CPCU 540 Vocabulary

Chapter 1 – Introduction to Corporate Finance and Accounting

* Stakeholder – anyone with a financial interest in the corporation
* Sarbanes-Oxley Act of 2022 – a federal statutory law governing corporate directors in the areas of investor protection, internal controls, and civil and criminal penalties.
* Working Capital – liquidity measure calculated by subtracting current liabilities from current assets. Determines a company's ability to finance immediate operations (inventory).
* Capital Structure – corporation's mix of long-term debt and equity.
* Capital Budgeting – planning and managing of a corporation's long-term investments.
* Statutory Accounting Principles (SAP) – accounting principles and practices permitted by an insurer's state of domicile.
* Fair Value – the market value of an asset or liability.

Chapter 2 – GAAP Financial Statements

* Financial Statement – document that quantitatively presents an organization's financial activities or status.
* Accounting – the classification, analysis, and determination of the appropriate method of reporting the effects of the bookkeeping records in an organization's financial statements.
* Balance Sheet – reports the assets, liabilities, and owners' equity as of a specific date.
* Current Assets – asset classification that includes cash and other assets expected to be converted to cash, sold, or exchanged within one year.
* Current Liabilities – liability classification including obligations whose payments are reasonably expected to require the use of cash within one year.
* Retained Earnings – net income an organization retains for reinvestment in operations.
* Revenue – inflow of assets (cash or accounts receivable) from the sale of products or rendering of services.
* Gross Profit – income statement value of revenue (sales) minus the cost of goods sold.

Gross Profit = Sales – Costs of Goods Sold

* Gross Profit Margin – gross profit shown as a percentage of overall sales.

Gross Profit Margin = (Sales – Costs of Goods Sold) ÷ Sales

* Operating Income – income statement value calculated as gross profit less selling, general, and administrative expenses.

Operating Income = Gross Profit – Selling, General, & Administrative Expenses

* Comprehensive Income – measure of income beyond income statement that includes unrealized gains and losses.
* Changes in Shareholder's Equity – financial statement explaining changes in the organization's capital accounts during a specific period.
* Paid-In Capital – total amount invested in an organization by the owners
* Treasury Stock – corporate stock issued as fully paid to a stockholder and reacquired by the corporation to use for business purposes.
* Statement of Cash Flows – financial statement summarizing cash effects of operating, investing, and financing activities during a specific period.
* Depreciation Expense – accounting method spreading out expense of purchase over life expectancy of the item.
* Generally Accepted Accounting Principles (GAAP) – common set of accounting standards and procedures used in preparation of financial statements to ensure consistency.
* Transparency – provision of sufficient detail to enable a prudent investor to understand the economic effects of those transactions on the financial statement.

Chapter 3 – GAAP Financial Statement Analysis

* Vertical Analysis – statements to highlight basic relationships among items within a single set of financial statements.
* Trend Analysis – identifies patterns in past losses and projects these into the future or comparing financial statement data across two or more periods.
* Ratio Analysis – used to study financial condition of an account by relating two or more similar businesses or items from accounting records.
* Common-Size Statement – statement in which amounts are reported as a percentage.
* Net Profit Margin – Profit shown as a percentage with a deduction for expenses.

Net Profit Margin = (Sales – Cost of Goods Sold – Expenses) ÷ Sales

* Accounts Receivable Turnover Ratio – efficiency ratio indicating how quickly amounts owed are collected. Equal to credit sales divided by accounts receivable.

Accounts Receivable Turnover Ratio = Credit Sales ÷ Accounts Receivable

* Days Sales Outstanding – average number of days it takes for a company to collect.

Days Sales Outstanding = 365 days ÷ Accounts Receivable Turnover Ratio

= 365 days ÷ (Credit Sales ÷ Accounts Receivable)

* Fixed Asset – resources that cannot be sold or consumed within business cycle and considered to be long lived.
* Inventory Turnover Ratio – efficiency ratio indicating how quickly inventory is sold.

Inventory Turnover Ratio = Cost of goods sold ÷ Inventory

* Current Ratio – liquidity ratio indicating company's ability to meet short-term financial obligations.

Current Ratio = Current Assets ÷ Current Liabilities.

* Acid-Test Ratio (Quick Ratio) – liquidity ratio providing measure of company's ability to meet current obligations if it cannot sell its inventory.

Acid-Test Ratio = (Cash + Marketable securities + Accounts receivable) ÷ Current Liabilities

* Debt-to-Equity Ratio – leverage ratio measuring extent a company is financed using borrowing rather than equity.

