Small Medium Enterprises Guide to Risk Management

1. Introduction

This guide should heighten your awareness of business insurance and encourage you to consider carefully the various insurance policies and options available to you. Adequate insurance coverage is imperative for a firm to be successful.

In addition to helping you identify, minimize and, in some instances, eliminate business risks, this guide includes a checklist to help you strengthen your insurance policy and provides guidelines for discussions you should have with your insurance company.

2. Risk and the Small Business

Is your business a risky business? Every small business is. Just think for a minute about the hundreds of things that most business owners worry about. A few are predictable or, at the very least, are items that you can plan for and perhaps even control to a certain extent, such as,

Expected sales volume:

- Salary costs
- Taxes
- Overhead
- Equipment and supply costs
- The price you charge for the goods or services you offer to your customers

Others are unpredictable and largely beyond your control, such as:

- Actions your competitors take
- Changing tastes and trends
- The effect these actions and changes have on your market and your customers
- The local economy and its impact on your customer base (for example, plant closings or unemployment)

Still other events can directly affect your day-to-day operations, reduce profits and result in unexpected financial losses serious enough to destroy or even bankrupt your business. You've probably already considered the most obvious risks, such as fire or injury, and have bought insurance to protect against them. But there are hundreds of other losses and liabilities that every small business faces, many of which are overlooked or ignored.

Large corporations often employ a full-time Risk Manager to identify and analyze possible exposures to loss or liability. The Risk Manager takes steps to protect the firm against accidental and preventable loss and to minimize the financial consequences of unpreventable or unavoidable losses. But most small businesses can't afford the services of a Risk Manager, even part time, so the business owner often has to take on that responsibility.

3. What is Risk Management?

Risk Management consists of:

1. Identifying and analyzing the events that may cause loss
2. Choosing the best way to deal with each of these potentials for loss

4. Exposures to Loss

Identifying exposures is a vital first step to risk management; until you know the scope of all possible losses, you won't be able to develop a realistic, cost-effective strategy for dealing with them.

It is not easy to recognize the hundreds of hazards or perils that can lead to an unexpected loss. For example, unless you've experienced a fire, you may not realize how extensive fire losses can be. Damage to the building and its contents are obvious, but you should also consider:

- Smoke and water damage
- Damage to employees' personal property and to others' property (e.g. data-processing equipment you lease or customers' property left with you for inspection or repair) kept on the premises
- The amount of business you'll lose during the time it takes to return your business to normal
- The potential permanent loss of customers to competitors

Begin the process of identifying exposures by taking a close look at each of your business operations and asking yourself what could cause a loss. If there are dozens of exposures you may find dozens of answers.

For each exposure you identify, ask yourself how serious is that loss. This question focuses on the possible severity of each exposure, e.g. what would that loss cost? The purpose here is not to determine the source of replacement or repair funds, but the full cost of the loss.

Business owners use a risk analysis questionnaire or survey available, as a checklist.

In general, most questionnaires and surveys address the potential for:

- Property losses
- Business interruption losses
- Liability losses
- Key person losses
- Vehicle losses
- Injury to employees

Property Losses

Property losses from one of the following:

- Physical damage to property
- Loss of use of property
- Criminal activity

Physical Damage

Property damage can be caused by many common perils, such as fire, windstorm, lightning and vandalism. To cope effectively with the possibility of physical damage to property, the business owner should consider more than just damage to or destruction of a building. Contents may be even more susceptible. Manufacturers might lose raw materials and finished goods, and merchants, valuable inventories and fixtures. Any business might lose valuable accounting records, making it difficult to bill or collect from customers. Vital machinery or equipment may become inoperable, and, if replacements can't be found and installed immediately, the business may even be forced to temporarily shut down.

Loss of Use

You can lose the use of your business property for reasons other than physical damage. Government can close a manufacturer for violating health and safety regulations. The local health department can close a restaurant because of unsanitary conditions. These are normally uninsurable losses unless caused by an insured peril, e.g. fire.

Criminal Activity

Small businesses may also be susceptible to crimes. Burglary and robbery are obvious perils, but so are employee theft, embezzlement and forgery. Merchants, in particular, may need protection against losses caused by forged checks or unauthorized use of credit cards

Business Interruption Losses

You have already seen how a direct loss from fire can shut down a business temporarily. Although insurance provides money for repairing or rebuilding property damaged as a direct result of fire, most policies do not cover indirect losses, such as income that is lost while the business is interrupted for repairs.

