CRM PRINCIPLES OF RISK MANAGEMENT

STUDY GUIDE

EXAM PREP AND ANSWER KEY

- **Knowledge Checks**
- **Check-Ins**
- **Self-Quizzes**
- **Sample Exam Questions**
- **Glossary of Terms**

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CRM | PRINCIPLES OF RISK MANAGEMENT

STUDY GUIDE

EXAM PREP AND ANSWER KEY

This Study Guide has been prepared to enhance your learning experience. It contains all of the Check-In questions, Knowledge Checks, and Self-Quizzes contained within the course, along with an Answer Key and Glossary. Use it as a tool to help practice and assess your knowledge of the course material, but *do not* mistake it for a comprehensive "short-cut" to preparing for the final exam.

Be sure to take a look at the Appendix that follows the Answer Key in this Study Guide. It contains valuable suggestions for test preparation and study techniques, as well as some sample exam questions and a glossary of terms.

Your path to success in passing the final exam will come from your attentiveness during the course and the effort you put into preparation.

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Tools to Assess Your Knowledge

Check-Ins, Knowledge Checks,
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Section 1: Introduction to Risk Management

Introduction

Check-In

True or false? In Bryce's Sailboat Business, a risk management function would exist to support Bryce's organization with a particular strategy. And in doing so, he would need to employ a systematic process targeted at mitigating exposures that might delay his plans.

True **False**

What is Risk?

Check-In

Directions: Imagine that one of your clients owns a company that manufactures and sells a variety of granola breakfast and snack products. Identify three examples of pure and speculative risk associated with your client's business.

Pure Risks	Speculative Risks
1. ______	1. ______
2. ______	2. ______
3. ______	3. ______

A Common Vocabulary

Knowledge Check

1. Phillips Company owns an old office building in Memphis, TN. The risk manager has been lobbying to retrofit the building to withstand potential perils. He explains that the building sits on the New Madrid fault line. Please identify the peril and hazard that the risk manager is concerned about and be prepared to explain your thinking.

2. Peter steps off the escalator and stumbles. He is not injured and heads home. The next morning, he wakes up in pain. Which risk management term applies here? Please explain your thinking.

The Steps of the Risk Management Process

Knowledge Check

Nancy is the risk manager at Risk and Insurance University and is conducting her annual review of the risk management program throughout the day. State which step in the risk management process is being executed:

1. Nancy's first meeting of the day includes the University's insurance broker and chief financial officer as various insurance policies and retention options are reviewed.

2. Before lunch, Nancy tours the campus along with building managers, maintenance professionals, and grounds keepers to ensure various safety protocols are being followed and all safety mechanisms are functioning properly.

The Impacts of an Effective Risk Management Program

Knowledge Check

Provide an example from current events where a miscalculation or inaction on the part of an organization resulted in damage to its reputation—from which the organization might or might not have recovered.

Sample Answer:

Total Cost of Risk (TCOR)

Knowledge Check

Nancy is the risk manager for Pinnacle Products. She is reviewing a TCOR report prepared by the risk management intern. Nancy is concerned that the intern may not have a good understanding of the elements of TCOR. Which of the items in the report below support Nancy's concern? (Check any/all that don't fall within the elements of TCOR.)

- ☐ $300,000 – insurance premiums for all lines of coverages
- ☐ $20,000 – repair of office equipment damaged by an employee's negligence
- ☐ $55,000 – settlement of a general liability claim paid by the insurer and billed back to the insured
- ☐ $10,000 – safety consultant hired to perform physical inspections at each of the locations
- ☐ $4,000 – the recovery of damage to a company-owned vehicle from a negligent driver's insurer
- ☐ $65,000 – salary of the Director of Marketing including her benefits
- ☐ $15,000 – overtime paid to an employee filling in for another employee who was out of work recovering from a work-related accident

Emerging Risks

Knowledge Check

The Great Resignation has created wide-spread impact on employment markets. In the US alone, April 2021 saw more than four million people quit their jobs, according to a summary from the Department of Labor. The US Bureau of Labor Statistics has reported that in 2021, 12.1 million young people between the ages of 20 to 34 quit their jobs between June and August. Explain how or why the Great Resignation reflects the common elements of emerging risk.

Section 1 Self-Quiz

Directions: Indicate whether the statement is True or False.

1. One example of an industry that is basically immune to risk is the restaurant industry.

   True **False**

2. In the risk management arena (including the insurance world), definitions of risk are usually dependent upon the particular job function or area of expertise of the source.

   True **False**

3. Jeremy owns shares of Disney stock. The risk that would be associated with changes in the value of Disney's stock is known as speculative risk.

   True **False**

4. Pure risk involves a situation or incident with multiple outcomes, not simply loss or no loss.

   True **False**

Directions: Select the correct letter to match each term with the appropriate definition.

A. Peril	______ a reduction in the value of assets
B. Risk appetite	______ a situation, practice, or condition that may lead to an insured's susceptibility to adverse finance consequences or loss
C. Loss	______ an event that disrupts or interrupts normal activities and may become a loss
D. Exposure	______ a cause of loss or any action or event that causes a loss
E. Claim	______ a demand for payment or a company's moral or ethical obligation to pay damages as a result of a loss or occurrence
F. Incident	______ the organization's willingness to accept or tolerate risk

Directions: Select the correct answer for each question from the options given.

1. A factor increasing the likelihood that a loss will occur or the severity of a loss that occurs is known as a(n) ____________.
   - [ ] accident
   - [ ] hazard
   - [ ] occurrence
   - [ ] expected Loss

2. _______ is the dollar amount of a given loss or the aggregate dollar amount of all losses for a given period, usually the policy period.
   - [ ] Accident
   - [ ] Expected loss
   - [ ] Severity
   - [ ] Frequency

3. Identify which one of the following is **NOT** a step in the risk management process.
   - [ ] Risk control
   - [ ] Risk administration
   - [ ] Risk analysis
   - [ ] Risk accumulation

4. The step in the risk management process that includes any conscious action or inaction to minimize (at optimal cost) the probability, frequency, severity, or unpredictability of a loss is the ______ step.
   - [ ] risk control
   - [ ] risk administration
   - [ ] risk analysis
   - [ ] risk financing

5. The step in the risk management process that may be used for verification and classification of loss data, including predicting and range of losses, would be ____________.
   - [ ] risk control
   - [ ] risk analysis
   - [ ] risk administration
   - [ ] risk financing

6. Which one of the following is **NOT** an impact of an effective risk management program?
   - ☐ Improved quality, processes, and technology
   - ☐ Improved workforce morale and productivity
   - ☐ Protected cash flow and assets
   - ☐ Increased sales and market share

7. When implemented correctly, TCOR helps to change an organization's _______ for the better.
   - ☐ employees
   - ☐ productivity
   - ☐ risk culture
   - ☐ reputation

8. In the TCOR formula, which one of the following examples would be an **indirect cost**?
   - ☐ Reputation
   - ☐ Deductibles
   - ☐ Premiums
   - ☐ Training

9. In the TCOR formula, which one of the following examples would be a **retained loss**?
   - ☐ Replacement cost
   - ☐ Deductible
   - ☐ Letter of credit
   - ☐ Overtime

10. Emerging risks share several common elements which increase their difficulty to identify and manage. What is an example of one of those common elements?
    - ☐ High uncertainty
    - ☐ Predictability and thus well planned for
    - ☐ Cost prohibitive impacts to organizations
    - ☐ May be eliminated through regulatory intervention

Section 2: Risk Management and the Organization

The Governing Documents of a Risk Management Program

Knowledge Check

Eleanor is the newly hired risk manager for First Main Bank. During her first week on the job, she has determined that there are no governing documents for the risk management department. She has begun working on putting them in place. She starts with the bank's mission statement:

"The mission of First Main Bank Corporation is to be a profitable, progressive company of the highest quality, offering financial services to communities in Michigan. The FMB team is to be diligent in seeking out the needs and expectations of our customers. Our unwavering commitment is to provide customers with superior service in a caring, responsive way."

Eleanor drafts the risk management mission statement.

"The mission of risk management services is to consistently inform management of risk issues facing the company, its assets, and its employees; to treat risk in the methods most beneficial, economical, feasible, and sensible for the safety, security, and integrity of the company and its partners—our employees, directors, shareholders, customers, service providers, and the communities we serve."

Has she succeeded? Why or why not?

Organizational Risk Culture (ORC)

Knowledge Check

Richard is a welder in an equipment manufacturing facility. One day, he sees the CEO walking on the work floor without a hard hat or safety glasses. Richard promptly turns off and puts down his torch and walks over to the CEO and reminds him that he must follow the safety rules which are established for all employees.

Which element of the ORC allows Richard to be comfortable approaching and correcting a member of senior management? Explain why.

General Classes of Risk

Knowledge Check

Kidz Stuff manufactures children's clothing and accessories. The company licensed rights to a variety of popular movie characters for use on their clothing and shoes. The movie company's employment practices have recently come under scrutiny by state employment authorities, and a number of civil lawsuits are underway. Explain how the risks associated with these circumstances could be classified.

Risk Appetite and Risk-Taking Ability

Knowledge Check

Marcia is the risk manager for a technology consortium. The company is considering acquiring a mid-sized competitor to gain greater market share and access to their intellectual property. Marcia is part of the due diligence team and feels that a risk appetite and risk-taking ability analysis should be the first step in the due diligence process. Why would this analysis be important?

Section 2 Self-Quiz

Directions: Select the class of risk applicable in each of the following scenarios.

