the income statement gradually over time, normally as a depreciation expense. A depreciation expense spreads out the expense of a large purchase over time and may be calculated based on the item’s life expectancy or, more arbitrarily for accounting convenience, according to generally accepted accounting principles (GAAP). Depreciation is common operating expense. As such, depreciation lowers the business’s net income for tax purposes. Capital expenditures would be the purchase of real estate and other large purchases that are not considered operations.

**Net Income**

If expense and losses exceed revenue and gains for the period, then the organization has a net loss and is not operating profitably. Negative net income is known as net loss. The ability to earn net income is essential to a business’s continuation. Anything that decreases revenue or increases expenses threatens a business profit and its future. Net Income is calculated this way:

Net income = Revenue – Expenses (including depreciation) + Gains – losses – Taxes

C**omprehensive Income**

**Question: Explain why the financial Accounting Standards Board (FASB) created a reporting standard for comprehensive income**

In the late 1990s, the Financial Accounting Standards Board (FASB) began requiring organizations to report not only their income but also their comprehensive income. Comprehensive income is defined in the Financial Accounting Standards Board’s (FASB) ASC Topic 220 “Comprehensive Income” is the change in equity [net assets] of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distribution to owners. In other words, comprehensive income includes an organization’s net income from the income statement plus other income that is not required to be reported on the income statement.

This other income that is not reported is referred to as “other comprehensive income”. Other comprehensive income can include unrealized gains and losses on securities for sale, foreign currency translation gains or losses, and minimum pension liability for adjustments.

**Creation of this reporting standard was driven by concerns that other comprehensive income of some organizations was materially important to the stakeholders of the organization and therefore, needed to be reported**.

**Part 4 - Statement of Changes in Shareholders Equity and Statement of Cash Flows**

Stakeholders often need more information about an organization than what the balance sheet and income statement can provide. Two other important financial statements are the statement of changes in shareholder’s equity and the statement of cash flows. **The financial statements reflects entity’s reputation in the marketplace.**

Two key financial statements measure activity during a fixed period

* The statement of changes in shareholder’s equity explains increases or decreases in capital accounts
* **The statement of cash flows summarizes the cash effects of an organization’s operating, investing, and financing activities**.

**Statement of Changes in Shareholder’s equity**

The statement of changes in shareholder’s equity shows changes from the beginning to the end of the period for each major component of the capital accounts that constitute the shareholder’s equity.

Statement of changes in shareholder’s equity: The financial statement that explains any changes that have occurred in the organization’s capital accounts during a specific period.

**\*\* There are four major components of shareholder’s equity:**

* **Paid-In Capital**

**Paid in capital is the amount of money raised by issuing stock, calculated as the par value of the stock issued plus any additional paid-in capital over the par value**. Par value is an arbitrary dollar value that a corporation assigns to its shares. Most new stock is issued at a very low or no par value and is sold for whatever price the market is willing to pay.

* **Retained Earnings**

**An organization may use retained earnings for purposes such as funding capital expenditures, research and development, or debt repayment. Dividends are the portion of an organization’s profits that is paid to shareholders. Dividends are not deducted as expenses to arrive at net income; therefore, they are deducted from net income to determine the change in retained earnings from one period to the next. One of the purposes of the retained earnings section of the shareholder’s equity is to connect the income statement to the balance sheet by indicating how much of the net income of the company is being reinvested for ongoing and future business needs rather than distributed to the owners in the form of dividends**.