A special kind of insurance covers indirect losses that occur when a direct loss (that results from a covered peril, such as fire) forces a temporary interruption of business. Business interruption insurance reimburses policyholders for the difference between normal income and the income earned during the enforced shutdown period. Not only is income reduced or cut off completely during such interruptions, but many business expenses continue, such as taxes, loan payments and salaries to key employees, interest, depreciation and utilities. Without income to pay these expenses, the business is forced to dip into reserves if any.

Interruptions in business also often trigger extra expenses. For example, overtime may be authorized to speed the business towards full operation again, or it may reopen with a skeleton staff (additional payroll) in temporary quarters (additional rent) using leased furniture and equipment (additional overhead). These expenses put an added strain on finances at a time when little if any income is being produced.

A firm can also buy business interruption insurance to protect against interruptions triggered by direct loss on someone else's property. For example, if a key supplier is shut down by a fire and can't deliver critical raw materials to a manufacturer, the manufacturer's business may be seriously interrupted.

Property damage at a key customer's business may have the same effect. If you depend on one firm for most of your volume and that firm is forced to suspend purchasing, you will lose income.

Liability Losses

Every business also faces exposure to liability losses. A business may become legally liable (i.e. responsible for payment) for bodily injury suffered by another person or persons, or for damage to or destruction of the property of others.

This liability may be the result of :

- A court decision (as in a lawsuit charging negligence)

- Statutory provisions (such as an Employee Compensation from employers liability law)

- Violation of contract provisions (a contract that makes one party responsible for certain kinds of losses)

Public Liability

A business may be held liable for injuries or other losses suffered by a member of the general public as the result of the firm's (or its employees') negligence or fault. Examples include:

- A customer in a firm's building trips on a broken step

- A defective product causes injury to its user

- Improper installation of a product causes injury to a customer

- A tenant is held responsible for a third-party injury occurring on the rented property, due to a clause he or she signed agreeing to such responsibility

Your daily paper will provide dozens of other examples. A firm that is found legally liable for harming a third party must pay damages to compensate the injured party. Sometimes the court also imposes punitive damages and, in cases involving violation of statutes designed to protect the community, the court may levy fines in order to discourage future violations.

Regardless of who wins or loses a lawsuit, litigation is time consuming and expensive. No matter how ridiculous or unfounded the suit may be, productive business hours are lost, lawyers must be retained and paid and other related costs must be met while the suit is being contested.

Liability to Employees

Laws require most employers to compensate employees for loss of income or medical expenses resulting from work-related disease or injury (except for certain self-inflicted injuries). Should an employee die as a result of a job-related accident or disease, the employee's family also collects a specified amount if the employer is found liable of an error or emission.

So far, the exposures we have looked at have all been more or less external to the business. There are, however, several major exposures that have to do with the business itself.

Key Person Losses

What would happen to your business if an accident or illness makes it impossible for you to work? What if one of your partners or your sales manager suddenly dies? Most of us would rather not think about such a "what if", but it is important for you to prepare your business for survival long before a key person dies or is disabled.

Serious Illness or Disabled Owner

- What will the owner's source of income be? How will it be treated for tax purposes?
- Who will continue the business? What if that person is not qualified or is a minor?

Death of an Owner

- If a will is not in place before the owner's death, will the business close or will someone inherit it?
- If the owner's life savings are invested in the business, will the surviving family be able to use them wisely?
- What will be the surviving family's source of income while the future of the business is being decided? If the business is to be sold, where will working capital come from for the transition period? How will the fair market value of the business be determined? Will the fair market value change because of the loss of a key person?
- If the business forms the bulk of the estate, what are the income and inheritance tax implications for the surviving spouse and heirs?
- Is there some pre-death strategy that could minimize that tax liability?

The answers to these questions can best be determined with the help of your business' planning team: your lawyer and accountant. Their expertise in estate planning, financial planning, and current legal and tax will help you develop a plan for your business' survival.

Death of a Partner

Unless the partners have prepared some other binding arrangement, a partnership is dissolved when one partner dies. The duties of the surviving partner(s) are limited to winding up the affairs of the partnership. Also, the surviving partner(s) will be personally liable for losses that the business's assets are insufficient to cover.

Partners may set up agreements for the surviving partner(s) to purchase the deceased partner's interest at a prearranged valuation. Business life insurance on each partner can provide the funds needed to purchase that interest.

- Who should pay the premium? The business? Each partner?
- What are the advantages and disadvantages of these alternatives?
- What are the tax implications of each?
- How would each affect the firm's cash flow?

There are many insurance covers and many ways to set up the necessary insurance. Your insurance company can suggest a wide range of options compatible with your needs, your firm's cash position and tax implications.

Death of a Major Shareholder

In most small businesses, there are only a few shareholders, and most of them take an active part in running the business.

