

ENTREPRENEURIAL MANAGEMENT – LECTURE 14

CHAPTER 14 – **Managing Risk**

LESSON 14

Managing Risk

Learning Objective 14.1 – What is Business Risk?

To various people, risk means different things. It could indicate the possibility of failing an exam for a student. Risk for a retiree could be the possibility of being unable to live comfortably on a fixed income. It takes the shape of the risk that a new business would fail for an entrepreneur. "In this world, nothing can be considered to be certain, except death and taxes," Benjamin Franklin once stated. This aphorism could be extended to encompass commercial risks by small business entrepreneurs.

Simply put, risk refers to the "possibility of harm or loss." The probability of losses linked with a firm's assets and earnings potential is referred to as business risk. The term "assets" is used here to refer to not only goods and equipment, but also people, customers, and a company's reputation. Market risk and pure risk can both be used to examine the nature of business risk. The uncertainty associated with an investment choice is known as market risk. An entrepreneur who invests in a new firm aspires to make a profit, but understands that the end result could be a loss. She or he will learn the final result only after finding the investment opportunity, devising plans, and investing resources. Pure risk refers to a situation in which the only outcomes are loss or no loss—there is no possibility of profit. Property ownership, for example, entails the risk of loss due to fire or extreme weather. There are just two possible outcomes: loss or no loss. In general, only pure risk may be insured. That is, insurance isn't designed to shield investors from market risks, which include the possibility of both profit and loss.

Learning Objective 14.2 – Basic Types of Risk

Property, liabilities, and staff are the three primary risks that any company faces. Let's look at these sorts of pure risk, which are associated with a company's physical, legal, and human characteristics.

Property Risk

Real property and personal property are the two primary categories of property. Real property consists of land and anything related to it physically, such as buildings. Some business owners prefer to own land and structures, while others opt to lease critical real estate. It is essential to note, however, that some leases hold the lessee liable for any loss or damage to the leased property. Personal property

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consists of all non-real estate assets. Personal property consists of machinery, equipment (including computers), furniture, fixtures, inventory, and vehicles. While the location of real property is immovable, personal property can be relocated. The computer security concerns posed by hackers and spyware to the tiny company's computers are among the risks to its personal property. There are numerous methods for determining the worth of a piece of property. Replacement value is the cost of replacing personal items and reconstructing real property at current prices. For instance, a building erected ten years ago at a cost of \$1,000,000 may now have a replacement value of \$1,400,000 due to escalating material and labor costs. A property's actual cash value (ACV) is significantly different from its replacement value, as this insurance phrase refers to the property's depreciated worth.

Peril

A hazard is a factor that causes losses. Natural phenomena such as storms, floods, earthquakes, and lightning can cause certain threats. Location can enhance a property's vulnerability to certain dangers; for example, seaside residences are more vulnerable to wind damage and flooding, and properties near fault lines are more prone to earthquake damage.

Losses

Typically, when one analyzes property loss, one imagines a direct loss, in which physical damage to the property reduces its value to the owner.

Indirect property loss is less obvious since it occurs from the inability to continue routine activities after a direct loss. For instance, if a delivery van is damaged in an accident, the business's ability to distribute products to clients may be hindered.

Liability Risks

Legal liability that may emerge from various company acts is currently a big worry for businesses. A society establishes laws to govern the interactions between its members. These statutes preserve individual liberties and rights. If a business or one of its agents infringes these protected rights, the business is responsible for any resulting loss or damage. Legal liability may result from statutory liability, contractual liability, or tort liability.

Statutory Liability

Several statutes impose legal obligations on businesses. For example, each state has enacted workers' compensation laws that, in the vast majority of cases, force employers to provide specific

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payments to injured workers, regardless of fault. The majority of workers' compensation legislation require companies to provide the following benefits to employees injured on the job: reimbursement of medical expenses, compensation for lost wages, payment of rehabilitation costs, and death benefits for the employee's family.

Contractual Liability

Frequently, businesses get into contracts with third parties. These contracts may include a lease of property, a sales deal with a consumer, or an agreement with an outsourcing agency or a construction company. The inclusion of an indemnification clause is a common denominator with the majority of these contracts.