* **Accumulated Other Comprehensive Income**

**Comprehensive income includes a corporation’s net income from the income statement plus other income that is not required to be reported on the income statement. Three components of other comprehensive income include change in unrealized appreciation or depreciation of investments, foreign currency translation gains or losses, and changes in minimum pension liability.**

* **Treasury Stock**

**When a corporation buys back its own stock, those shares become treasury stock. The cost of treasury stock is deducted from shareholder’s equity because the company used an asset (cash) to buy back stock that it had previously issued and it had initially reported the stock payment in the paid-in capital section of the shareholder’s equity.**

**Statement of Cash Flows**

**The purpose of the statement of cash flows if to identify the sources and uses of cash during the year, essentially reconciling any difference in the beginning and ending balances in the cash account. This statement is used to determine an organization’s ability to generate positive future cash flows, its ability to meet its financial obligations, and its need for additional financing. It is also used to determine the reasons for any differences between net income and associated cash receipts and disbursements, such as those resulting from loan proceeds or repayments, increases or decrease in accounts receivable, or depreciation expense.**

**Operating Activities**

The operating activities starts with the net income figure, which reflects operating cash flows (such as cash receipts from the sale of goods and services) and operating cash outflows (such as cash payments to suppliers and employees). However, the net income figure also reflects noncash revenue (such as increase in accounts receivable) and noncash expenses (such as depreciation and an increase in accounts payable). Although changes in these amounts either increase or decrease net income, they do not reflect the receipt for use of cash.

**Investing activities**

The investing activities section reflects the actual cash inflows and outflows that have occurred as a result of activities such as the sale or purchase of property, plant, or equipment; the acquisition or disposal of marketable securities; and receipt of payments on loans made to others.

**Financing Activities**

The financing activities section reports the cash inflows and outflows that have occurred as a result of activities such as issuing or repurchasing stock, bonds, or mortgages. Financing activities include cash payments for the payment of dividends.

**Part 5 – Comparison of Property Casualty Insurer and Non-insurer GAAP Financial Statements**

Historically, property-casualty insurers in the United States have used statutory accounting principles (SAP) for financial reporting. Insurers that are publicly traded are required to report under generally accepted accounting principles (GAAP) as well.

Standards for GAAP were originally developed for commercial and industrial organizations but have been adapted for financial service organizations. The Financial Accounting Standards Board’s (FASB) ASC Topic 944 “Financial Services-Insurance,” specifically applies GAAP standards to insurers.

**Differences Between Insurer and Non-Insurer Financial Statements**

**Question: Describe two differences in the assets and liabilities of insurers as compared with non-insurers operations**

**Once an insurance policy has been sold, liabilities are created over the time it takes to earn the premium and pay all losses. These liabilities are unique to insurers and appear on the liability side of an insurer’s balance sheet. The premium income from product sales and the investment income from assets are the most important sources of revenue to insurers,** while losses and loss adjustment expenses are unique source of expenses.

**Balance Sheet**

An insurer’s US GAAP balance sheet retains the same format as the balance sheet of any other organization. The assets of the insurer equal the liabilities plus the shareholder’s equity and the balance sheet balances. However, insurers do have different categories of assets and liabilities that appear on the balance sheet.

**Assets**

**Question: Describe the four categories of insurer financial investments**

An insurer’s investment strategy and performance are vital to its success and are stringently reviewed by rating agencies and regulators. Therefore, financial investments dominate an insurer’s asset side of the balance sheet. **An insurer’s financial investments are usually broken down into four categories:**

* **Short term investments – less than 1 year to mature**
* **Fixed maturity investments – greater than 1 year such as treasury or long-term bonds**
* **Equity securities – usually common or preferred stock in publicly traded organizations**
* **Other invested assets.**

**In addition to the categories of investments, insurers also have these three unique types of assets;**

* **Premium receivables**
* **Reinsurance recoverables (money owed by the reinsurer)**
* **Deferred policy acquisition costs (prepaid expense)**

**Liabilities**

On the liability side of the balance sheet, an insurer has two unique categories of reserves:

* Unpaid losses and loss adjustment expenses
* Unearned premium

**Question: Describe what is represented by the unearned premium reserve listed as a liability on an insurer’s balance sheet**

**The insurer’s other principal liability is the unearned premium reserve. This liability represents the amount of premiums received from policyholders but not yet earned. Policyholders pay premiums before the period for which they are covered and sometimes pay the entire premium before the policy period begins. Although insurers receive cash for the premium at the start of the policy period, they can earn premium proportionately as the policy period transpire**.