1. Manufacturers fear tort attorneys will find a favorable venue to try class action lawsuits in the hope that juries will be responsive to their arguments.
   - ☐ Juridical
   - ☐ Technological
   - ☐ Social
   - ☐ Economic
2. A recycling plant is required to install expensive safety equipment because of Occupational Safety and Health Administration (OSHA) requirements.
   - ☐ Social
   - ☐ Legal
   - ☐ Economic
   - ☐ Technological
3. Interest rate fluctuations in emerging markets are creating concern for international investors.
   - ☐ Physical
   - ☐ Technological
   - ☐ Social
   - ☐ Economic
4. A large retail box store's customer database is accessed by unauthorized persons and the personal information is compromised.
   - ☐ Technological, possibly Social and/or Economic
   - ☐ Physical, possibly Social and/or Economic
   - ☐ Social and Legal
   - ☐ Physical and Legal

Directions: Indicate whether the statement is True or False.

1. The risk management mission statement, risk management policy statement, and risk management manual are the governing documents of a risk management program.

   True **False**

2. Demonstrating and communicating to all employees senior management's support for the risk management program is one of the four key purposes of the risk management manual.

   True **False**

3. If you are looking to find out an organization's strategy for managing risks and its relevance to the overall strategic plan, goals, and objectives, you would want to consult the risk management mission statement.

   True **False**

4. The risk management mission statement may include a brief description of the organization's philosophies, its competitive advantages, and its vision.

   True **False**

5. Organizational risk culture is the collection of values, expectations, and practices that guide and inform the actions of all members of the risk management team.

   True **False**

6. Risks arising from a jury or judge's decision are examples of political risk.

   True **False**

Section 3: Introduction to Risk Identification

The Importance of Risk Identification

Check-In

What happens if an exposure is not identified? Choose the correct answer from the choices below.

- ☐ There is an increased likelihood of financial loss which the company or individual must bear.
- ☐ It will be identified eventually from the loss runs.
- ☐ The agent will be held responsible.

Logical Classifications

Knowledge Check

An oil rig in the Gulf of Mexico explodes, injuring employees and spilling millions of gallons of oil. Indicate which of the logical classifications apply; be sure to explain your reasoning.

Negligence

Knowledge Check

The risk manager for a retail grocery store was asked to explain to the store's management team what could cause the store to be legally responsible for damages. The risk manager explained that liability could arise from torts.
How would you explain torts to the management team to make this clear, as well as how negligence comes into play?

1. What is a tort?

2. Define negligence and list its four elements.

Requirements of Enforceable Contracts

Knowledge Check

Goode Winery has a long-term contract with USA Fine Dining Restaurants to provide 25 cases of wine each month. Yesterday, USA Fine Dining notified the winery that it will not accept any further deliveries and refuses to meet with Goode Winery to discuss the matter. This creates a significant problem for Goode as it will now be stuck with excess inventory since USA Fine Dining was its largest customer.

If Goode decides to sue and the court rules in Goode's favor, it can impose remedies for a breach of contract. Explain two possible remedies the court could impose and be sure to explain your thinking.

1. ____

   ____

2. ____

   ____

Section 3 Self-Quiz

Directions: Indicate whether each statement is True or False.

1. An increased likelihood of a financial loss occurs when a risk is overlooked.

   True **False**

2. Cash and securities are considered examples of intellectual property.

   True **False**

3. When it comes to human resources, the majority of these exposures can be controlled by external policies and procedures.

   True **False**

4. Property, liability, human resources, and net income are all examples of logical classifications of exposures, perils, hazards, and/or losses.

   True **False**

5. The definition of negligence does NOT include a failure to exercise a degree of care that a reasonably prudent person under similar circumstances would exercise.

   True **False**

6. Liquidated damages are those whose value is stipulated in the contract as the amount to be paid regardless of any provable damages if the contract is breached.

   True **False**

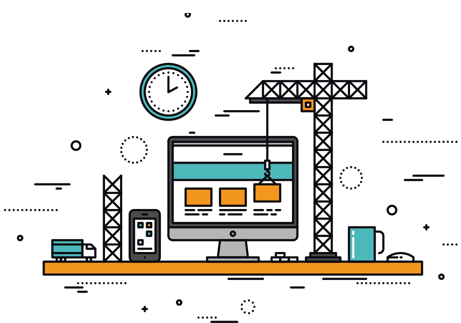
Directions: Select the correct answer.

1. Each of the following are examples of real property EXCEPT for:
   - ☐ retaining walls
   - ☐ office buildings
   - ☐ storage silos
   - ☐ furnishings
2. Each of the following are examples of personal/business property EXCEPT for:
   - ☐ inventory
   - ☐ hardware
   - ☐ licenses and franchises
   - ☐ records and documents
3. Select the answer that expresses two of the four elements of which negligence is comprised.
   - ☐ Duty of care and reasonable actions
   - ☐ Causation and damages
   - ☐ Breach of duty and deliberate action
   - ☐ Causation and criminal intent
4. A private or civil wrong, other than a breach of contract, for which the courts will allow an action (lawsuit) for damages is known as a _______.
   - ☐ service mark
   - ☐ tort
   - ☐ trade secret
   - ☐ peril
5. Each of the following are examples of the four requirements of an enforceable contract EXCEPT:
   - ☐ a legal purpose
   - ☐ genuine agreement or assent
   - ☐ competent parties
   - ☐ liquidated damages

Section 4: Risk Identification Methods – Self-Administered Tools

Classifying Exposures, Perils, and Hazards

Knowledge Check



Build-it Construction is a new client of yours. Build-it's CEO is concerned about increased growth Built-in is seeing in their number of losses, so she decides to implement a risk management program. You advise your client that to do an effective job, you must first classify and define sources of risk faced by Build-it. List the four logical classifications of exposures faced by Build-it and provide an example of an exposure to loss that might exist in one of the classifications. Make sure you're able to explain your line of thinking.

1.

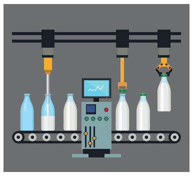
2.

3.

4.

Self-administered Methodologies for Risk Identification

Knowledge Check



Gabriel, the risk manager for a bottling company, has been recruited by a competitor. He knows that the sooner he can come up-to-speed on his new employer's operations, the faster he can make informed suggestions. Please describe two types of checklists Gabriel might use and why they would be helpful. What led you to this decision?

1. ______________________________

____

2. ______________________________

____

Check-In

1. Chris, a risk manager, wants to identify new exposures. Which identification method will help Chris in this process?
   - ☐ A physical inspection
   - ☐ An asset checklist
   - ☐ A perils checklist
   - ☐ An examination of the logical classifications of exposures the organization faces

2. True or false? A checklist cannot identify new exposures and their perils and hazards because the "new" exposure will not be on the checklist."

   True **False**

Check-In

You are the producer of the concert performance diagrammed in the flowchart presented on the facing page. You are trying to identify potential exposures associated with this concert. What events or circumstance can cause a loss or disruption to property, human resources, liability, and/or net income in the production of this performance?

Section 4 Self-Quiz

Directions: Indicate whether each statement is True or False.

1. A human peril is one arising from being in business, such as a recession.

   True **False**

2. A peril arising out of a natural disaster such as a damage from a hurricane would be an example of a natural peril.

   True **False**

3. Loss of income would be an example of a peril under the economic peril classification.

   True **False**

4. Hazards can be easily classified into the following three types: moral, morale, and associated.

   True **False**

5. The intent to cause harm, such as stealing someone's identity or passwords, would be an example of a morale hazard.

   True **False**

6. Morale hazards are those that arise out of indifference, such as not locking your car because you know it is insured and there is nothing valuable in it.

   True **False**

7. Physical hazards exist naturally or are those that are caused by human negligence, such as the presence of dead trees in near proximity to buildings, or speeding on an expressway.

   True **False**

8. It is not imperative for a hazard to be associated with a peril.

   True **False**

Directions: Select the correct answer.

1. A document to aid the risk manager in systematically searching and identifying as many exposures, perils, and hazards as possible—and one that can be simple or expansive—is known as a:
   - ☐ compliance review
   - ☐ flowchart
   - ☐ checklist
   - ☐ specialty resource method
2. All of the following are strengths to the flowchart method of exposure identification EXCEPT:
   - ☐ indicates frequency or severity of events
   - ☐ can identify punch points or bottlenecks
   - ☐ can determine the critical path or activity
   - ☐ identifies dependencies upon other outside organizations or infrastructures

Section 5: Analytic Risk Identification Methods

Analytic Methodologies

Check-In

Directions: Select the term that best completes each statement.

1. Recognizing an organization's ______________________________ others is an important outcome of reviewing contracts.

   obligations to | **reliance on**

2. During contract reviews, a risk manager must be aware of the possibility of third-party ___________________________.

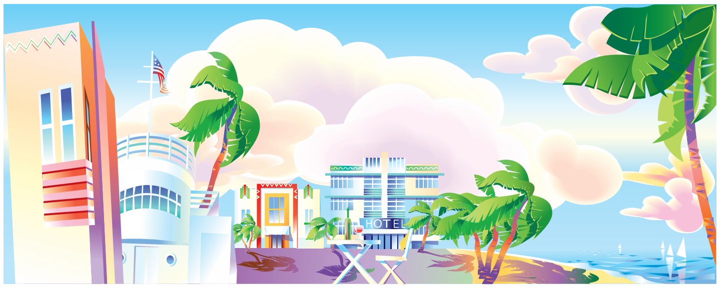
   noncompliance | **exposures to statutes and regulations**

Check-In

Directions: Match the identification method on the left with its description on the right.

A. Non-insurance contract review	_____ A risk manager conducts a review to determine which assets would be excluded from coverage for a particular peril.
B. Compliance review	_____ A risk manager reviews hold harmless clauses to determine obligations owed.
C. Insurance policy review	_____ A human resources director conducts a review to determine if employees' professional certifications and licenses are up to date according to state law.
D. Financial statement analysis	_____ A risk manager wishes to determine net income exposures that could impact the company.

