

# Entrepreneurial Management

## **Chapter 14**

### **Managing Risk in the Small Business**

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*After studying this chapter,  
you should be able to...*



1. Define *business risk*, and explain its two dimensions.
2. Identify the basic types of pure risk.
3. Describe the steps in the risk management process, and explain how risk management can be used in small companies.
4. Explain the basic principles used in evaluating an insurance program.
5. Identify the common types of business insurance coverage.

# What is Business Risk?

- Risk
  - The possibility of suffering harm or loss.
- Business Risk
  - The possibility of losses associated with the assets and the earnings potential of a firm.
- Market Risk
  - The uncertainty (gain or loss) associated with an investment decision.
- Pure Risk
  - The uncertainty associated with a situation where only loss or no loss can occur—there is no potential for gain (only downside).
  - Only form of risk that is insurable.

# Basic Types of Pure Risk: Property

- Real Property
  - Land and anything physically attached to the land, such as buildings
- Personal Property
  - Machinery, equipment, furniture, fixtures, stock, and vehicles
- Replacement Value of Property
  - The cost to replace or replicate property at today's prices
- Actual Cash Value (ACV)
  - An insurance term that refers to the depreciated value of a property

# Basic Types of Pure Risk (cont'd)

- **Peril**
  - A cause of loss, either through natural events or through the acts of people
- **Direct Loss**
  - A loss in which physical damage to property reduces its value to the property owner
- **Indirect Loss**
  - A loss arising from inability to carry on normal operations due to a direct loss to property

# Liability Risks: Statutory Liability

- Workers' Compensation Legislation
  - Laws obligating the employer to pay the employee for an employment-related injury or illness, regardless of fault.

# Business Activity-Related Liability Risks

- **Contractual Liability**
  - Performance or financial obligations (risks) that firms assume when entering into contracts with other parties
- **Indemnification Clause**
  - A contractual clause that requires one party to assume the financial consequences of another party's legal liabilities.

# Liability Risks: Contractual Liability

- Torts

- Wrongful acts or omissions for which an injured can take legal action against the wrongdoer for monetary damages

- Establishing Negligence

- A legal duty between parties to act (or not to act) to cause injury (damage)
- A failure to provide the appropriate standard of care
- The presence of actual injury or damages
- Action that was proximate cause of injury or damage