Tort Liability

Civil wrongs include contract violations and torts. Torts are unlawful acts or omissions for which a victim may file a lawsuit against the defendant in order to recover monetary damages. Commonly, carelessness is alleged in tort lawsuits, but four factors must be present for someone to be held guilty of a negligent act:

1. A legal obligation exists between the parties.
2. failure to provide the required level of care
3. Existence of harm or loss
4. proof that the negligent behavior is the direct cause of the loss

Personnel Risks

Personnel hazards are risks that directly affect specific individuals, but may also have indirect effects on a company. In this category, the key risks include premature death, poor health, and inadequate retirement income.

Learning Objective 14.3 – Risk Management

Risk management comprises all actions made to maintain a company's assets and profitability. Due to the fact that risk management evolved from insurance management, the two terms are frequently used interchangeably. Risk management include both insurable and uninsurable risks, as well as non-insurance ways to decreasing all types of risk. It focuses on locating the most efficient strategy to lower the cost of risk management. Insurance is merely one of various methods for mitigating the inherent risks a business

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will always face. A comprehensive treatment of all types of liability protection is outside the scope of this article. Experts and specific information sources on protecting a small business should be consulted before to making these choices.

The Process of Risk Management

Five steps are required to develop and implement a risk management program.

Step 1: Identify and understand risks

Step 2: Evaluate the potential severity of risks

Step 3: Select methods to manage risk.

Step 4: Implement the decision

Step 5: Review and evaluate

Risk Management in the Small Business

Risk management is a major issue regardless of the nature or size of an organization. Too frequently, small enterprises analyze possible risk insufficiently. "Small businesses spend more time arranging company picnics than preparing for an event that might put them out of business," says Katherine Heaviside, president of Epoch 5, a crisis communication-focused public relations agency.

Learning Objective 14.5 – Basic Principles of a Sound Insurance Program

What types of dangers are insured? Which coverage kinds should be purchased? How much protection is sufficient? There are no straightforward answers to these problems. The owner of a small business should become as aware as possible about the numerous types of insurance and then collaborate with a reliable insurance agent to evaluate risks and build adequate protection plans. In analyzing an insurance program, three fundamental tenets must be observed:

1. Consider the various insurance policies that may be appropriate for your business.
2. Secure insurance coverage for all major potential losses.
3. Consider the feasibility and affordability of insuring smaller potential losses.

Learning Objective 14.6 – Common Types of Business Insurance

Property and Casualty Insurance

Property and casualty insurance consist of property insurance, business general liability insurance, automobile insurance, workers' compensation insurance, crime insurance, and other policies.

Property Insurance

A business owner uses a property insurance policy to insure buildings and personal property owned by the business, as well as properties not owned by the business but for which the business owner, as the lessee, is responsible to insure.

Commercial General Liability Insurance

A commercial general liability (CGL) insurance policy is the fundamental liability coverage for small enterprises. A CGL policy provides coverage for property liability, operations liability, product liability, and finished operations liability. We live in a litigious age, and small businesses are obvious candidates for liability litigation. A CGL policy offers primary coverage against claims stemming from any accident that causes in bodily injury or property damage, unless specifically excluded. It does not include coverage for automobile liability, professional liability, or employer liability, which all require a separate policy for adequate protection.

Automobile Insurance

The purpose of an auto insurance policy is to provide liability coverage as well as physical damage coverage for risks including collision, theft, vandalism, hail, and flood. The risk of physical damage to vehicles is significantly smaller than the risk of a costly liability claim following an accident caused by the driver at fault. Small business owners may opt to self-insure against the reduced risk of physical damage, but they should not self-insure against liability risk.

Workers' Compensation Insurance

In accordance with state laws, workers' compensation insurance offers benefits to employees injured on the job. In general, these benefits include covering for medical bills, pay loss, and rehabilitation expenses, as well as death benefits for the families of deceased employees. Employers' liability insurance provides the business owner with additional protection against numerous forms of liability litigation that may result from an employee's injury or death.

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Crime Insurance

Although there are other forms of crime insurance coverage that a small business owner may wish to consider, covering against employee dishonesty is the most important. Small firms are typically extremely reliant on their staff and would not deliberately employ someone they believed to be dishonest.

Business Owners' and Package Policies

A business owner's policy typically combines property insurance and commercial general liability insurance into a single insurance policy (BOP). Nonetheless, construction companies, manufacturers, financial institutions, and other firms with yearly revenues more than \$10 million typically do not qualify for a BOP. The benefits of a BOP at any site include: (1) a lower premium than would be necessary to purchase all coverages separately; (2) the automatic inclusion of business interruption insurance; and (3) automatic replacement value protection as opposed to actual cash value protection.