Knowledge Check



Lucas is a new risk manager for a Florida resort hotel. He is trying to understand the types of workers compensation losses that have been happening at the resort. His finance officer presents him with the loss run presented on the following page. Lucas does not feel that he can use the information to project future losses as he feels the data is incomplete.

1. Please explain what Lucas means.

____

____

2. Lucas is also concerned with the integrity of the data. Please provide some examples from the loss run which support Lucas' concerns.

____

____

____

____

Section 5 Self-Quiz

Directions: Select the correct answer.

1. ______________ are useful for organizations with exposures that fall within all four logical classifications. They can be conducted by internal or external personnel who observe organizational personnel in their natural surroundings.
   - ☐ Flowcharts
   - ☐ Checklists
   - ☐ Non-insurance contract reviews
   - ☐ Physical inspections
2. The insurance policy review method is used for:
   - ☐ reviewing an insurance contract and related documents to determine exposures and perils that are and are not covered
   - ☐ reviewing contracts other than insurance policies
   - ☐ internal and external personnel possessing expertise in a special field of knowledge to identify exposures, perils, and hazards
   - ☐ identifying dependencies upon other outside organizations or infrastructures
3. The procedures and policies review method can be used for:
   - ☐ determining compliance with regulation and laws
   - ☐ identifying values that are subject to loss
   - ☐ evaluating the organization's bylaws, board minutes, mission statements, org. charts, and employee manuals
4. Which of the following is NOT a characteristic of credible loss data?
   - ☐ Integrity
   - ☐ Completeness
   - ☐ Consistency
   - ☐ Sufficiency
5. Indicate if the following are internal (I) or external (E) sources of data.

   Insurance carrier loss runs ______

   Accounting entries on financial statements ______

   National Safety Council ______

   First aid logs ______

   Bureau of Transportation Statistics ______

6. Which of the following documents is NOT analyzed during the contract review method?
   - ☐ Leases
   - ☐ Hold harmless and indemnification agreements
   - ☐ Insurance policies
   - ☐ Bills of lading
7. Being the basis for initial insight in developing crisis contingency plans is the strength of which method?
   - ☐ Compliance review method
   - ☐ Financial statement analysis method
   - ☐ Procedures and policies review method
   - ☐ Non-insurance contract review method
8. Which one of the following is an example of a weakness in utilizing the loss data analysis method?
   - ☐ Information gathered through loss data analysis can be used for forecasting losses or predicting and preventing future incidents.
   - ☐ This method is used to evaluate the effectiveness of the risk management program and for benchmarking the organization against others in its industry, or itself, over time.
   - ☐ Besides its limited applicability to property and net income, the reality is that organizational politics may prevent effective treatment of exposures.
   - ☐ Because this method is driven by losses which have occurred, it only works when losses have been reported.

Section 6: Financial Statement Analysis

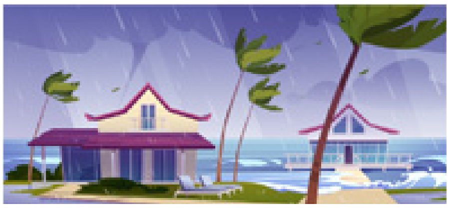
Accounting, Financing, and Risk Management

Knowledge Check

Mary is the founder of a new stationery printing company, "Mary's Mark." While Mary is not an accountant, she knows that she will need proper accounting systems and procedures in place. You, as Mary's risk manager, want to assist her in terms of her compliance obligations. Which accounting system(s) would you recommend and why?

Property Valuation Methods and Financial Statements

Check-In



A Cancun resort suffered a windstorm loss to the hotel building from a recent tropical storm system and is preparing its insurance proof of loss. The risk management department and accounting department have prepared the following exhibit:

Cost to build ten years ago	**$ 37,000,000**
Current construction cost	**$ 52,000,000**
Accumulated depreciation as per the accounting records	**$ 6,000,000**
Current comparable value appraisal for refinancing effort *(30% of value was land)*	**$80,000,000**
Net present value of future income for the next 40 years	**$ 75,000,000**
The insurance adjustor's calculated depreciation	**$ 12,000,000**

The risk management department has also calculated the following property valuations:

Market value *Current appraisal minus the land* *80,000 – (0.30 x 80,000) = 56,000*	**$ 56,000,000**
Book value *Historical cost minus accumulated depreciation*	**$ 31,000,000**
Replacement cost *Current construction cost*	**$ 52,000,000**
Actual cash value *Replacement cost minus insurance depreciation of $12,000,000*	**$40,000,000**

You know that the historical cost is ______________________________.

Knowledge Check

Your client owns a restaurant that is housed in an 18th-century brick bank building which she purchased five years ago. The original furnishings of the bank remain, including the vault. All of these furnishings have been incorporated into the restaurant operations. Which of the property valuation methods would you recommend your client use to insure the building and its original contents?

Financial Statement Types

Check-In

Directions: Select the term that best completes each statement.

1. Financial statement analysis may reveal understated or overstated ____________________ being carried on an organization's books.

   financial capabilities **values**

2. ____________________________________ is the reduction in the value of an asset over time.

   Depreciation **Amortization**

Check-In

Directions: Indicate whether these components are part of the balance sheet or the income statement.

1. Operating revenue
   - ☐ Balance sheet
   - ☐ Income statement
2. Current liabilities
   - ☐ Balance sheet
   - ☐ Income statement
3. Cost of goods sold
   - ☐ Balance sheet
   - ☐ Income statement
4. Fixed assets
   - ☐ Balance sheet
   - ☐ Income statement
5. Shareholders' equity
   - ☐ Balance sheet
   - ☐ Income statement
6. Depreciation
   - ☐ Balance sheet
   - ☐ Income statement

Check-In

Rita is reviewing the statement of cash flow for her organization. She is becoming concerned that outflows exceed inflows by a significant amount. While she knows the business is seasonal, she does not believe that the numbers can be correct. What is the first thing Rita should check before raising her concerns?

Knowledge Check

1. Mary, your risk management intern, is looking at the income statement of your company. She is confused by the difference between depreciation and amortization. Provide Mary with an example that illustrates each of these concepts.

2. A balance sheet is a summary of the organization's assets, liabilities, and owner's equity as of a specific point in time. Why would the balance sheet be of interest to potential investors?

Financial Ratios

Knowledge Check

Mary Donner, a risk manager, is preparing a report on the state of the risk management department for Sarah Packer, the CFO. Mary knows that Sarah supports the use of financial statement ratio analysis in measuring the progress of the company over time.

Mary calculates the following financial ratios by using the most recent financial statements to measure the progress of the organization. She prepares a report to share with Sarah that discloses the following financial information.

What red flags, if any, can you identify from these numbers?

1. Current ratio = 4.77
   Current assets/Current liabilities 186,000/39,000

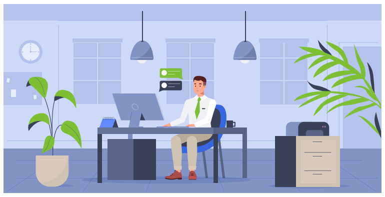
2. Debt ratio = 0.708
   Total debts/Total assets 328,000/463,000

3. Net profit margin = 2.14%
   Net profit/Sales 7,500/350,000

4. Return on equity = 5.5%
   Net income/Equity 7,500/135,000

Financial Statement Analysis and Risk Management

Knowledge Check



Allen is an intern in the risk management department. He wants to understand the impact of net income losses on the company and on the risk management department budget. As his boss, explain to Allen how he can derive information from the financial statements.

Section 6 Self-Quiz

Directions: Indicate whether each statement is True or False.

1. Finance is the process of recording and classifying business and financial transactions and reporting them on an organization's financial statements.

   True **False**

2. The process of managing an organization's assets, liabilities, and cash flow to maximize shareholder (or stakeholder) wealth is known as risk management.

   True **False**

3. US law requires businesses that release financial statements to the public and publicly traded companies to follow GAAP guidelines.

   True **False**

4. Managerial accounting is a set of accounting regulations prescribed by the NAIC for the preparation of the insurance company's financial statements.

   True **False**

5. Governmental, or fund accounting, is used in organizations whose purpose is for the public good. Public or private investment in these organizations does not occur and their operations do not compare to typical business entities.

   True **False**

Directions: Select the correct letter to match each term with the appropriate definition.

A. Market value **B.** Economic value **C.** Historical cost **D.** Functional replacement cost **E.** Actual cash value **F.** Book value **G.** Other property valuation bases	______ The historical cost, less accumulated depreciation ______ The amount a willing buyer will give to a willing seller ______ The original purchase price of property ______ A future stream of income assigned to the property ______ The replacement cost, less an allowance for depreciation or obsolescence ______ The cost to repair or replace damaged or destroyed property with materials that are essentially the equivalent of the property, when original materials are unavailable ______ In some unusual circumstances, none of the previous property valuation methods are appropriate, and the risk manager may have to devise a basis that is acceptable to an underwriter and to the organization.

Directions: Select the correct answer.

1. A summary of the organization's assets, liabilities, and owner's equity as of a specific point in time describes the:
   - ☐ income statement
   - ☐ balance sheet
   - ☐ statement of cash flow

2. A summary of the effects of cash on the operating, investing, and financial activities of an organization for a specific period of time describes the:
   - ☐ balance sheet
   - ☐ statement of cash flow
   - ☐ income statement

3. A summary of the organization's financial performance for a specific period of time describes the:
   - ☐ balance sheet
   - ☐ income statement
   - ☐ statement of cash flow

4. When using common financial ratios, there are important points to remember. Identify what is NOT one of these points.
   - ☐ The organization's ability to repay creditors over the long term does not impact the organization's financial leverage.
   - ☐ There is no "perfect" or "ideal" ratio. The appropriate ratio or range of ratios depends largely upon the type of organization.
   - ☐ The ratios are very dependent upon the type of financial system used to generate the numerator and denominator.