# Liability Risks: Contractual Liability (cont'd)

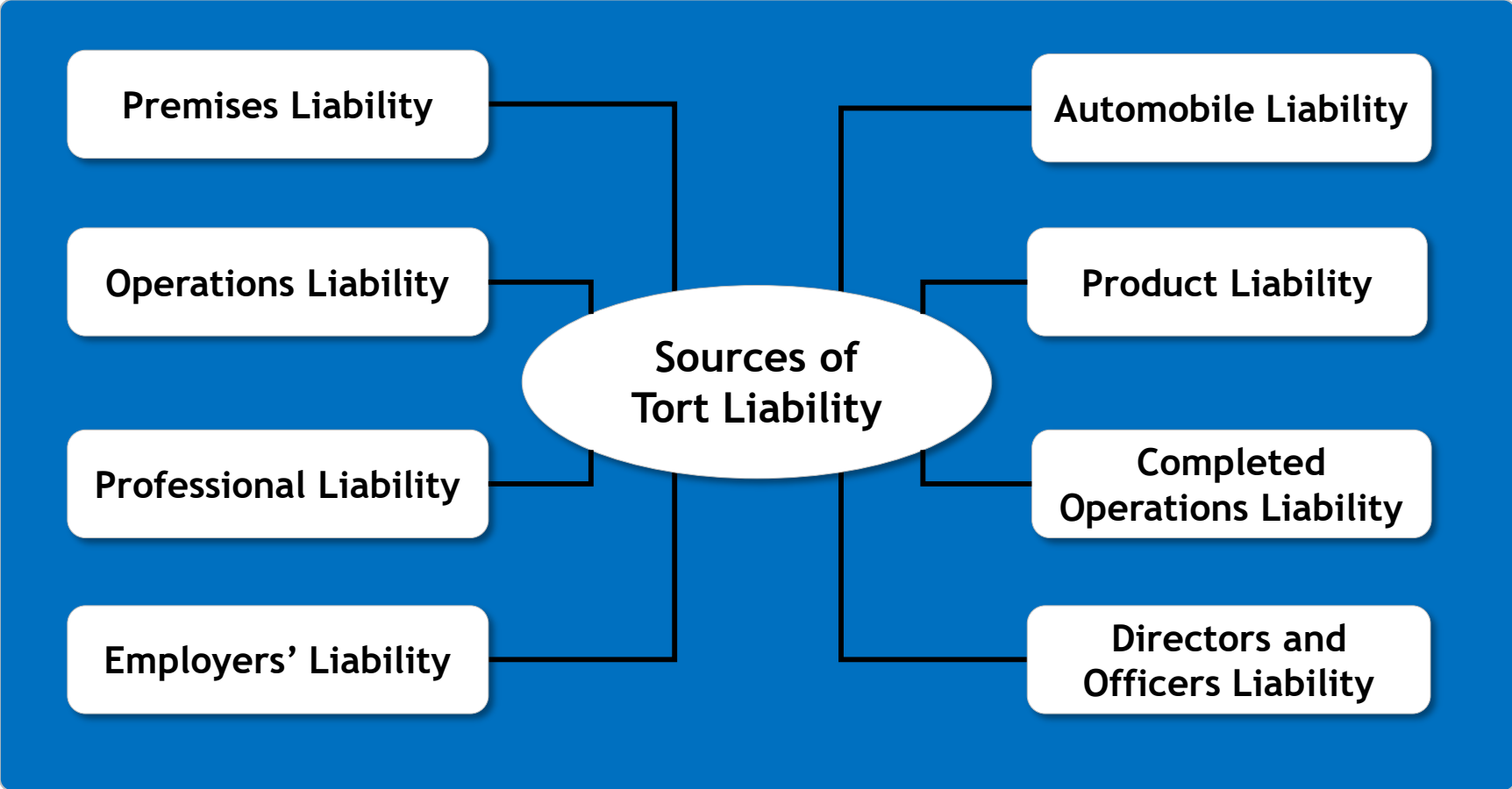
- Reasonable (Prudent Person) Standard
  - The typical standard of care, based on what a reasonable or prudent person would have done under similar circumstances.
- Compensatory Damages
  - Economic or noneconomic damages intended to make the claimant whole, by indemnifying the claimant for any injuries or damage arising from the negligent action

# Torts: Types of Compensatory Damages

- **Economic Damages**
  - Compensatory damages related to an economic loss, such as medical expense, loss of income, or the cost of property replacement/restoration
- **Noneconomic Damages**
  - Compensatory damages for such losses as pain and suffering, mental anguish, and loss of consortium
- **Punitive Damages**
  - Damages intended to punish wrongdoers for gross negligence or a callous disregard for the interests of others and to have a deterrent effect

# Product Liability

- Manufacturing Defect
  - A defect resulting from a problem that occurs during the manufacturing process causing the product to subsequently not be made according to specifications.
- Design Defect
  - A defect resulting from a dangerous design, even though the product was made according to specifications.
- Marketing Defect
  - A defect resulting from failure to convey to the user that hazards are associated with a product or to provide adequate instructions on safe product use.



# Personnel Risks

- Personnel Risks
  - Risks that directly affect individual employees, but may have an indirect impact on a business as well.
    - ❖ Premature death
    - ❖ Poor health
    - ❖ Insufficient retirement income