**Shareholder’s Equity**

If an insurer is organized as a stock company, there will be common and sometimes preferred stock shares outstanding. Common and preferred stock is carried on the balance sheet at par value, and, if the stock is originally issued for an amount above par value, the additional amount appears in the shareholder’s equity section as additional paid-in capital. Retained earnings represent accumulated net income retained in the business. Accumulated other Comprehensive income (loss) represent other comprehensive income reported on an accumulated basis.

**Income Statement**

An insurer’s GAAP income statement retains the same format and general categories as the income statement for any other organization.

**Revenues**

The primary revenues generated by property-casualty insurers are premiums earned and income from investments. Investments generate two types of income for insurers that appear on the income statement: Investment income and net realized investment gains or losses.

**Expenses**

The primary expense of property-casualty insurers included in the income statement are losses and loss adjustment expenses. In addition to these claims expenses, insurers incur expenses acquiring and underwriting policies (policy acquisition costs and other underwriting expenses), paying interest expenses on any debt they have outstanding (interest expense), and paying administrative and other expenses.

**Net Income**

The net income calculation for a property-casualty insurer is identical to that used by non-insurers. The total revenues minus the total expenses calculation yields the income before taxes. Once income tax expense is taken into account, the resulting balance is the net income.

**Statement of Comprehensive Income**

Similar to non-insurance organization, property-casualty insurers have the option of reporting comprehensive income on the income statement or on a separate statement of comprehensive income. The components of the statement of comprehensive income for insurers are the same as those for their organizations:

**The statement of comprehensive income for insurers may contain significant amounts of income not reported on the balance sheet because of the importance of investments. Because insurers have a significant percentage of their assets in investments, the unrealized appreciation or depreciation of those investments may be substantial**.

**Statement of Shareholder’s Equity**

The statement of shareholder’s equity is the financial statement that explains any changes that have occurred in the insurer’s capital accounts over the fiscal period being examined. Any activity affecting the value of shareholder’s equity, such as the issuance of common stock, is shown and used to reconcile the changes in shareholder’s equity between the beginning and the end of the period. Comprehensive income (loss) also appear in the statement and is used to reconcile the difference between the beginning and end accumulated comprehensive income.

**Statement of Cash Flows**

Insurers like other organizations, generate cash flows from three main sources: Operating activities, investing activities, and financing activities.

If an insurer has issued debt or equity securities of its own, the cash flows from that activity appear in the cash flows from financing activities.

**Part 6 - Supplemental Sources of Financial Information**

While the balance sheet, income statement, and other financial statements provide valuable information about an organization, a more complete financial picture of an organization is developed by examining additional sources of financial information.

Some information is best communicated through other reports, such as these:

**Notes to Financial Statements**

**Question: Describe where and when companies record accruals for loss contingencies**

Financial statements are the central feature of financial reporting. However, in the interest of complete disclosure, some information is better provided, or can only be provided, in notes to the financial statements.

**Notes to financial statements contain additional details that are disclosed to explain or amplify the information presented in financial statements. These items are included in the notes:**

* **A brief description of the nature of the company’s operations**
* **A summary of significant accounting policies and changes to accounting policies**
* **A detailed listing of long-term debt**
* **A summary of loss contingencies and other commitments (such as long-term rental commitments for leased property)**
* **A report of selected financial information by business segment**
* **Any other explanations that management deems necessary to help the user understand the financial statements**

**Companies record accruals for loss contingencies directly to the balance sheet and income statement when it is probable that the liability (loss) has been incurred and the amount can be reasonably estimated**. However, companies can also be subject to loss contingencies for which the results are not reasonably estimated at the time of the preparation of the financial statements. In such cases, the fact that the company is exposed to possible loss and liability must be disclosed in the notes to the financial statement to ensure that the statements will not be misleading. The disclosure should include the nature of the contingency, the potential damages and a statement of the likelihood that future events will confirm the loss.