Debt-to-Equity = Long-term Debt ÷ Equity

* Debt-to-Assets Ratio – leverage ratio measuring extent to which assets are financed with debt.

Debt-to-Assets Ratio = Total Liabilities ÷ Total Assets

* Return on Assets (ROA) – profitability ratio that shows how well a company uses resources.

ROA = Net Income ÷ Total Assets

ROA = (Net income / Sales) x (Sales / Total Assets)

* Return on Equity (ROE) – profitability ratio showing how well a company uses its assets.

ROE = ROA x Equity Multiplier

ROE = Net profit margin x Asset Turnover x Equity Multiplier

ROE = (Net income ÷ Sales) x (Sales ÷ Total Assets) x (Total Assets ÷ Equity)

* DuPont Identity – method of analyzing ROA and ROE by breaking them down into their component ratios, allowing analysis of which factors are driving returns.

For ROA, components show whether ROA is generated by high net income compared to sales or through a high level of sales compared to assets. ROA can also be used to compare two different companies with large difference in net profit or asset turnover.

For ROE, components include ROA, whose components were outlined above, and how well a company uses its equity in relation to assets.

Chapter 4 – Insurer Statutory Accounting

* Policyholders' Surplus – like owners' equity under GAAP, compares assets to liabilities.

Policyholder's Surplus = Assets - Liabilities

* Accounting equation – the equation that relates assets to liabilities and owners' equity.

Assets = Liabilities – Owners' Equity

* Matching Principle – accounting rule requiring expenses incurred in generating revenues to be matched against those revenues.
* Non-Admitted Status – property, such as office furniture, that regulators do not allow to be shown as assets because they cannot be readily converted to cash.
* Admitted Assets – assets meeting liquidity standards and can thereby be reported on balance sheet according to SAP standards.
* Reinsurance Recoverables – amounts due for losses and expenses to an insurer under reinsurance agreements.
* Unauthorized Reinsurer – reinsurer not licensed or otherwise authorized to do business in the insurer's primary state of domicile.
* NAIC Statement – primary financial statement prepared by insurers and required by every state insurance department.
* Loss Adjustment Expense Reserves – money set aside for estimated cost of settling and defending claims for losses that have already occurred.
* Loss Reserve – money set aside for estimated losses that have occurred and been reported, but are not settled.
* Unearned Premium Reserve – an insurer liability representing premiums received from policyholders and not yet earned. Equal to the sum of the following for all policies:

Total Premium x (Days Remaining in Policy Period ÷ Days in Policy Period)

* Surplus Note – unsecured debt instrument issued by insurers to raise additional capital for a mutual insurance company who cannot issue stock like a stock insurance company.

Chapter 5 – Insurer Statutory Annual Statement Analysis

* Liquidity – ease with which an asset can be converted to cash.
* Capacity – ability of an insurer to write additional business, usually based on comparison of written premium to policyholder's surplus, because of new writings strain on surplus.
* Written Premiums – total premium on all policies written during a particular period.
* Earned Premiums – portion of written premium corresponding to coverage already provided.
* Benchmarking – process of comparing results to industry standards or best practices.
* Capacity Ratio (Leverage Ratio) – indicates financial strength or ability to write new business.

Leverage Ratio = Gross Written Premium ÷ Policyholders Surplus

* Reserves-to-Surplus Ratio – measures of ability of surplus to absorb reserve increases.

Unearned Premium Reserve + Loss & LAE Reserves ÷ Policyholders Surplus

* Ceding Commission – amount paid by a reinsurer to an insurer to cover part of all of insurer's policy acquisition expenses.
* Insurance Leverage – extent to which surplus can support a given level of reserves.
* Liquidity Ratio – measures extent to which an insurer can meet obligations due.

(Cash + Invested Assets) ÷ (UE Premium Reserve + Loss & LAE Reserves)

* Loss Ratio – comparison of losses to earned premiums.

Loss Ratio = (Incurred Losses + LAE) ÷ Earned Premiums

* Expense Ratio – cost of underwriting business against premium written

Expense Ratio = Underwriting Expenses ÷ Written Premium

* Combined Ratio – profitability ratio indicating underwriting profit or loss. Combination of Loss Ratio and Expense Ratio. Anything below 100% indicates profit.

Combined Ratio = Loss Ratio + Expense Ratio

* Operating Ratio – measures overall pre-tax operational profit from underwriting and investing activities.

Operating Ratio = Combined Ratio – Investment Income Ratio

* Investment Income Ratio – measures income earned from the investment portfolio for each dollar of earned premium. If below 100% it indicates a profit from core operations.