# Risk Management

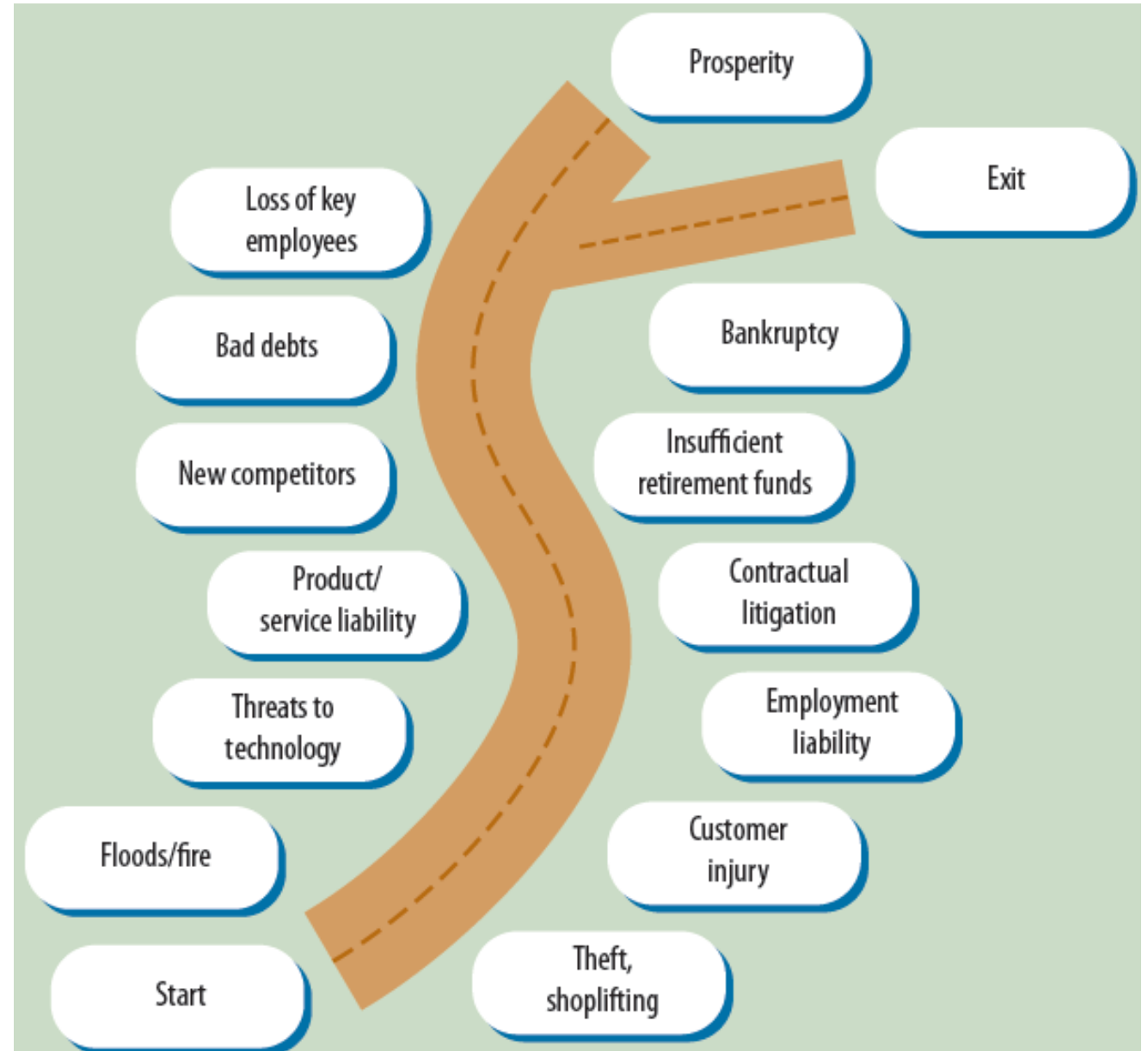
- Risk Management

- Involves ways of coping with risk that are designed to preserve assets and the earning power of a firm.
- Involves finding the best way possible to reduce the cost of dealing with risk.
- Insurance is only one of several approaches to minimizing the pure risks a firm is sure to encounter.