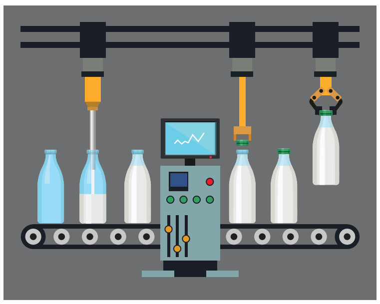
5. Profitability ratios measure returns in several ways. An example of this would be which one of the following formulas?
   - ☐ Quick ratio = (current assets – inventory) ÷ current liabilities
   - ☐ Debt ratio = total debt ÷ total assets
   - ☐ Return on assets (ROA) = net income ÷ total assets

6. Financial statement analysis is used to do all of the following EXCEPT:
   - ☐ review asset valuation
   - ☐ assess liquidity and financial strength
   - ☐ benchmark financial capacity against competitors
   - ☐ assess risk tolerance levels and bonding capacity

Section 7: Introduction to Enterprise Risk Management

Broad Categories of Risk for ERM

Knowledge Check



A beverage manufacturer with a strong market share is considering launching a new low-carb formulation of their beverage. Historically risk averse, they are seeking to move from a TRM perspective to ERM. Several members of the board do not understand ERM and believe that this is a dangerous risk and only perceive the downside. You have been part of the due diligence team that researched this proposal and value the ERM approach. Please explain how ERM would consider the upside of taking this risk.

Check-In

Identify which of the ERM broad categories of risk apply to the following examples:

1. Despite wide-spread public commentary and media attention, a university decides it does not need to examine its diversity policies.

   ____

2. D.C. Power believes the demand for electricity will skyrocket following predictions for record temperature highs during the summer. They purchase "Congestion Contracts" to ensure delivery of power from remote locations in times of greatest demands.

   ____

3. A well known producer of baked goods uses a single source for its flour.

   ____

4. An automobile manufacturer wishes to create an injury-free vehicle by 2030. The car of the future will be able to steer, brake, and learn about the road ahead from a vast array of electronic sensors located around the vehicle.

   ____

Knowledge Check

Betsy is the owner of a small delivery service. She is wondering if ERM is right for her company. Betsy just doesn't see how all of the broad categories of risk can apply to her. She understands how hazard applies, but the others are not as clear cut. Using rising gasoline prices as an example, explain to Betsy how those prices fit within the financial and strategic categories.

The Impact of ERM on an Organization

Check-In

1. In his will, your great-uncle gave you $10,000 with the condition that you must invest the money by purchasing $10,000 in stock from Company A or $10,000 in stock from Company B. After a little research, you determine an investment in Company A will be worthless at the end of the year, but there is a 40% chance the stock in Company B will be worthless, a 10% chance it will be worth $10,000 and a 50% chance it will be worth $20,000.

   Which investment option is riskier?

2. You pay $5 for a gift card that has a potential value of $100. To activate the gift card and claim the $100, you must correctly call the toss of a coin. If your call is incorrect, the gift card has no value. There are no second chances—you get only one call of the coin toss.

   Is there risk in accepting this offer?

Knowledge Check

Your CFO suggests she understands that TRM places risk identification and ownership with the risk manager and that ERM uses subject-matter experts and risk committees to identify organization risk. You, as risk manager, want to help her distinguish between the two approaches. What else should she know?

The ERM Implementation Process

Knowledge Check

Will wants to convince his senior management team to consider moving to ERM. He gives everyone a book about enterprise risk management which focuses on using ERM principles to boost market share. Will feels secure in knowing that once his management team agrees, he will be ready to go. Will plans on giving all employees a copy of the book and holding book club meetings. After those meetings, everything will be in place. What do you think of Will's plan?

Knowledge Check

Laura is the commercial lines service manager in a midsized insurance agency. The owner, Daniel, has just returned from a CRM course and is interested in implementing an ERM program for the agency. Laura shares that she can't imagine there being an upside to the risks the agency faces. How should the owner respond to Laura's statement? Is Laura an obstacle to ERM implementation?

Section 7 Self-Quiz

Directions: Select the correct answer.

1. ________ is/are a cross-functional view of risk affecting all areas of the entire organization.
   - ☐ Enterprise risk management (ERM)
   - ☐ Traditional risk management (TRM)
   - ☐ Cross-functional committees

2. ERM is all of the following EXCEPT:
   - ☐ applied at every level of the organization
   - ☐ supportive of strategic goals and objectives
   - ☐ a collage of disparate policies and approaches

3. Identify a characteristic that would fall under TRM.
   - ☐ It manages downside risks.
   - ☐ It is proactive and supportive.
   - ☐ It has the potential to affect both upside and downside.

4. _____ is/are considered to be a functional, siloed view of risks affecting one or more areas of the organization and only addresses pure risk.
   - ☐ Enterprise risk management (ERM)
   - ☐ Cross-functional committees
   - ☐ Traditional risk management (TRM)

5. From the list below, select the answer that is NOT an impact of ERM on the organization.
   - ☐ It protects the organization's reputation and brand.
   - ☐ It increases profitability through a reduction in costs or increase in revenue (or both).
   - ☐ It raises awareness of the importance of risk management in the organization.
   - ☐ It creates a competitive edge.

6. From the following, identify the example that is NOT a requirement of ERM implementation.
   - ☐ An ERM assessment
   - ☐ Documented and adequate cashflow
   - ☐ Support from the senior management team
   - ☐ An established framework

Directions: Select the correct letter to match each term with the appropriate definition.

A. Financial risks **B.** Operational risks **C.** Hazard risks **D.** Strategic risks	______ Risks that are closely associated with interest rates, investments, credit, liquidity, asset market value, equity and commodity market risks, receivables, currency and foreign exchange, and cash flow ______ Risks that are commonly addressed in traditional risk management programs, for example, property damage ______ Risks whose origins are centered on the day-to-day affairs of an organization; for example, talent management ______ Risk that originates with the decisions coming out of the executive boardroom; for example, intellectual capital

Answer Key

Section 1: Introduction to Risk Management

Introduction

Check-In

True or false? In Bryce's Sailboat Business, a risk management function would exist to support Bryce's organization with a particular strategy. And in doing so, he would need to employ a systematic process targeted at mitigating exposures that might delay his plans.

True **False**

What is Risk?

Check-In

Directions: Imagine that one of your clients owns a company that manufactures and sells a variety of granola breakfast and snack products. Identify three examples of pure and speculative risk associated with your client's business.

Pure Risks	Speculative Risks
Sample Answers:	
1. A valuable piece of equipment stops working.	1. They roll out a new granola bar which may or may not sell well.
2. The product is tainted in the manufacturing process and causes food poisoning.	2. They decide to branch out into energy bars which may or may not be successful .
3. The plant burns down and production is stopped.	3. They launch a new advertising campaign with a "spokes-mouse" which may or may not improve sales and reputation.

A Common Vocabulary

Knowledge Check

1. Phillips Company owns an old office building in Memphis, TN. The risk manager has been lobbying to retrofit the building to withstand potential perils. He explains that the building sits on the New Madrid fault line. Please identify the peril and hazard that the risk manager is concerned about and be prepared to explain your thinking.

Sample Answer:

The exposure is the building and any occupants, the peril is earthquake, and the hazard is the fact that the building is not built to withstand an earthquake. (Also acceptable—the hazard is the location of the building on a fault line.)

2. Peter steps off the escalator and stumbles. He is not injured and heads home. The next morning, he wakes up in pain. Which risk management term applies here? Please explain your thinking.

Sample Answer:

When Peter stumbles, it is an incident—there is no known injury at that time. When he wakes up the next morning in pain, the incident has evolved into an accident. Accident is the term that applies here.

The Steps of the Risk Management Process

Knowledge Check

Nancy is the risk manager at Risk and Insurance University and is conducting her annual review of the risk management program throughout the day. State which step in the risk management process is being executed:

1. Nancy's first meeting of the day includes the University's insurance broker and chief financial officer as various insurance policies and retention options are reviewed.

   Risk financing

2. Before lunch, Nancy tours the campus along with building managers, maintenance professionals, and grounds keepers to ensure various safety protocols are being followed and all safety mechanisms are functioning properly.

   Risk control

The Impacts of an Effective Risk Management Program

Knowledge Check

Provide an example from current events where a miscalculation or inaction on the part of an organization resulted in damage to its reputation—from which the organization might or might not have recovered.

Sample Answer:

Answers will be varied but may include items like: Volkswagen circumventing emission controls, the BP oil spill, Target getting hacked and losing records for 40 million customers, Uber facing 56 sexual harassment claims which later revealed minority discrimination and the existence of an unethical and hostile workplace.

Total Cost of Risk (TCOR)

Knowledge Check

Nancy is the risk manager for Pinnacle Products. She is reviewing a TCOR report prepared by the risk management intern. Nancy is concerned that the intern may not have a good understanding of the elements of TCOR. Which of the items in the report below support Nancy's concern? (Check any/all that don't fall within the elements of TCOR.)

- [ ] $300,000 – insurance premiums for all lines of coverages
- [x] $20,000 – repair of office equipment damaged by an employee's negligence
- [ ] $55,000 – settlement of a general liability claim paid by the insurer and billed back to the insured
- [ ] $10,000 – safety consultant hired to perform physical inspections at each of the locations
- [ ] $4,000 – the recovery of damage to a company-owned vehicle from a negligent driver's insurer
- [x] $65,000 – salary of the Director of Marketing including her benefits
- [ ] $15,000 – overtime paid to an employee filling in for another employee who was out of work recovering from a work-related accident

The cost to repair office equipment and the salary of the Director of Marketing do not fall within the elements of TCOR. The recovery of damage to a company owned vehicle will be a credit against the overall TCOR. Nancy is justified in her concerns.