Investment Income Ratio = Investment Income ÷ Earned Premium

* Investment Yield Ratio – indicates the total return on investments compared to base assets.

Net Investment Gain or Loss ÷ (Total Cash + Invested Assets)

* Return on Policyholder's Surplus – shows rate of return insurer is earning on its resources.

Net Income ÷ Policyholders' Surplus

* IRIS Ratios – ratios examined by regulators annually to review financial health of insurers.

Chapter 6 – Cash Flow Valuation

* Future Value – value that an amount today will be worth at a certain point in the future.

Future Value = Present Value x (1 + Interest Rate)

or

FV = PV x (1 + r)

* Simple Interest – interest earned only on the original amount invested.

FV = PV x (1 + r)

* Compound Interest – interest earned on both the original amount invested and any interest previously earned.

FV2 = FV1 x (1 + r)

which is equal to

FV2 = PV x (1 + r) X (1 + r)

which can be shortened to

FVN = PV x (1 + r) N

When interest is compounded more than once per year you must take into account the number of times per year interest is paid, expressed as M.

FVN = PV x (1 + r ÷ M) N x M

* Stated Interest Rate – quoted annual rate of interest that does not take into account frequency of compounding.
* Effective Annual Interest Rate – reflects the effect of compounding more than once a year.
* Discounting – process of calculating present value of a future amount.
* Discount Rate – interest rate on loans made by the Federal Reserve to deposit banks.
* Present Value – value today of money that will be received in the future.

PV = FVN ÷ (1 + r) N

* Annuity – series of fixed payments made on specified dates over a set period.

Calculated as the sum of the Future Values paid in the future.

* Ordinary Annuity – series of equal periodic payments made at the end of each period.
* Annuity Due – series of equal periodic payments made at the beginning of each period.
* Perpetuity – a series of fixed payments made on specified dates indefinitely.
* Net Present Value (NPV) – present value of all future net cash flows.

Calculated as the sum of a series of Present Value calculations.

Chapter 7 – Bonds and Stocks

* Financial Market – mechanism used for trading securities.
* Securities – written instruments representing either money or other property.
* Money Market – financial market in which short-term securities are traded.
* Capital Market – financial market in which long-term securities are traded.
* Primary Market – mechanism in which new securities are sold, with the proceeds going directly to the issuer.
* Bid Price – the price a dealer is willing to pay for a security.
* Asked Price – the price at which a dealer is willing to sell a security.
* Bid-Asked Spread – the difference between the bid price and the asked price of a security.
* Secondary Market – mechanism for investors to buy and sell previously issued securities.
* Market Depth – ability of a market to handles a large number of security transactions without a significant effect on prices.
* Market Breadth – percentage of overall market that is participating in move up or down.
* General Obligation Bond – municipal debt instrument secured by full faith, credit, and taxing authority of the state or municipality.
* Revenue Bond – debt instrument payable entirely from revenue received from users of the financed project.
* Eurobond – long-term debt issued and offered outside the issuer's country of origin.
* Bond – a long-term debt instrument that requires the issuer to pay a set annual interest rate and the borrowed sum on a specified date.
* Indenture Agreement – legal document detailing terms of a bond.
* Maturity Date – date on which a bond's principal becomes due.
* Principal – the amount borrowed under a loan.
* Face Value – bond's original value and amount paid at maturity.
* Coupon Rate – bond's annual interest rate, stated as a percentage of par value.
* Coupon – amount of interest paid on dates specified in indenture agreement.
* Convertible Bond – debt instrument giving the holder the option to convert the bond to another security at a specified price within a given period of time.
* Guaranteed Bond – debt instrument guaranteed by an entity other than the issuer.
* Floating Rate Bond – debt instrument that pays interest at a rate indexed to U.S. Treasury security or money market rates.
* Zero-Coupon Bond – corporate bond that does not pay periodic interest income.
* Sinking Fund Provision – requires a bond issuer to set aside money as periodic intervals for purpose of repaying a portion of existing bonds each year.
* Secured Bond – debt instrument secured by specific assets with priority over funds received in liquidation of those assets.
* Debenture Bond – an unsecured general obligation of the issuing corporation.
* Asset-Backed Security – financial instrument collateralized by a pool of loans, leases, or other receivables.
* Mortgage-Backed Securities – financial instrument collateralized by a pool of mortgages.
* Yield to Maturity (YTM) – a measure of the total rate of return a bondholder will earn if bond is held to maturity.
* Credit Risk – the risk that customers or creditors will fail to make promised payments as they become due.
* Investment Grade Bond – bond issued receiving one of the top four investment quality ratings from Moody's and/or S&P.
* Junk Bond – bond receiving Ba / BB or lower rating from Moody's and/or S&P.
* Liquidity Risk – risk that an asset cannot be sold on short notice without a loss.
* Liquidity Premium – additional return to compensate investors for relative illiquidity of an investment. Greater illiquidity yields a higher return demanded.
* Term Structure – effect of a bond's price on the length of time to maturity.
* Maturity Premium – the difference in yield between one term of maturity and another.
* Real Rate of Return – rate of return adjusted for effects of inflation.
* Inflation Premium – increase in return to account for expected decrease in purchasing power due to price inflation.
* Preferred Stock – non-voting stock that has priority over common stock regarding dividends and corporate liquidation.
* Cumulative Preferred Stock – security that gives the holder the right to receive accrued unpaid dividends before dividends are paid to common stockholders.
* Noncumulative Preferred Stock – security that does not give holder the right to receive accrued unpaid dividends.
* Convertible Preferred Stock – allows the holder to convert it to a states number of common shares of the issuing company.
* Common Stock – ownership interest providing rights, privileges, and receipt of dividends.
* Fundamental Analysis – method of determining stock price by analyzing data fundamental to the company, such as expected growth of earnings, sales stability, dividend payout ratio, financial leverage, and institutional stock ownership.
* Dividend Payout Ratio – dividends paid divided by earnings.
* Technical Analysis – method of determining stock price by trying to detect patterns in market activity statistics, past prices, and market value.
* Efficient Market Hypothesis – asserts that stock prices reflect expectations of all market participants and that no individual investor has superior knowledge.
* Amortized Cost – accounting recognition of the difference between bond purchase price and face value from the purchase until maturity.
* Mark-to-Market – adjustment in an asset's valuation to reflect changes in its actual or estimated market price.
* International Financial Reporting Standards (IFRS) – financial standards developed by the International Accounting Standards Board (IASB).
* Realized Capital Gain – profit earned when an asset is sold for more than its cost.
* Unrealized Capital Gain – profit not yet earned on an asset whose value exceeds its original purchase price, but has not yet been sold.
* Impairment – the reduction in the cost basis of a financial asset by an amount that is deemed to be unrecoverable.