## The Process of Risk Management

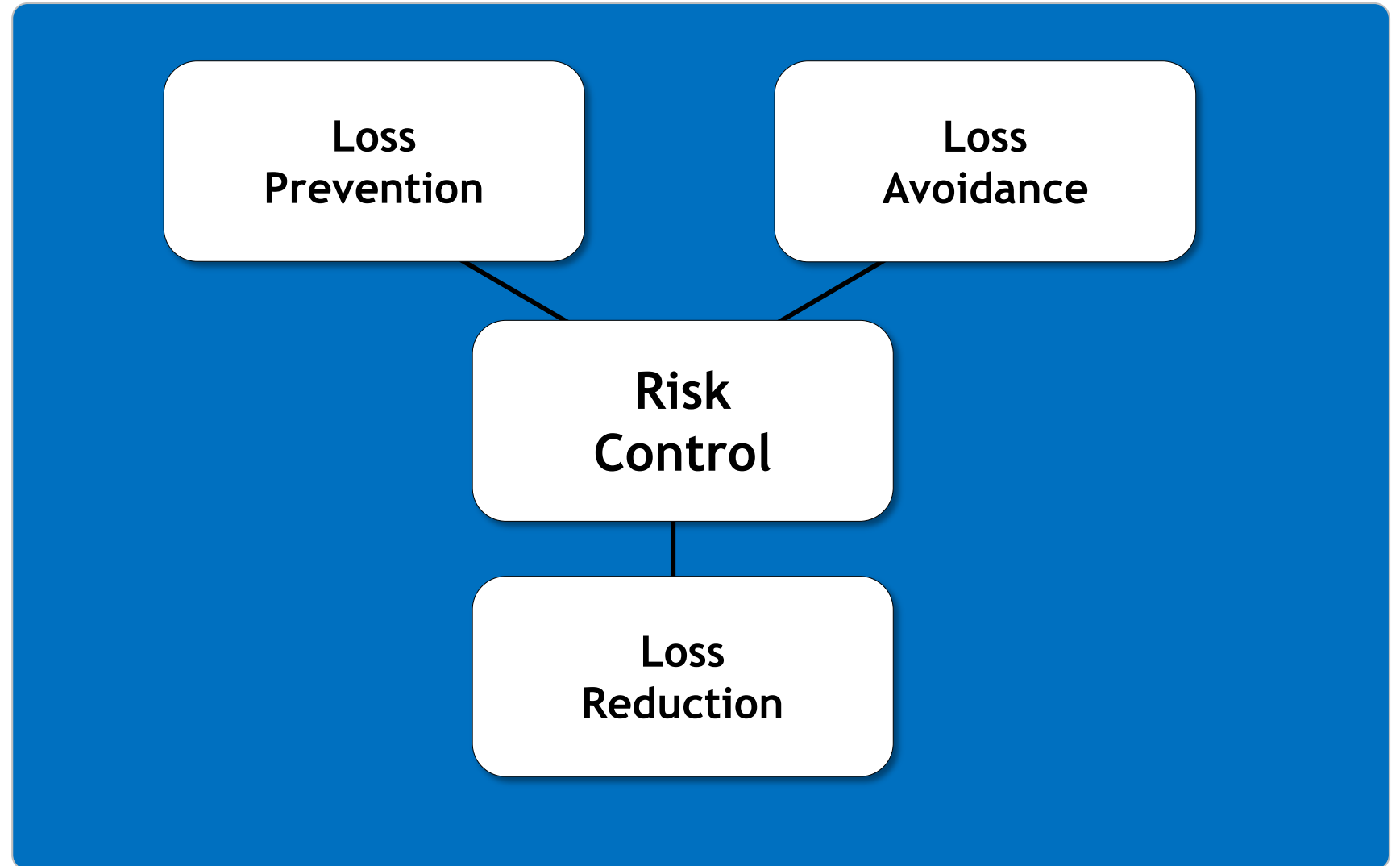
- 1 → Identify and understand risks.
- 2 → Evaluate risks.
- 3 → Select methods to manage risks.
- 4 → Implement the decision.
- 5 → Review and evaluate.