Emerging Risks

Knowledge Check

The Great Resignation has created wide-spread impact on employment markets. In the US alone, April 2021 saw more than four million people quit their jobs, according to a summary from the Department of Labor. The US Bureau of Labor Statistics has reported that in 2021, 12.1 million young people between the ages of 20 to 34 quit their jobs between June and August. Explain how or why the Great Resignation reflects the common elements of emerging risk.

Sample Answer:

Answers will be varied but may include items like:

High uncertainty – which stems from the absence of reliable information. As such, frequency and severity of resignations and the continued dwindling of the workforce are hard to predict and quantify.

No common approach across organizations – Employers are reacting differently in trying to cope with the talent loss and inability to replace those who have resigned. Some may be "growing" their future workforce through internship programs. Others may be reconsidering salary and benefit structures to attract the limited talent available.

Regulatory involvement – At this time there has been no regulatory involvement in private industry issues and concerns. Is regulatory involvement foreseeable based on our social structure and form of government?

Section 1 Self-Quiz

Directions: Indicate whether the statement is True or False.

1. One example of an industry that is basically immune to risk is the restaurant industry.

   True **False**

   There is no business in existence that is immune to risk. Attempting to avoid all risk would be akin to not starting the business in the first place.

2. In the risk management arena (including the insurance world), definitions of risk are usually dependent upon the particular job function or area of expertise of the source.

   True **False**

   In the risk management arena (including the insurance world), we find different definitions of risk, which are usually dependent upon the particular job function or area of expertise of the source. To an underwriter, the risk is the subject of the insurance, the person or entity being insured.

3. Jeremy owns shares of Disney stock. The risk that would be associated with changes in the value of Disney's stock is known as speculative risk.

   True **False**

   Speculative risk is usually associated with business or financial risk. For example, speculative risk includes positive and negative changes in the value of a company's stock and positive and negative changes in a market that affect the demand for a company's manufactured goods.

4. Pure risk involves a situation or incident with multiple outcomes, not simply loss or no loss.

   True **False**

   Pure risk involves a situation or incident whose only outcome can either be loss or no loss. There is no opportunity for gain. Pure risks include threats to property and people, as well as liability for injuries to others.

Directions: Select the correct letter to match each term with the appropriate definition.

A. Peril	C. a reduction in the value of assets
B. Risk appetite	D. a situation, practice, or condition that may lead to an insured's susceptibility to adverse finance consequences or loss
C. Loss	F. an event that disrupts or interrupts normal activities and may become a loss
D. Exposure	A. a cause of loss or any action or event that causes a loss
E. Claim	E. a demand for payment or a company's moral or ethical obligation to pay damages as a result of a loss or occurrence
F. Incident	B. the organization's willingness to accept or tolerate risk

Directions: Select the correct answer for each question from the options given.

1. A factor increasing the likelihood that a loss will occur or the severity of a loss that occurs is known as a(n) ____________.
   - [ ] accident
   - [x] hazard
   - [ ] occurrence
   - [ ] expected Loss

2. _______ is the dollar amount of a given loss or the aggregate dollar amount of all losses for a given period, usually the policy period.
   - [ ] Accident
   - [ ] Expected loss
   - [x] Severity
   - [ ] Frequency

3. Identify which one of the following is **NOT** a step in the risk management process.
   - [ ] Risk control
   - [ ] Risk administration
   - [ ] Risk analysis
   - [x] Risk accumulation

4. The step in the risk management process that includes any conscious action or inaction to minimize (at optimal cost) the probability, frequency, severity, or unpredictability of a loss is the ______ step.
   - [x] risk control
   - [ ] risk administration
   - [ ] risk analysis
   - [ ] risk financing

5. The step in the risk management process that may be used for verification and classification of loss data, including predicting and range of losses, would be ____________.
   - [ ] risk control
   - [x] risk analysis
   - [ ] risk administration
   - [ ] risk financing

6. Which one of the following is **NOT** an impact of an effective risk management program?
   - [ ] Improved quality, processes, and technology
   - [ ] Improved workforce morale and productivity
   - [ ] Protected cash flow and assets
   - [x] Increased sales and market share

7. When implemented correctly, TCOR helps to change an organization's _______ for the better.
   - [ ] employees
   - [ ] productivity
   - [x] risk culture
   - [ ] reputation

8. In the TCOR formula, which one of the following examples would be an **indirect cost**?
   - [x] Reputation
   - [ ] Deductibles
   - [ ] Premiums
   - [ ] Training

9. In the TCOR formula, which one of the following examples would be a **retained loss**?
   - [ ] Replacement cost
   - [x] Deductible
   - [ ] Letter of credit
   - [ ] Overtime

10. Emerging risks share several common elements which increase their difficulty to identify and manage. What is an example of one of those common elements?
    - [x] High uncertainty
    - [ ] Predictability and thus well planned for
    - [ ] Cost prohibitive impacts to organizations
    - [ ] May be eliminated through regulatory intervention

Section 2: Risk Management and the Organization

The Governing Documents of a Risk Management Program

Knowledge Check

Eleanor is the newly hired risk manager for First Main Bank. During her first week on the job, she has determined that there are no governing documents for the risk management department. She has begun working on putting them in place. She starts with the bank's mission statement:

"The mission of First Main Bank Corporation is to be a profitable, progressive company of the highest quality, offering financial services to communities in Michigan. The FMB team is to be diligent in seeking out the needs and expectations of our customers. Our unwavering commitment is to provide customers with superior service in a caring, responsive way."

Eleanor drafts the risk management mission statement.

"The mission of risk management services is to consistently inform management of risk issues facing the company, its assets, and its employees; to treat risk in the methods most beneficial, economical, feasible, and sensible for the safety, security, and integrity of the company and its partners—our employees, directors, shareholders, customers, service providers, and the communities we serve."

Has she succeeded? Why or why not?

Sample Answer:

Eleanor has been successful, she has mirrored the Bank's mission statement in expressing concern for its customers.

Organizational Risk Culture (ORC)

Knowledge Check

Richard is a welder in an equipment manufacturing facility. One day, he sees the CEO walking on the work floor without a hard hat or safety glasses. Richard promptly turns off and puts down his torch and walks over to the CEO and reminds him that he must follow the safety rules which are established for all employees.

Which element of the ORC allows Richard to be comfortable approaching and correcting a member of senior management? Explain why.

Sample Answer:

Accountability and authority makes every member of the organization a risk manager. Richard is empowered by the ORC to speak to those who are not following risk management policies and procedures.

General Classes of Risk

Knowledge Check

Kidz Stuff manufactures children's clothing and accessories. The company licensed rights to a variety of popular movie characters for use on their clothing and shoes. The movie company's employment practices have recently come under scrutiny by state employment authorities, and a number of civil lawsuits are underway. Explain how the risks associated with these circumstances could be classified.

Sample Answer:

Social: They may lose good will and sustain damage to their reputation due to their association with the movie company and its questionable behavior.

Economic: They could experience a drop in sales for the same reason.

Risk Appetite and Risk-Taking Ability

Knowledge Check

Marcia is the risk manager for a technology consortium. The company is considering acquiring a mid-sized competitor to gain greater market share and access to their intellectual property. Marcia is part of the due diligence team and feels that a risk appetite and risk-taking ability analysis should be the first step in the due diligence process. Why would this analysis be important?

Sample Answers:

In terms of risk appetite, areas to consider are the impact the acquisition may have on the company's reputation and good will. Will they be seen as "gobbling up" the smaller competitor? Will their market share be so big after the acquisition that it will draw the attention of regulators? Does the company have the appetite for dealing with the potential negative ramifications?

In terms of risk-taking ability, there are several costs to be considered—the cost of legal counsel to negotiate and draw up the contracts, the actual acquisition costs and any financing costs, any costs associated with acquiring the competitor's employees, and post-transactional costs such as combining leadership teams and benefit plans.

Section 2 Self-Quiz

Directions: Select the class of risk applicable in each of the following scenarios.

1. Manufacturers fear tort attorneys will find a favorable venue to try class action lawsuits in the hope that juries will be responsive to their arguments.
   - [x] Juridical
   - [ ] Technological
   - [ ] Social
   - [ ] Economic
2. A recycling plant is required to install expensive safety equipment because of Occupational Safety and Health Administration (OSHA) requirements.
   - [ ] Social
   - [x] Legal
   - [ ] Economic
   - [ ] Technological
3. Interest rate fluctuations in emerging markets are creating concern for international investors.
   - [ ] Physical
   - [ ] Technological
   - [ ] Social
   - [x] Economic
4. A large retail box store's customer database is accessed by unauthorized persons and the personal information is compromised.
   - [x] Technological, possibly Social and/or Economic
   - [ ] Physical, possibly Social and/or Economic
   - [ ] Social and Legal
   - [ ] Physical and Legal

Directions: Indicate whether the statement is True or False.

1. The risk management mission statement, risk management policy statement, and risk management manual are the governing documents of a risk management program.

   True **False**

   The mission statement, policy statement, and manual are the governing documents of a risk management program.

2. Demonstrating and communicating to all employees senior management's support for the risk management program is one of the four key purposes of the risk management manual.

   True **False**

   There are four key purposes to the risk management manual: 1) it demonstrates and communicates senior management's support for the risk management program to all employees; 2) it establishes expected levels of performance and cooperation; 3) it familiarizes ALL personnel with procedures to effectively manage risks and exposures; and 4) it provides a convenient reference or "how to" guide for such activities as job safety, electronic messaging, or reporting procedures for incidents and accidents in accordance with insurance policy terms and risk management department requirements.