Chapter 8 – Insurer Investment Portfolio Management

* Variance – measure of difference of a value from the average. The difference between the value and the average is squared and then divided by the number of values in a set (N) minus one.

Variance = Sum of Squared Deviations ÷ (n – 1)

* Standard Deviation – square root of variance or the mean of the individual value's variation. A low standard deviation indicates the data points are close to the mean while a high standard means the data points are fairly spread out.

Standard Deviation = √ Variance

* Coefficient of Variation – a comparison of standard deviation against the mean to help compare two data sets whose standard deviations may be similar but who have very different means.

Coefficient of Variation = Standard Deviation ÷ Mean

* Value at Risk – value beyond which the probability of loss on a portfolio exceeds the value over a given time period. Determined by the probability of a dollar loss and the time horizon during which a loss can occur:

VaR of 5% with one day time horizon of $300,000 means that there is a 5% probability of losing $300,000 or more in one day.

* Beta – measure of an asset's volatility relative to overall market for that asset.

A beta of 1 means it is equally as volatile as the market. Anything above one indicates a higher volatility and anything below one represents a lower volatility.

* Risk-Return Trade-off – tendency of return to increase as risk increases.
* Market Risk – uncertainty about future value of an investment because of potential market changes for that asset.
* Company-Specific Risk (Unsystematic Risk) – risk affecting a specific company or a small group of companies, but not the overall market.
* Diversification – risk control technique that spreads loss exposures over numerous products, markets, or regions to reduce overall risk while maximizing return.
* Correlation – the degree to which assets move relative to each other or independently, ranging from +1 to -1.

If two securities have a correlation of +1, then they are perfectively positively correlated and price changes always move in the same direction. If they are -1, or perfectively negatively correlated, then their price changes always move in opposite directions. If their price movements are totally unrelated, or uncorrelated, then the correlation coefficient is zero.

* Efficient Frontier – portfolio combination that generates the highest rate of return for a given level of risk or the lowest risk for a given level of return.
* Cash Matching – process of matching an investment's maturity value with the amount of expected loss payments.
* Reinvestment Risk – risk that the rate of interest at time of reinvestment will be unfavorable.
* Duration – a measure of a security's weighted average life.