Miscellaneous Policies

Small enterprises may also make use of a number of miscellaneous insurance coverage. These include employment practices liability insurance, umbrella liability insurance, inland marine insurance, professional liability insurance, and cyber liability insurance. As stated previously, employment practices liability policies are intended to protect business owners from employment-related claims originating from discrimination, sexual harassment, or wrongful termination. Additional layers of liability protection are provided by umbrella liability plans.

Life and Health Insurance

A business's employees are covered by three types of insurance: health insurance, key-person life insurance, and disability insurance. (Workers' compensation insurance is a sort of property and casualty insurance.

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Assignment

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Explain the following

1. Define business risk, and explain its two dimensions.
2. Identify the basic types of pure risk.
3. Explain the basic principles used in evaluating an insurance program.

Answer key

1. Business risk is the possibility of losses associated with the assets and earnings potential of a firm.
 - Business risks can be classified into two broad categories: market risk and pure risk.
 - Market risk is the uncertainty associated with an investment decision.
 - Pure risk exists in a situation where only loss or no loss can occur—there is no potential gain.
 - In general, only pure risk is insurable.
2.
 - Pure risks that any business faces fall into three groups: property risks, liability risks, and personnel risks.
 - Property risks involve potential damage to or loss of real property (e.g., land and buildings) and personal property (e.g., equipment).
 - Liability risks arise from statutory liability, contractual liability, or tort liability.
 - Personnel risks, such as premature death, poor health, and insufficient retirement income, directly affect individuals but may indirectly impact the business as well.
3.
 - Three basic principles should be followed in evaluating an insurance program: (1) Consider the various policies appropriate for your business, (2) secure coverage for all major potential losses, and (3) consider the feasibility and affordability of insuring smaller potential losses.
 - Basic coverage needed by almost all small businesses includes property insurance, commercial general liability insurance, automobile liability insurance, workers' compensation insurance, and crime insurance.
 - Property insurance must cover the full replacement value of a firm's buildings and personal property.
 - A small business owner must determine what distinguishes a "smaller" potential loss from a "major" potential loss and then decide if it makes sense to insure against smaller potential losses.

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Quiz

Identification

1. Identifying the specific perils covered in a property insurance policy.
2. Making funds available to cover losses that cannot be eliminated by risk control.
3. Buying insurance or making contractual arrangements that transfer risk to others.
4. A defect resulting from a problem that occurs during the manufacturing process, causing the product to subsequently not be made according to specification.
5. A form of punishment beyond compensatory damages that intends to punish wrongdoers for gross negligence or callous disregard and to have a deterrent effect.
6. Compensatory damages that relate to economic loss, such as medical expenses and loss of income.
7. Compensatory damages for such losses as pain and suffering, mental anguish, and loss of physical abilities.
8. A contractual clause that requires one party to assume the financial consequences of another party's legal liabilities.
9. Wrongful acts or omissions for which an injured party can take legal action against the wrongdoer for monetary damages.
10. The possibility of losses associated with the assets and earnings potential of a firm.

Answer key

1. Named-peril Approach
2. Risk financing
3. Risk transfer
4. manufacturing defect
5. punitive damages
6. economic damages
7. noneconomic damages
8. indemnification clause
9. torts

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10. business risk

True or False'

1. The nature of business risk can be observed from two perspectives: personal risk and pure risk.
2. Perils such as theft and vandalism involve criminal acts performed by people against business owners.
3. Business income cannot be reduced by events or conditions that are not related to direct losses.
4. The financial impact of such a labor action may be just as real to a business as physical damage to property, but the insurance protection available for indirect losses applies only when direct damage events trigger the loss of use.
5. This statutory liability is not potentially significant for any business.
6. The idea behind the contractual transfer of liability is to shift the responsibility to the party with the most control over the risk exposure
7. Employers can be quite adversely impacted by the untimely death of an employee if that employee can be easily replaced.
8. A less likely occurrence than death of an employee is poor health.
9. Employers often provide some form of health insurance as a benefit of employment.
10. The final category of personnel risk involves the possibility of outliving one's wealth

Answer Key

1. False
2. True
3. False
4. True
5. False
6. True
7. False
8. True
9. False
10. True