3. If you are looking to find out an organization's strategy for managing risks and its relevance to the overall strategic plan, goals, and objectives, you would want to consult the risk management mission statement.

   True **False**

   The risk management policy statement deals more specifically with the various areas of risk management. It defines the organization's policy for managing risks and its relevance to the overall strategic plan, goals, and objectives, including its risk management philosophy and ethical considerations.

4. The risk management mission statement may include a brief description of the organization's philosophies, its competitive advantages, and its vision.

   True **False**

   In general, the mission statement is short, giving a brief statement of why the organization exists, what its overall goal is, the goals of its operations, what products or services it provides to its primary market or customers, and its area of operation. The mission statement may also include a brief description of the organization's philosophies, its competitive advantages, and its vision.

5. Organizational risk culture is the collection of values, expectations, and practices that guide and inform the actions of all members of the risk management team.

True **False**

Organizational risk culture is the collection of values, expectations, and practices that guide and inform the actions of all members of the risk management team.

6. Risks arising from a jury or judge's decision are examples of political risk.

True **False**

These are examples of juridical risk—risks arising from a jury or judge's decision or from court or jury attitudes. The nature of a particular jurisdiction may be very litigious and famous for large verdict awards.

Section 3: Introduction to Risk Identification

The Importance of Risk Identification

Check-In

What happens if an exposure is not identified? Choose the correct answer from the choices below.

- [x] There is an increased likelihood of financial loss which the company or individual must bear.
- [ ] It will be identified eventually from the loss runs.
- [ ] The agent will be held responsible.

Logical Classifications

Knowledge Check

An oil rig in the Gulf of Mexico explodes, injuring employees and spilling millions of gallons of oil. Indicate which of the logical classifications apply; be sure to explain your reasoning.

Sample Answers:

Human resources: death and injury to the employees

Property: loss of production platform and equipment

Liability: damages sustained by individuals and businesses due to the oil spill

Net income: loss of revenue and increased expenses due to shut down of the platform and increased compliance costs, defense costs of lawsuits, contractual obligations not met

Negligence

Knowledge Check

The risk manager for a retail grocery store was asked to explain to the store's management team what could cause the store to be legally responsible for damages. The risk manager explained that liability could arise from torts.
How would you explain torts to the management team to make this clear, as well as how negligence comes into play?

1. What is a tort?

   A tort is a private or civil wrong, other than a breach of contract, for which the courts will allow an action (lawsuit) for damages.

2. Define negligence and list its four elements.

   Negligence is failure to exercise that degree of care which a reasonably prudent person would exercise under the same circumstances.

   A. A duty owed (by the defendant to the plaintiff)

   B. A breach of that duty

   C. Causation – a proximate cause between the breach of the duty and the injury/ damages, an unbroken chain of events

   D. Damages – actual damages resulting from the breach

Requirements of Enforceable Contracts

Knowledge Check

Goode Winery has a long-term contract with USA Fine Dining Restaurants to provide 25 cases of wine each month. Yesterday, USA Fine Dining notified the winery that it will not accept any further deliveries and refuses to meet with Goode Winery to discuss the matter. This creates a significant problem for Goode as it will now be stuck with excess inventory since USA Fine Dining was its largest customer.

If Goode decides to sue and the court rules in Goode's favor, it can impose remedies for a breach of contract. Explain two possible remedies the court could impose and be sure to explain your thinking.

Sample Answers:

Damages: (money) compensatory, punitive, or liquidated. The court could require USA to pay Goode the amount of money it has lost or will lose due to the breach of contract.

Reformation: change the contract to reflect true intentions of the parties. In this instance reformation probably would not apply. The contract terms are not in question.

Injunction: requirement to refrain from doing an act. The court could require USA to stop refusing to accept the wine.

Performance: compliance with contractual promises. The court could require USA to accept and pay for shipments as per the contract terms and to provide a non-renewal or termination notice as per the contract.

Section 3 Self-Quiz

Directions: Indicate whether each statement is True or False.

1. An increased likelihood of a financial loss occurs when a risk is overlooked.

   True **False**

   If a risk is overlooked, the most obvious concern is there is an increased likelihood of financial loss, which could occur through a variety of means.

2. Cash and securities are considered examples of intellectual property.

   True **False**

   Cash and securities are considered examples of personal property/business property.

3. When it comes to human resources, the majority of these exposures can be controlled by external policies and procedures.

   True **False**

   The majority of human resources exposures can be controlled by *internal* policies and procedures.

4. Property, liability, human resources, and net income are all examples of logical classifications of exposures, perils, hazards, and/or losses.

   True **False**

   Property, liability, human resources, and net income are all examples of logical classifications of exposures, perils, hazards, and/or losses.

5. The definition of negligence does NOT include a failure to exercise a degree of care that a reasonably prudent person would exercise under similar circumstances.

   True **False**

   Negligence is defined as the failure to exercise a degree of care that a reasonably prudent person would exercise under similar circumstances.

6. Liquidated damages are those whose value is stipulated in the contract as the amount to be paid regardless of any provable damages if the contract is breached.

   True **False**

   Liquidated damages are those whose value is stipulated in the contract as the amount to be paid regardless of any provable damages if the contract is breached.

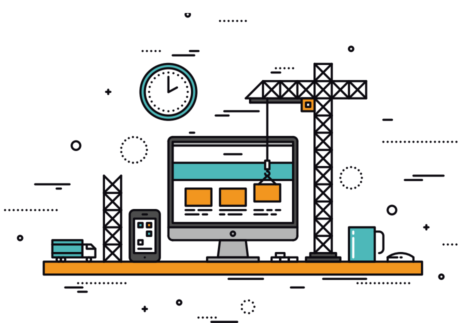
Directions: Select the correct answer.

1. Each of the following are examples of real property EXCEPT for:
   - [ ] retaining walls
   - [ ] office buildings
   - [ ] storage silos
   - [x] furnishings
2. Each of the following are examples of personal/business property EXCEPT for:
   - [ ] inventory
   - [ ] hardware
   - [x] licenses and franchises
   - [ ] records and documents
3. Select the answer that expresses two of the four elements of which negligence is comprised.
   - [ ] Duty of care and reasonable actions
   - [x] Causation and damages
   - [ ] Breach of duty and deliberate action
   - [ ] Causation and criminal intent
4. A private or civil wrong, other than a breach of contract, for which the courts will allow an action (lawsuit) for damages is known as a _______.
   - [ ] service mark
   - [x] tort
   - [ ] trade secret
   - [ ] peril
5. Each of the following are examples of the four requirements of an enforceable contract EXCEPT:
   - [ ] a legal purpose
   - [ ] genuine agreement or assent
   - [ ] competent parties
   - [x] liquidated damages

Section 4: Risk Identification Methods – Self-Administered Tools

Classifying Exposures, Perils, and Hazards

Knowledge Check



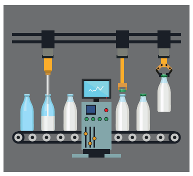
Build-it Construction is a new client of yours. Build-it's CEO is concerned about increased growth Built-in is seeing in their number of losses, so she decides to implement a risk management program. You advise your client that to do an effective job, you must first classify and define sources of risk faced by Build-it. List the four logical classifications of exposures faced by Build-it and provide an example of an exposure to loss that might exist in each of the classifications. Make sure you're able to explain your line of thinking.

Sample Answers:

1. **Property:** real property, personal property, intellectual property, intangible property; examples include buildings, office equipment, patents
2. **Human Resources:** owners, partners, shareholders, board members and officers, employees—both management and non-management, outside employees (leased and temporary workers, borrowed workers, volunteers), independent contractors, others (primary clients)
3. **Liability:** premises and operations, personal injury, advertising and communications, products, completed operations, statutory compliance, injuries to others, property damage
4. **Net Income:** investment activities, market conditions and fluctuations, reduction of income or increase in expenses, speculative risks

Self-administered Methodologies for Risk Identification

Knowledge Check



Gabriel, the risk manager for a bottling company, has been recruited by a competitor. He knows that the sooner he can come up-to-speed on his new employer's operations, the faster he can make informed suggestions. Please describe two types of checklists Gabriel might use and why they would be helpful. What led you to this decision?

Sample Answers (only two answers are required):

1. A preliminary information checklist will provide general information about the organization, covering its organizational structure, ownership, personnel, and a broad description of its activities. It is a great tool to help Gabriel orient himself to his new employer
2. An asset checklist includes all resources and capacities. Such a checklist prompts staff to account for assets and often leads to the identification of often-overlooked assets. This will allow Gabriel to know what equipment, machinery, raw materials, and inventory his employer has in inventory.
3. The perils checklist is used to identify the original source or cause of loss once the exposure is identified and BEFORE a loss occurs. This will help Gabriel institute proactive risk control measures.

Check-In

1. Chris, a risk manager, wants to identify new exposures. Which identification method will help Chris in this process?

   - [x] A physical inspection
   - [ ] An asset checklist
   - [ ] A perils checklist
   - [ ] An examination of the logical classifications of exposures the organization faces

2. True or false? A checklist cannot identify new exposures and their perils and hazards because the “new” exposure will not be on the checklist.

   True **False**

   A checklist cannot identify new exposures and their perils and hazards because unless the checklist creator has a crystal ball, the “new” exposure will not be on the checklist. The checklist is essentially a yes/no document that only identifies the presence of the listed item. A physical inspection may be able to find unreported and unidentified exposures, perils, and hazards.

Check-In

You are the producer of the concert performance diagrammed in the flowchart presented on the facing page. You are trying to identify potential exposures associated with this concert. What events or circumstance can cause a loss or disruption to property, human resources, liability, and/or net income in the production of this performance?