Death of a major shareholder often throws a spotlight on the survivors' differences. Conflict or major personality clashes can seriously threaten the survival of a firm. Dissension also damages employee morale, can lead to a loss of business and may even harm the firm's credit rating.

Unless otherwise provided for, the deceased major shareholder's shares will become part of his or her estate. While the estate is being settled, the estate administrator can vote in the deceased shareholder's place. If a controlling interest in the firm is involved, the administrator can name a new board of directors and take over full control of the corporation.

- What if the heirs decide to get involved in the business? If they decide to retain the stock, will it provide enough income to support them?

- If the heirs decide to sell the stock, will the other major shareholders have the right of first refusal? Can a plan be set up to allow the surviving shareholders to finance a buyout of the heirs' holdings? Without such a plan, will the remaining shareholders' search for buyout funds have any impact on the firm's credit?

Once again, planning is essential. Your lawyer, accountant and insurance company can develop a legally binding strategy to prevent outsiders from unexpectedly coming into the business and to ensure an orderly changing of the guard should a major shareholder die.

Loss of a Key Person

What would happen if you were to suddenly lose the services of a key person (e.g. a sales manager or the office manager/bookkeeper) because of illness, disability or death?

- What impact will that person's absence have on sales volume? Costs? Productivity? Efficiency? The firm's credit?

- How will you reassign duties to cover the missing person's functions?

- What extra costs will you have to incur to recruit a replacement?

- How long will it take before the replacement is trained and productive?

5. Small Group Benefits

We've already touched briefly on some legally required employee benefits:

- Social Security
- Employee Compensation from Employer's Liability
- Temporary disability benefits

Most firms recognize that employees expect basic benefits in addition to those listed above. As an employer, you compete for the most qualified individuals in the local labor pool. Unless you offer at least minimal benefits, attracting and keeping qualified employees may be very difficult.

You may want to consider offering one or more of the following benefits:

- Pensions
- Group health protection or group health plan. Health benefits may include life /death insurance, medical, prescription medicines and major medical expenses
- Other group insurance benefits (life, travel, accidental death and personal, vehicles and homeowners)

6. Loss Exposures and Risk Management

As you can see, a business may face several types of risks and exposures. Once exposures have been identified and analyzed, and employee benefits have been reviewed, you must decide upon the risk management measures that will best protect your business. The next two steps in this process are similar to those we face in managing our personal finances.

1. Loss control - What can be done to prevent or limit exposure?
2. Guaranteeing availability of funds - What techniques can be used to ensure that funds will be available for unavoidable losses?

Limiting Exposure to Loss

Avoiding Risks

One principle of loss prevention and control is the same in business as it is in personal life: avoid activities that are too hazardous. For example, a merchant may decide not to sell a particular product because it is likely to injure customers; thus, the firm avoids a product-liability exposure, or if you can't avoid an exposure completely, minimize it.

An apartment owner may decide against constructing a new building on a rural hillside site that has a long history of bushfires. Instead, he builds on level, suburban land, which is supplied by town water and is two minutes from a fire station. Although exposure of loss from fire can be eliminated completely, this owner has reduced the possible severity of loss by choosing a safer site. Look again to see if the extent of possible loss can be further reduced.

That same apartment owner, for example, may decide to build using fire-resistant construction and materials, thereby reducing the chance of a fire's spreading. He may also decide to install smoke detectors, fire alarms and sprinkler systems throughout the building.

Risk Retention

A business owner may decide that the firm can afford to absorb some losses, either because the frequency and probability of those losses are low or because the euro's value of the losses is manageable.

For example, a firm owns several business vehicles. The drivers have an excellent safety record, and exposure to collision is low because these vans cover rural routes. These are older vehicles, and their book value has decreased substantially. The firm decides to drop the collision coverage completely. If an accident damages one or more of the vans, the firm will pay for damages with company funds. In effect, the firm has decided to retain the risk itself rather than transfer the risk to an insurance company by paying for collision insurance. An alternative is that the firm could decide to retain only part of the risk and insure the rest.

Transferring Risk

Another method of managing exposure to loss is by transferring the risk. Although most businesses do this by buying insurance (which transfers some or all of the risk to the insurance company), there are noninsurance options.

- In the above example, the firm may decide to eliminate the collision exposure completely by selling the firm's vans and hiring a local delivery service. This solution eliminates not only the collision exposure, but also the exposures associated with owning and maintaining the vans. In effect, the firm has transferred all of the expenses to the local delivery service.

- To reduce exposure to property damage, a retailer may decide to cut in-store inventories and to handle certain items on a special-order basis only. The owner will place small reorders with suppliers more frequently. The result? Lower inventory values in the store, therefore, lower exposure. The retailer is actually transferring much of the exposure of property loss to the suppliers.