Examples of contingencies:

* Current or pending litigation
* Obligations related to product warranties and product defects
* Risk of damage to or uninsured loss of company property by fire, explosion, or another hazard
* Hold harmless agreements

**Securities and Exchange Commission Filings**

All publicly traded companies are required to file quarterly and annual financial information with the SEC. They are also required to file a notice of any potential material events that might affect the company’s financial condition. The filings that the users of financial statements access most often are the annual form 10-K report, the quarterly form 10-Q report and the form 8-K material event report.

EDGAR: Electronic Data Gathering, Analysis and Retrieval System

The SEC developed EDGAR to automate the collection, validation, indexing, acceptance, and forwarding of registration statements, periodic reports and other forms that it requires all foreign and domestic companies to submit.

**Form 10-K**

Form 10-K, which publicly traded companies must file annually with the SEC, is similar to the company’s own annual report, except that is contains more-detailed information about the company’s business, finances and management. It also includes information not contained in the company’s annual report to shareholders, such as the company’s bylaws and other legal documents.

**Form 10-Q**

Publicly traded companies are also required to file **a quarterly report with the SEC on Form 10-Q**. The 10-Q report is an abbreviated version of the 10-K report. The information contained in the 10-Q report includes unaudited financial statements, a Management Discussion & Analysis (MD&A) for the quarter, and a list of material events that have occurred with the company during the prior three months.

**Form 8-K**

**Question: Describe the events that trigger the filing of a Form 8-K**

Form 8-K is the “Current report that publicly traded companies must file with the SEC. It is used to announce major events that shareholders should know about.

**Events that trigger an 8-K filing include these:**

* **Material definitive agreements entered into or terminated that are not in the ordinary course of the company’s business, such as a definitive agreement to sell a significant operating division to an unrelated company**
* **Release of nonpublic information about a company’s financial condition**
* **Creation of a direct financial obligation (such as long-term operating lease) under an off-balance sheet arrangement – that is, an arrangement that does not have to be recorded in the financial statements**
* **Change of independent auditor certifying the financial statements**
* **Departure or election of directors and departure of appointment of principal officers**

**While these events are also noted in the management discussion section of the 10-Q and 10-K reports, the 8-K must be filed with the SEC within 4 business days of the triggering event** to provide shareholders with information in a timely manner, so they don’t have to wait for the 10-Q or 10-K report filings.

**Company Annual Reports**

**Question: Explain how an insurance professional may find a company’s annual report to be a valuable source of information**

An annual report is a formal report on the company’s performance for the stated year. The audience for the annual report is the company’s shareholders and other interested parties such as customers, vendors and investors. **Insurance professionals find the annual report a valuable source of information about the company’s business purpose and philosophy, its financial results, and its directions for the future. This information helps provide a general background for making specific underwriting decisions**.

The united States SEC requires a publicly traded company to keep shareholders informed of its financial state on a regular basis. The annual report is the main method of reporting how the company is performing and explaining the scope of the business, its mission, and its management philosophy. The annual report consists of sections required by the SEC and other information the company believes is appropriate to provide. The sections required include:

* Financial statements and notes
* Auditor’s report
* Report of management
* Management’s discussion and analysis of results of operations and financial condition
* Selected financial data

**Report of Management**

The report of management is a report to the users of the financial statements in which the company’s management acknowledges its responsibility for the quality and integrity of the company’s financial statements, as well as for the accuracy and effectiveness of internal controls over financial reporting. It also attests that management’s assessment of the internal controls has been audited by an independent accounting firm. The report is signed by the chairman of the board and the chief financial officer.