Answers will vary based on the steps in the process. e.g., The performer could get laryngitis, the transportation company could breach their contract, the venue could sustain fire damages

Section 4 Self-Quiz

Directions: Indicate whether each statement is True or False.

1. A human peril is one arising from being in business, such as a recession.

   True **False**

   Human perils are those arising out of human behaviors, whether intentional or accidental, such as fires, trips and falls, criminal acts, or negligence.

2. A peril arising out of a natural disaster such as a damage from a hurricane would be an example of a natural peril.

   True **False**

   Natural perils are those arising out of nature, such as wind, lightning, flood, and earthquake.

3. Loss of income would be an example of a peril under the economic peril classification.

   True **False**

   Economic perils are those arising from being in business, such as acts of competitors, recessions, interest rate changes, and the like.

4. Hazards can be easily classified into the following three types: moral, morale, and associated.

   True **False**

   Hazards can easily be classified into physical, moral, and morale type hazards.

5. The intent to cause harm, such as stealing someone's identity or passwords, would be an example of a morale hazard.

   True **False**

   Moral hazards are those that arise out of defects in human character, such as the intent to cause harm or stealing someone's identity or passwords.

6. Morale hazards are those that arise out of indifference, such as not locking your car because you know it is insured and there is nothing valuable in it.

   True **False**

   Morale hazards are those that arise out of indifference, such as not locking your car because you know it is insured and there is nothing valuable in it.

7. Physical hazards exist naturally or are those that are caused by human negligence, such as the presence of dead trees in near proximity to buildings, or speeding on an expressway.

   True **False**

   Physical hazards are physical conditions that exist naturally or those that are caused by human negligence, such as the presence of dead trees in near proximity to buildings or speeding on an expressway.

8. It is not imperative for a hazard to be associated with a peril.

   True **False**

   Associated with perils are hazards that increase the likelihood of a loss occurring or the severity of a loss that does occur. For something to be considered a hazard, it must be associated with a given peril, so the hazard of improperly stored oily rags in a workshop, for example, may increase the likelihood of a fire loss occurring but not an earthquake loss.

Directions: Select the correct answer.

1. A document to aid the risk manager in systematically searching and identifying as many exposures, perils, and hazards as possible—and one that can be simple or expansive—is known as a:
   - [ ] compliance review
   - [ ] flowchart
   - [x] checklist
   - [ ] specialty resource method
2. All of the following are strengths to the flowchart method of exposure identification EXCEPT:
   - [x] indicates frequency or severity of events
   - [ ] can identify punch points or bottlenecks
   - [ ] can determine the critical path or activity
   - [ ] identifies dependencies upon other outside organizations or infrastructures

Section 5: Analytic Risk Identification Methods

Analytic Methodologies

Check-In

Directions: Select the term that best completes each statement.

1. Recognizing an organization's ______________________ others is an important outcome of reviewing contracts.

   obligations to **reliance on**

2. During contract reviews, a risk manager must be aware of the possibility of third-party ______________________ .

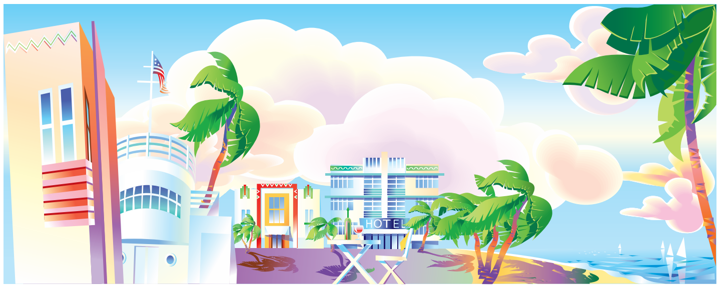
   noncompliance **exposures to statutes and regulations**

Check-In

Directions: Match the identification method on the left with its description on the right.

A. Non-insurance contract review	C. A risk manager conducts a review to determine which assets would be excluded from coverage for a particular peril.
B. Compliance review	A. A risk manager reviews hold harmless clauses to determine obligations owed.
C. Insurance policy review	B. A human resources director conducts a review to determine if employees' professional certifications and licenses are up to date according to state law.
D. Financial statement analysis	D. A risk manager wishes to determine net income exposures that could impact the company.

Knowledge Check



Lucas is a new risk manager for a Florida resort hotel. He is trying to understand the types of workers compensation losses that have been happening at the resort. His finance officer presents him with the loss run presented on the following page. Lucas does not feel that he can use the information to project future losses as he feels the data is incomplete.

1. Please explain what Lucas means.

   Sample Answer:

   For data to be complete, all events are included whether covered by insurance or not, and enough data must be available; (at least five years of data, and at least 30 data points per year). The loss run provided by the finance officer only has three years of loss data and fewer than 30 data points per year.

2. Lucas is also concerned with the integrity of the data. Please provide some examples from the loss run which support Lucas' concerns.

   Sample Answers include:

   Ena Goodman (fourth from the bottom) – Her injury is a contused foot, but reserves are over $5,000. Is the injury description correct?

   Farah Cherry (first row) – She is losing time from work, but no disability payments are shown. Reserves seem high for a neck strain; also, this is a carrying injury. How did she strain her neck and not her back?

   Patty Frazier (seventh from the bottom) – Her injury is "fracture legs." Are both legs fractured? If only one leg is fractured, then right or left should be noted. No lost time, and minimal medical bills—this doesn't sound likely.

   A general concern is that the loss run does not indicate if individual claims are open or closed; that must be "drawn" from the financial data.

   There are lots of small medical-only claims and not a lot of claim activity which would indicate good claims cost control, if the data is correct.

Section 5 Self-Quiz

Directions: Select the correct answer.

1. ______________ are useful for organizations with exposures that fall within all four logical classifications. They can be conducted by internal or external personnel who observe organizational personnel in their natural surroundings.
   - [ ] Flowcharts
   - [ ] Checklists
   - [ ] Non-insurance contract reviews
   - [x] Physical inspections
2. The insurance policy review method is used for:
   - [x] reviewing an insurance contract and related documents to determine exposures and perils that are and are not covered
   - [ ] reviewing contracts other than insurance policies
   - [ ] internal and external personnel possessing expertise in a special field of knowledge to identify exposures, perils, and hazards
   - [ ] identifying dependencies upon other outside organizations or infrastructures
3. The procedures and policies review method can be used for:
   - [ ] determining compliance with regulation and laws
   - [ ] identifying values that are subject to loss
   - [x] evaluating the organization's bylaws, board minutes, mission statements, org. charts, and employee manuals
4. Which of the following is NOT a characteristic of credible loss data?
   - [ ] Integrity
   - [ ] Completeness
   - [ ] Consistency
   - [x] Sufficiency
5. Indicate if the following are internal (I) or external (E) sources of data.

   Insurance carrier loss runs _I_

   Accounting entries on financial statements _I_

   National Safety Council _E_

   First aid logs _I_

   Bureau of Transportation Statistics _E_

6. Which of the following documents is NOT analyzed during the contract review method?

   - [ ] Leases
   - [ ] Hold harmless and indemnification agreements
   - [x] Insurance policies
   - [ ] Bills of lading

7. Being the basis for initial insight in developing crisis contingency plans is the strength of which method?

   - [ ] Compliance review method
   - [x] Financial statement analysis method
   - [ ] Procedures and policies review method
   - [ ] Non-insurance contract review method

8. Which one of the following is an example of a weakness in utilizing the loss data analysis method?

   - [ ] Information gathered through loss data analysis can be used for forecasting losses or predicting and preventing future incidents.
   - [ ] This method is used to evaluate the effectiveness of the risk management program and for benchmarking the organization against others in its industry, or itself, over time.
   - [ ] Besides its limited applicability to property and net income, the reality is that organizational politics may prevent effective treatment of exposures.
   - [x] Because this method is driven by losses which have occurred, it only works when losses have been reported.

Section 6: Financial Statement Analysis

Accounting, Financing, and Risk Management

Knowledge Check

Mary is the founder of a new stationery printing company, "Mary's Mark." While Mary is not an accountant, she knows that she will need proper accounting systems and procedures in place. You, as Mary's risk manager, want to assist her in terms of her compliance obligations. Which accounting system(s) would you recommend and why?

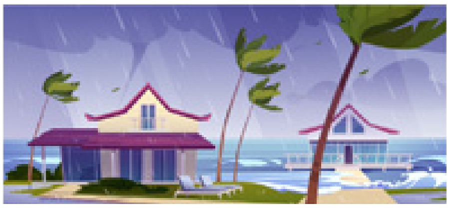
Sample Answer:

At a very minimum, Mary will need to utilize GAAP to make the process of financial reporting transparent. It uses standardized assumptions, terminology, definitions, and methods. This allows easy comparison of companies to outside parties. The transparency of GAAP will allow potential investors to make decisions about investing in the new company.

Mary will also need to be aware of IRS rules and guidelines for tax purposes and follow them consistently. As the company grows and prospers, Mary may want to consider a managerial accounting system to help make informed short-term and day-to-day financial decisions.

Property Valuation Methods and Financial Statements

Check-In



A Cancun resort suffered a windstorm loss to the hotel building from a recent tropical storm system and is preparing its insurance proof of loss. The risk management department and accounting department have prepared the following exhibit:

Cost to build ten years ago	**$ 37,000,000**
Current construction cost	**$ 52,000,000**
Accumulated depreciation as per the accounting records	**$ 6,000,000**
Current comparable value appraisal for refinancing effort *(30% of value was land)*	**$80,000,000**
Net present value of future income for the next 40 years	**$ 75,000,000**
The insurance adjustor's calculated depreciation	**$ 12,000,000**

The risk management department has also calculated the following property valuations:

Market value *Current appraisal minus the land* *80,000 – (0.30 x 80,000) = 56,000*	**$ 56,000,000**
Book value *Historical cost minus accumulated depreciation*	**$ 31,000,000**
Replacement cost *Current construction cost*	**$ 52,000,000**
Actual cash value *Replacement cost minus insurance depreciation of $12,000,000*	**$40,000,000**

You know that the historical cost is $37,000,000 (the original cost to build).