Insurance as a Risk Strategy

The most common method of transferring risk is insurance. By insuring your home and car, you have transferred much of the risk of loss to the company that issued the policy. You pay a relatively small amount in premium rather than run the risk of not protecting yourself against the possibility of a much larger financial loss.

In business insurance, as in personal insurance, only you can decide which exposures you absolutely must insure against. Some decisions, however, are already made for you:

- Those required by law (such as Employer's Liability).
- Those that others require. For example, you cannot register or operate a business vehicle unless you can prove that it is insured. Similarly, few lenders will finance property or construction unless it is adequately insured and the lender is named on the policy as having an insurable interest.

Services Insurers Provide

You may not be aware of other services that insurance companies provide to policyholders:

- Legal defense - Liability insurance (particularly for property damage and bodily injury) usually includes legal defense when the policyholder is a party to a lawsuit that involves a claim covered by the policy. Litigation is costly, whether the claimant's suit is valid or ridiculous. The legal defense provision greatly reduces those costs to the policyholder.
- Rehabilitation - Insurance companies that write a lot of Employee Compensation from employer's liability insurance may provide access to extensive rehabilitation services. Generally, these services help return injured workers to employment and, in some cases, may even help train the workers for a different job.
- Loss control services - Some commercial insurance policyholders may also qualify for consulting services of the insuring company's loss control (or engineering) department. This department is staffed with engineers and safety experts who specialize in inspecting business premises, identifying hazards, perils and possible trouble spots and recommending possible solutions.
- Claim management services - Some commercial insurers provide claim management services that support the policyholder in loss analysis.

7. What do I Need to Think about when Buying Insurance for a Business?

Insurance documentation - When applying for insurance cover, you will be asked to give information about your business. Your enterprise's information will enable us to assess your risk and advise you to take out the covers that better suit your own needs. Details will include name, address and business of the proposer, previous losses, and details of the risk to be insured. All questions are fully answered and all relevant facts concerning the business are disclosed to us. Failure to disclose all relevant facts fully, whether specifically asked or not, might entitle us to treat the policy as invalid.

8. Organizing your Insurance Policy

Good risk and insurance management is achieved through organization and planning. A lifetime of work and dreams can be lost in a few minutes if your insurance policy does not include certain elements. To ensure you are adequately covered, take these steps:

1. Recognize the various ways you can suffer loss
2. Follow the guides for buying insurance economically
3. Organize your insurance management program
4. Get professional advice

Recognize the Risks

The first step toward good protection is to recognize the risks you face. Some businesses will need coverage's not mentioned in the checklist. For example, if you use costly professional tools or equipment in your business, you may need special insurance covering loss or damage to the equipment or business interruption resulting from not being able to use the equipment.

Study Insurance Costs

Before you purchase insurance, investigate the methods by which you can reduce the costs of your coverage. Be sure to cover the following points:

1. Decide what perils to insure against and how much loss you might suffer from each
2. Cover your largest loss exposure first
3. Use as high a deductible as you can afford
4. Avoid duplication of insurance
5. Buy in as large a unit as possible. Many business policy packages are suitable for small businesses, which are designed to serve and often are the only way a small business can get adequate protection
6. Review your insurance program periodically to ensure that your coverage is adequate and your premiums are as low as possible yet consistent with sound protection

Have a Risk Management Plan

To manage your insurance program for good coverage at the lowest possible cost, you will need a definite plan that supports the objectives of your business. Here are some suggestions for good risk and insurance management:

1. Write down a clear statement of what you expect insurance to do for your firm

2. If an employer or partner is going to be responsible for your insurance program, be sure he or she understands the responsibility

3. Do everything possible to prevent losses and to keep those that do occur as low as possible

4. Go Direct to save money!

5. Don't try to save money by underinsuring or by not covering some perils that could cause loss, even though you think the probability of that loss occurring is very small. If it is small, the premiums also will be small

6. Keep losses better coverage at lower costs in the future

7. Have your property appraised periodically by independent appraisers. This informs you of your exposures, and allows you to prove more conclusively what your actual losses are if any occur

9. Summary

Some small business owners look on insurance as if it were a sort of tax. They recognize it as necessary but consider it a burdensome expense that should be kept at a minimum. Is this view justified? No, if you take a more conservative approach. Used correctly, insurance can contribute a great deal to your success by reducing the uncertainties under which you operate. It can reduce employee turnover, make it easier to sell customers on favorable terms and help your business continue in case an insured peril interrupts operations. The potential benefits of good insurance management make it well worth your study and attention.