**Management’s Discussion and Analysis of the Results**

Management’s discussion and analysis of results of operations and financial condition (MD&A) is essential to understanding a company’s financial statement. The SEC has set forth three goals for the MD&A.

* Provide a narrative explanation that enables users to view the company from management’s prospective
* Improve overall financial disclosure and provide the context within which financial statements should be analyzed
* Provide information about the quality and potential variability of the company’s income and cash flow that addresses the likelihood that past performance indicates future performance

An MD&A should explain the company’s operating results and condition. It should also provide insight into the opportunities, challenges, and risks faced by the company as well as the action the company is taking to address them.

**Question: Describe the three areas of disclosure on the Management Discussion & Analysis (MD&A) for which the Securities and Exchange Commission (SEC) issued interpretive guidelines in response to the Sarbanes-Oxley Act of 2002**

**The Sarbanes-Oxley Act of 2002 prompted the SEC to issue interpretive guidance for improved MD&A disclosure in three areas:**

* **Liquidity and capital resources, including off-balance sheet arrangements, contractual agreements, and contingent liabilities**
* **Certain trading activities involving non-exchange-traded contracts accounted for at fair market value, including buying or selling private securities**
* **Relationships and transactions with person or entities that derive benefits from non-independent relationships with the company or the company’s related parties.**

The reasoning behind the SEC’s provision of interpretive guidance in these areas was to bring greater transparency to financial reporting.

Transparency ; in the context of financial accounting, the provision of sufficient detail regarding transactions to enable a prudent investor to understand the economic effect of those transactions on the company’s financial statements.

**Part 7 – Limitations of Financial Statements**

**Question: Identify the significant limitations in the accuracy of financial statements**

The accounting concepts and principles used in preparing financial statements give the impression that the information provided in those statements is extremely accurate. However, the process of preparing financial statements requires using many estimates, assumptions and compromises.

**The standard of accuracy for a set of financial statements is that the fairly present the financial position of the organization and the results of its operations. However, a fair presentation is not necessarily accurate down to the smallest detail. Significant limitations of financial statement include these:**

* **Financial statements do not measure the economic value of an organization’s qualitative assets**
* **Financial statements do not give the current fair (market) value of all the organization’s assets and liabilities for determining the organization’s true worth**.

**Qualitative Assets**

**Question: Explain how an organization’s quantitative and qualitative assets are presented**

**Financial statements report on an organization’s quantitative economic data, but typically no value is assigned to the qualitative assets** the organization has developed, such as reputation in the marketplace, the loyal customers of its branded products, the strength of its management team, or its productive workforce. **Although these qualitative assets can be important as the quantitative assets when analyzing an organization, it is extremely difficult, if not impossible, to measure the qualitative assets. Therefore, such assets are not represented in the financial statements**. As more of the stock market value of an organization relies on these intangibles, new measures and ways to value them are being considered.

**Fair Value**

**Question: Explain how the cost principle of accounting limits the accuracy of the financial reporting of an organization’s current value of assets**

The fact that the financial statements do not reflect the current fair value of many of the organization’s assets and liabilities is partly the result of the operation of the cost principle of accounting**. Because the cost principle requires assets to be recorded at the price agreed on at the time of exchange, a balance sheet must reflect a building purchased thirty years ago at the original purchase price, even though it may have a substantially higher current value because of inflation and other market conditions**. Similarly, liabilities are recorded at the amount owed rather than the price at which the liability cold be transferred to another party.

**The income statement is also affected by the cost principle because many expenses, such as depreciation charges and cost of goods sold, reflect historical costs, not replacement costs**. The lack of current fair market values in the financial statements is a significant issue that accounting policy-making bodies within and outside the Unites States are working to resolve.

***An underwriter should not use the value of the building as stated on the balance sheet for determining the amount of insurance coverage needed. The value of the building on the balance sheet is the amount the owner paid for the building. It is likely the value of the building has changed since it was purchased.***