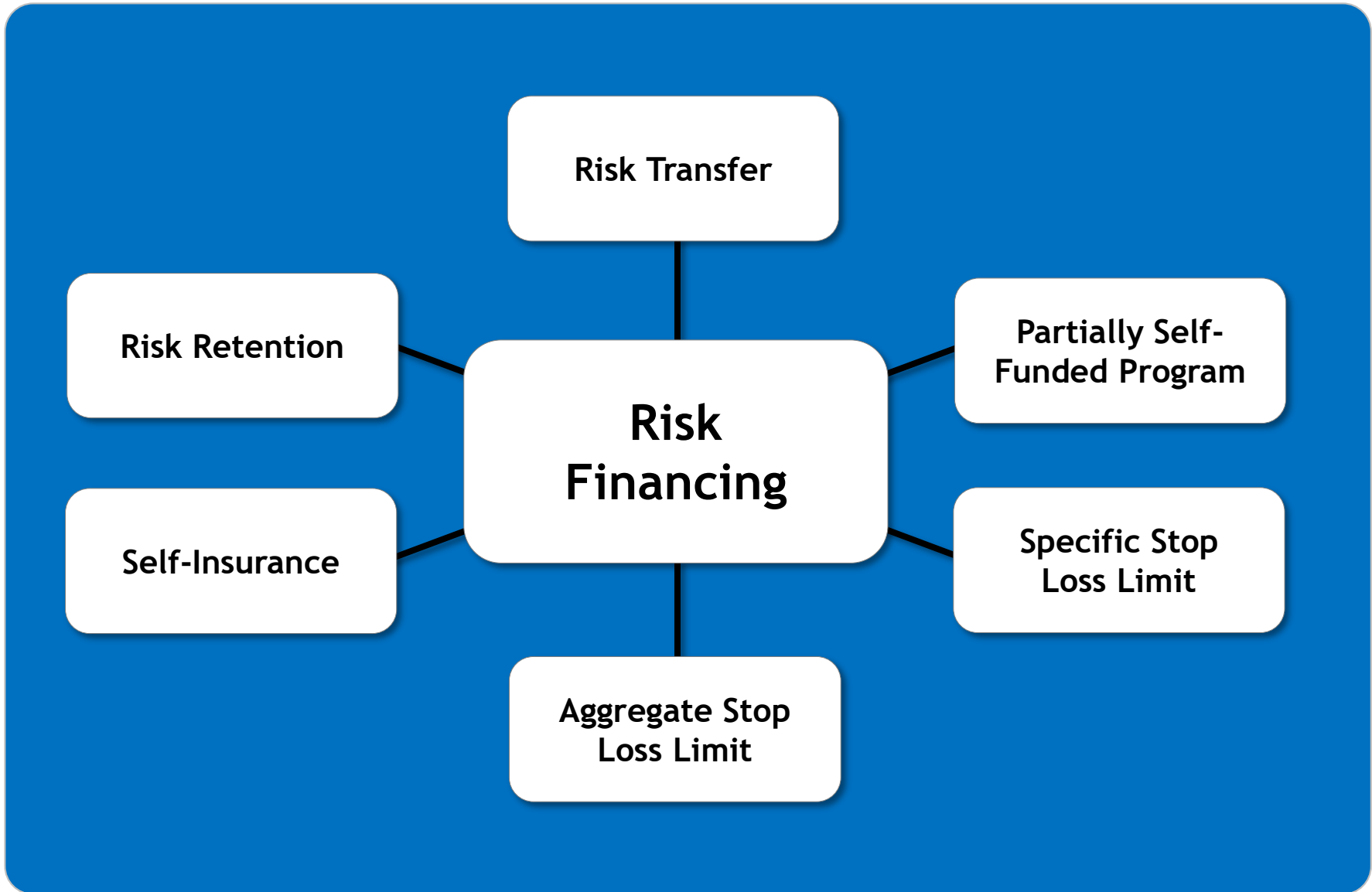
# Risks on the Road to Success



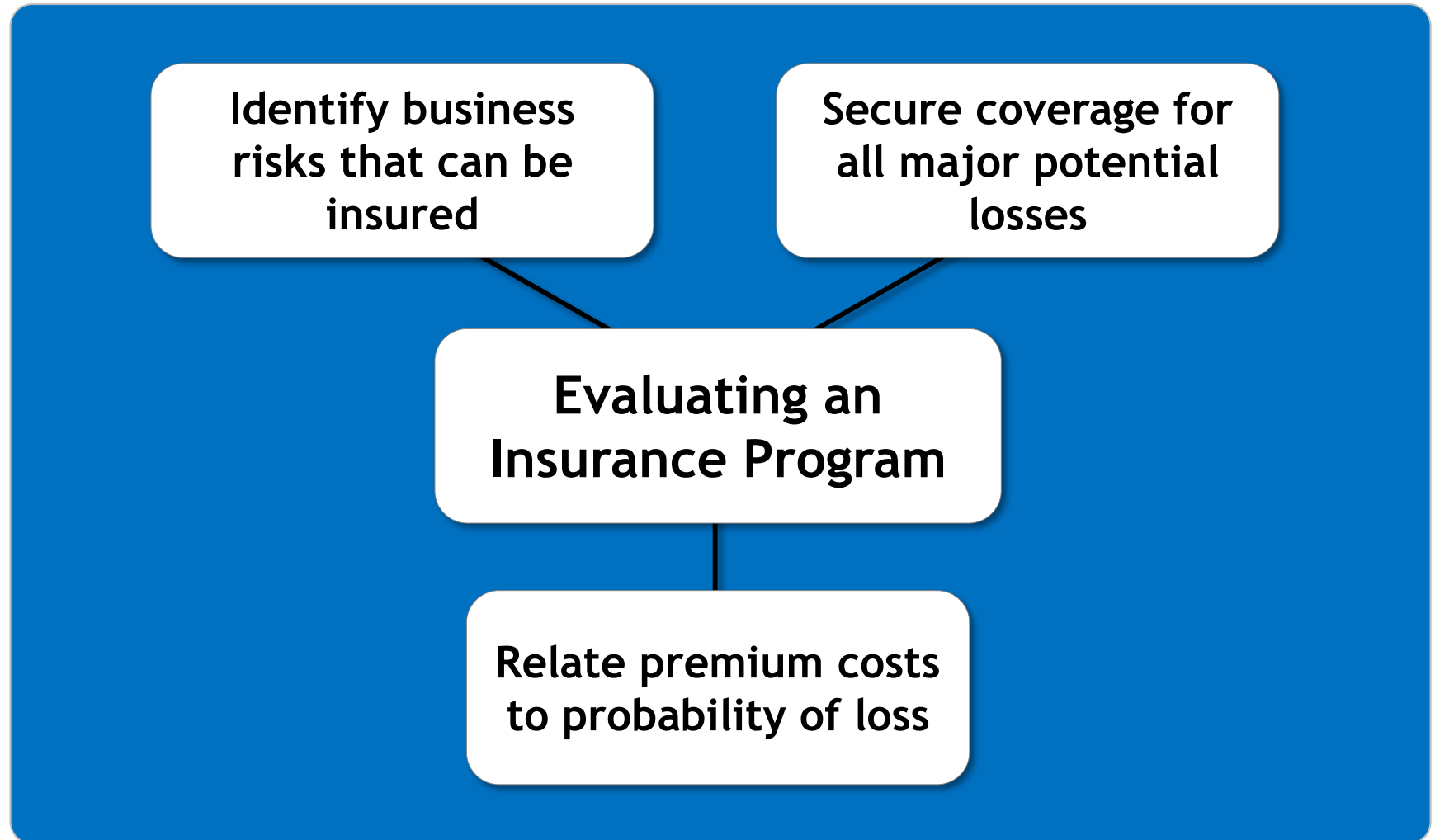
# Risk Management in the Small Business

- Risk Management Differences from Large Firms:
  - Small businesses pay insufficient attention to analyzing potential risk.
  - Large firms can assign responsibilities for risk management to a specialized staff manager.
  - Risk management is not something that requires immediate attention—until something happens.





# Basic Principles of a Sound Insurance Program



# Requirements for Obtaining Insurance

- The risk must be calculable so that premiums can be calculated.
- The risk must exist in large enough numbers to allow the law of averages to work.
- The insured property must have commercial value.
- The policyholder must have an insurable interest in the property or person insured.

# Common Types of Business Insurance

- Property and Casualty Insurance
  - Named-peril approach
    - ❖ Identifies the specific perils covered.
  - All-risk approach
    - ❖ Defines the perils covered by stating that all direct damages to property are covered except those caused by perils specifically excluded.
  - Coinsurance provision
    - ❖ Property must be insured for at least 80% of its value or a penalty will be applied to any covered loss.