For bonds, it is the number of years required to recover the true cost of a bond, considering the present value of all coupon and principal payments to be received in the future.

* Portfolio Immunization (Asset-Liability Matching) – the process of matching investment duration and liability duration so that assets are available to fund liabilities as they are due.

Chapter 9 – Insurer Capital: Needs and Sources

* Solvency – ability of an insurer to meet financial obligations due now or in future claims.
* Reinsurance – the contractual transfer of insurance risk from one insurer to another where the reinsurer agrees to accept insurance risk and indemnify the primary insurer for financial consequences of certain loss exposures in exchange for a premium paid by the insurer.

Also referred to as "insurance for insurance companies" because in catastrophe excess of loss reinsurance a primary insurance company purchases insurance coverage from a reinsurance company, exchanging premium for insurance coverage that protects them from catastrophic losses up to a certain limit.

* Loss Portfolio Transfer – a retroactive plan that applies to an entire portfolio of losses.

If the payment made by the insurer to transfer the loss liabilities is less than the value of loss reserves shown on its financial statements, losses are reduced by more than the assets paid to the reinsurer, resulting in an increase in capital.

* Payout Ratio – the proportion of a company's earnings or net income paid out as dividends to shareholders.

Chapter 10 – Capital Management

* Financial Leverage – the use of fixed cost funds (debt) to increase shareholder returns.
* Cost of Capital – the opportunity cost of funds provided by investors.
* Unsystematic Risk (Specific) – risk that arises from factors that are unique to a particular investment.
* Systemic Risk – risk that exists among all members of a market and therefore cannot be removed through diversification.
* Underwriting Risk – a measure of the loss volatility of the insurance sold by an insurer.
* Risk-Based Capital (RBC) – amount of capital needed to support insurer operations given the insurer's risk characteristics.
* Market Value Surplus – a name for net worth under fair value accounting, it is the fair value of assets minus fair value of liabilities.
* Enterprise Risk Management (ERM) – approach to managing an organizations key business risks and opportunities with the intent of maximizing shareholder value. Goes beyond portfolio management and looks at risk within all organizational departments.

Chapter 11 – Mergers and Acquisitions

* Merger – acquisition where two or more entities are combined into one.
* Acquisition – purchase of one company's stock by another company.
* Consolidation – combination of two entities into a new entity.
* Takeover – assumption of control by one corporation over another.
* Proxy Contest – a strategy for gaining control of a company by obtaining voting rights of the target's shareholders.
* Tender Offer – a purchase offer made directly to target's shareholders at a price greater than current market price.
* Divestiture – the disposal or sale of part of a company.
* Spin-Off – the creation of a new company from part of an existing company.
* Horizontal Acquisition – a combination of two companies in the same type of business.
* Vertical Acquisition – a combination of two companies involved in related lines of business, but at different stages of production.
* Conglomerate Acquisitions – a combination of two companies involved in unrelated lines of business.
* Revenue Efficiency – a measure of the extent to which a company's revenues can be increases through acquisition or merger with one or more entities.
* Cost Efficiency – a measure of the extent to which a company's costs can be reduced by acquisition or merger with one or more entities.
* Due Diligence – the process of examining a company's operations, finances, and management to verify material facts that affect company value.
* Loan Covenant – a condition that must be met to keep the loan in compliance.

Chapter 12 – The Underwriting Cycle

* Profit Cycle – a recurring increase and decrease in profits regarding a single organization or industry.
* Underwriting Cycle – a cyclical pattern of insurance pricing in which a soft market (low rates, relaxed underwriting, and underwriting losses) is eventually followed by a hard market (high rates, restrictive underwriting, and underwriting gains) before the pattern again repeats itself.
* Structural Change – gradual, long-term, and fundamental change involving institutional arrangements, products, services, roles, and regulation.
* Non-Admitted Insurer – an insurer who is not authorized by the state insurance department to do business within that state.
* Re-Underwriting – the process of analyzing the characteristics of policies within a portfolio and the trends that cause those characteristics.
* Capital – the accumulated assets of a business or an owner's equity in a business.
* Cash Flow – cash inflow minus cash outflow.
* Supply – in insurance terms, the aggregate willingness of all insurers to assume risk at a given time.
* Surplus Relief – a flow of funds into an insurer's policyholders' surplus when it has been reduced by the insurer's rapid growth in written premiums.
* Elastic Demand – willingness to purchase a product that varies significantly with price.
* Inelastic Demand – willingness to purchase a product regardless of a change in price.