Introduction to Corporate Finance and Accounting

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OVERVIEW OF CORPORATE FINANCE AND ACCOUNTING

The concepts of corporate finance and accounting are applied throughout the insurance industry, so every risk management and insurance professional needs to understand them.

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 closely related to finance, focuses on accumulating and reporting financial information to support decision making.

The 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.

Management, producers, risk management professionals, underwriters, claim representatives, data managers, actuaries, and accountants should understand the concepts underlying corporate finance as well as the accounting standards and techniques used to produce financial statements. For example, to maximize shareholder value, insurer executives should have an in-depth understanding of corporate finance and financial statements so as to examine various levels of debt versus equity financing and their effect on the organization's financial results.

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 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. For example, consider a claim for merchandise inventory that has been stolen or lost in some way that makes the physical confirmation of the amount lost impossible. The financial statements and the data used to prepare them, together with an understanding of the underlying concepts and principles, can help the claim representative to recreate the amount of merchandise inventory on hand before the loss.

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, and 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 the finance and accounting operations of the corporation in an ethical manner not only assists in meeting regulatory requirements, but also is essential to maintaining the integrity of the corporate identity and to retaining customers in a highly competitive marketplace.

Maximization of Shareholder Wealth

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 finance goal, it can result in several problems:

- Focusing on current profits to the 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. This increase in wealth provides compensation to shareholders for their capital investment and an incentive for them to further invest in the corporation.

Financial Transparency

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** also use the financial statements and reports of a corporation and rely on their financial transparency.

Stakeholder
Anyone with a financial interest in the corporation.

The importance of financial transparency has been demonstrated by high-profile cases such as Enron, which resulted in the owners, customers, employees, vendors, and other stakeholders collectively losing hundreds of billions of dollars. These cases led to legislation aimed at restoring investor faith in the financial reporting of United States corporations—in particular, the **Sarbanes-Oxley Act of 2002** (Sarbanes-Oxley). Although Sarbanes-Oxley applies only to publicly traded corporations, all corporations and corporate executives should be aware of the new expectations it creates among stakeholders in terms of financial transparency.

Sarbanes-Oxley Act of 2002
A federal statutory law governing corporate directors in the areas of investor protection, internal controls, and penalties, both civil and criminal.