# Coinsurance Example

If an insured building had a replacement value of \$500,000, the 80 percent policy limit would require that the property be insured for at least \$400,000 (\$500,000 x 0.80). If the building was insured for only \$300,000 and an insured loss of \$100,000 occurred, the recovery would be limited to \$75,000, calculated as follows:

$$\begin{aligned}\text{Coinsurance provision} &= \frac{\text{Insured value}}{\text{Policy limit \%} \times \text{Replacement value}} \times \text{Property loss} \\ &= \frac{\$300,000}{0.80 \times \$500,000} \times \$100,000 \\ &= 0.75 \times \$100,000 \\ &= \$75,000\end{aligned}$$

# Property and Casualty Insurance (cont'd)

- **Business Interruption Insurance**
  - Reimburses for lost income plus continuing expenses due to direct loss impacting business revenues.
- **Commercial General Liability (CGL) Coverage**
  - Covers bodily injury and property damage for which the business is liable.
- **Automobile Insurance**
  - Protects against liability and physical damage to a vehicle resulting from insured perils such as collision, theft, vandalism, hail, and flood.

# Property and Casualty Insurance (cont'd)

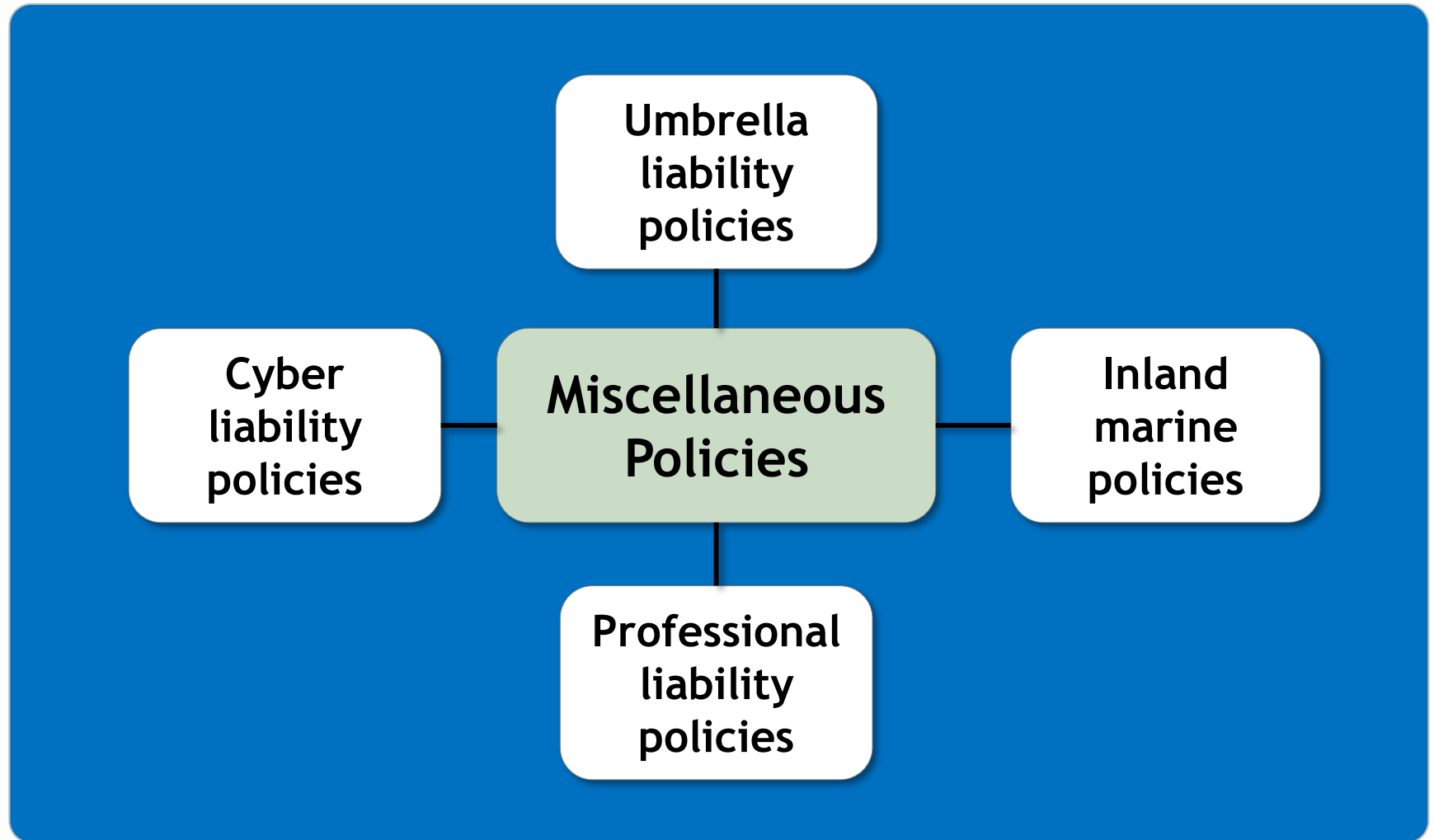
- Workers' Compensation Insurance
  - Provides benefits to employees for medical expenses, loss of wages, and rehabilitation expenses, as well as death benefits for employees' families.
- Crime Insurance
  - Coverage against employee dishonesty.

# Property and Casualty Insurance (cont'd)

- **Business Owner's Policy (BOP)**
  - A business version of a homeowner's policy, designed to meet the personal property and general liability insurance needs of small business owners
- **Advantages of BOP**
  - A lower premium than would otherwise be required to purchase all coverages separately
  - Automatic inclusion of business interruption insurance
  - Automatic replacement value protection, as opposed to actual cash value protection

# Property and Casualty Insurance (cont'd)

- **Package Policy**
  - A policy for small businesses that do not qualify for a BOP that combines property insurance and commercial general liability insurance.
- **Advantages of Package Policy**
  - A lower premium than would otherwise be required to purchase all coverages separately
  - Ease of adding other coverages more economically
  - Inclusion of business interruption insurance
  - Inclusion of crime insurance.



# Life and Health Insurance

- Health Insurance
  - Coverage for medical care at hospitals, doctors' offices, and rehabilitation facilities, that usually includes outpatient services and prescription drugs.
- Health Maintenance Organization (HMO)
  - A managed-care network that is less expensive than that of a PPO but limits employees' choices of medical care providers more than a PPO does.
- Preferred Provider Organization (PPO)
  - A managed-care network that provides health insurance that is generally more expensive than an HMO but offers a broader choice of medical providers

# Life and Health Insurance (cont'd)

- Key-Person Insurance
  - Provides benefits upon the death of a firm's key personnel.
- Disability Insurance
  - Provides benefits upon the disability of a firm's partner or other key employee.
    - ❖ Disability buyout insurance
    - ❖ Key-person disability insurance

# Key Terms

actual cash value (ACV)  
aggregate stop loss limit  
all-risk approach  
automobile insurance  
business interruption insurance  
business owner's policy (BOP)  
business risk  
coinsurance clause  
commercial general liability (CGL)  
insurance  
compensatory damages  
crime insurance  
design defect  
direct loss  
disability buyout insurance  
disability insurance  
economic damages  
health maintenance organization (HMO)  
indemnification clause  
indirect loss  
key-person life insurance  
loss avoidance  
loss prevention  
loss reduction  
manufacturing defect  
market risk  
marketing defect

# Key Terms

named-peril approach

noneconomic damages

package policy

partially self-funded program

peril

personal property

personnel risks

preferred provider organization (PPO)

proximate cause

punitive damages

pure risk

real property

reasonable (prudent person)

standard

replacement value of property

risk control

risk financing

risk management

risk retention

risk transfer

self-insurance

specific stop loss limit

torts

workers' compensation insurance

workers' compensation legislation

# Key Terms

commercial general liability (CGL) insurance

automobile insurance

crime insurance

business owner's policy (BOP)

package policy

health insurance

health maintenance organization (HMO)

preferred provider organization (PPO)

key-person insurance

disability insurance