Knowledge Check

Your client owns a restaurant that is housed in an 18th-century brick bank building which she purchased five years ago. The original furnishings of the bank remain, including the vault. All of these furnishings have been incorporated into the restaurant operations. Which of the property valuation methods would you recommend your client use to insure the building and its original contents?

Sample Answer:

The contents are probably not replaceable due to their age. In the case of a loss, functional replacement cost valuation would allow the interior of the building to be restored to look the same. It is unlikely, however, that an insurance company would be willing to insure the contents for replacement cost.

The building itself can be insured for market value assuming there is a market for this type of structure, or at replacement cost if like kind and quality materials are available. Since the building is brick, this should not be insurmountable.

Financial Statement Types

Check-In

Directions: Select the term that best completes each statement.

1. Financial statement analysis may reveal understated or overstated ____________________ being carried on an organization's books.

   financial capabilities **values**

2. ________________________________ is the reduction in the value of an asset over time.

   Depreciation **Amortization**

Check-In

Directions: Indicate whether these components are part of the balance sheet or the income statement.

1. Operating revenue
   - ☐ Balance sheet
   - ☑ Income statement
2. Current liabilities
   - ☑ Balance sheet
   - ☐ Income statement
3. Cost of goods sold
   - ☐ Balance sheet
   - ☑ Income statement
4. Fixed assets
   - ☑ Balance sheet
   - ☐ Income statement
5. Shareholders' equity
   - ☑ Balance sheet
   - ☐ Income statement
6. Depreciation
   - ☐ Balance sheet
   - ☑ Income statement

Check-In

Rita is reviewing the statement of cash flow for her organization. She is becoming concerned that outflows exceed inflows by a significant amount. While she knows the business is seasonal, she does not believe that the numbers can be correct. What is the first thing Rita should check before raising her concerns?

Sample Answer:

Rita should check the period of time covered by the statement. It may not be the most current information or it may not cover a long enough period of time for the seasonality aspect to balance out.

Knowledge Check

1. Mary, your risk management intern, is looking at the income statement of your company. She is confused by the difference between depreciation and amortization. Provide Mary with an example that illustrates each of these concepts.

Here are two examples—there is no set answer:

Depreciation is the reduction in the value of an asset over time for tax management purposes. Depreciation lowers income and tax liability; thereby, generating positive cash flow. For example, a business may depreciate its office furniture over a 10-year period and report the depreciated value in its financial statements

Amortization is used to periodically lower the book value of a loan or an intangible asset over a set period of time. A mortgage is a form of amortization spreading out the loan payments over time and gradually reducing the loan amount (principal).

2. A balance sheet is a summary of the organization's assets, liabilities, and owner's equity as of a specific point in time. Why would the balance sheet be of interest to potential investors?

Sample Answer:

Investors look at liquidity when deciding whether to loan or invest money in a business.

The balance sheet reflects the liquidity of the organization, which is the organizations' ability to pay off its short-term liabilities.

Financial Ratios

Knowledge Check

Mary Donner, a risk manager, is preparing a report on the state of the risk management department for Sarah Packer, the CFO. Mary knows that Sarah supports the use of financial statement ratio analysis in measuring the progress of the company over time.

Mary calculates the following financial ratios by using the most recent financial statements to measure the progress of the organization. She prepares a report to share with Sarah that discloses the following financial information.

What red flags, if any, can you identify from these numbers?

1. Current ratio = 4.77
   Current assets/Current liabilities 186,000/39,000

   The benchmark is 1.5 or greater. This is not an area of concern.

2. Debt ratio = 0.708
   Total debts/Total assets 328,000/463,000

   The benchmark is .50 or less. The company may be overextended.

3. Net profit margin = 2.14%
   Net profit/Sales 7,500/350,000

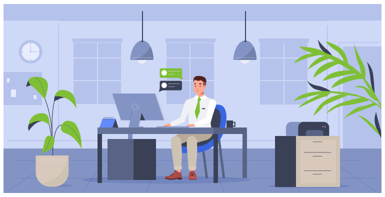
   There is no set benchmark, so this depends on what the company wants, but 2.14% is probably too low.

4. Return on equity = 5.5%
   Net income/Equity 7,500/135,000

   The benchmark standard is 15%, so this is much too low. The stakeholders are not getting a good return on their investment.

Financial Statement Analysis and Risk Management

Knowledge Check



Allen is an intern in the risk management department. He wants to understand the impact of net income losses on the company and on the risk management department budget. As his boss, explain to Allen how he can derive information from the financial statements.

Sample Answer:

A loss such as storm damage may impact operations and, eventually, profits. When and where a loss occurs such as in a low or high season, just before or after or during a season, at specific locations, divisions, or branches, likely will impact organization profitability as well. The expenses associated with recovering from a loss will be reflected in the income statement. Allen should also evaluate those expenses that will continue after the loss—which will continue and which are controllable? If the loss will result in a loss of revenues, there will be fewer funds available for risk management initiatives.

Section 6 Self-Quiz

Directions: Indicate whether each statement is True or False.

1. Finance is the process of recording and classifying business and financial transactions and reporting them on an organization's financial statements.

   True **False**

   Accounting is the process of recording and classifying business and financial transactions and reporting them on an organization's financial statements. Similarly, accounting is like keeping a check register and balancing your checkbook.

2. The process of managing an organization's assets, liabilities, and cash flow to maximize shareholder (or stakeholder) wealth is known as risk management.

   True **False**

   Finance is the process of managing an organization's assets, liabilities, and cash flow to maximize shareholder (or stakeholder) wealth.

3. US law requires businesses that release financial statements to the public and publicly traded companies to follow GAAP guidelines.

   True **False**

   The Financial Accounting Standards Board (FASB) uses GAAP as its foundation for comprehensive approved accounting methods and practices. US law requires businesses that release financial statements to the public and publicly traded companies to follow GAAP guidelines.

4. Managerial accounting is a set of accounting regulations prescribed by the NAIC for the preparation of the insurance company's financial statements.

   True **False**

   Managerial accounting is an internal accounting system that provides accurate and timely financial information to make short-term and day-to-day financial decisions. Such an accounting system is only used internally and is proprietary because it may reflect future development goals of an organization that are not for public knowledge.

5. Governmental, or fund accounting, is used in organizations whose purpose is for the public good. Public or private investment in these organizations does not occur and their operations do not compare to typical business entities.

True **False**

The purpose of these organizations is for the public good; public or private investment in these organizations does not occur and their operations do not compare to typical business entities.

Directions: Select the correct letter to match each term with the appropriate definition.

Terms	Definitions
A. Market value	F. The historical cost, less accumulated depreciation
B. Economic value	A. The amount a willing buyer will give to a willing seller
C. Historical cost	C. The original purchase price of property
D. Functional replacement cost	B. A future stream of income assigned to the property
E. Actual cash value	E. The replacement cost, less an allowance for depreciation or obsolescence
F. Book value	D. The cost to repair or replace damaged or destroyed property with materials that are essentially the equivalent of the property, when original materials are unavailable
G. Other property valuation bases	G. In some unusual circumstances, none of the previous property valuation methods are appropriate, and the risk manager may have to devise a basis that is acceptable to an underwriter and to the organization.

Directions: Select the correct answer.

1. A summary of the organization's assets, liabilities, and owner's equity as of a specific point in time describes the:
   - [ ] income statement
   - [x] balance sheet
   - [ ] statement of cash flow

2. A summary of the effects of cash on the operating, investing, and financial activities of an organization for a specific period of time describes the:
   - [ ] balance sheet
   - [x] statement of cash flow
   - [ ] income statement

3. A summary of the organization's financial performance for a specific period of time describes the:
   - [ ] balance sheet
   - [x] income statement
   - [ ] statement of cash flow

4. When using common financial ratios, there are important points to remember. Identify what is NOT one of these points.
   - [x] The organization's ability to repay creditors over the long term does not impact the organization's financial leverage.
   - [ ] There is no "perfect" or "ideal" ratio. The appropriate ratio or range of ratios depends largely upon the type of organization.
   - [ ] The ratios are very dependent upon the type of financial system used to generate the numerator and denominator.

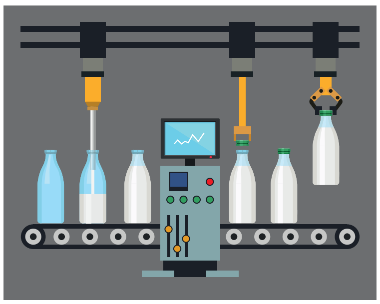
5. Profitability ratios measure returns in several ways. An example of this would be which one of the following formulas?
   - [ ] Quick ratio = (current assets – inventory) ÷ current liabilities
   - [ ] Debt ratio = total debt ÷ total assets
   - [x] Return on assets (ROA) = net income ÷ total assets

6. Financial statement analysis is used to do all of the following EXCEPT:
   - [ ] review asset valuation
   - [ ] assess liquidity and financial strength
   - [x] benchmark financial capacity against competitors
   - [ ] assess risk tolerance levels and bonding capacity

Section 7: Introduction to Enterprise Risk Management

Broad Categories of Risk for ERM

Knowledge Check



A beverage manufacturer with a strong market share is considering launching a new low-carb formulation of their beverage. Historically risk averse, they are seeking to move from a TRM perspective to ERM. Several members of the board do not understand ERM and believe that this is a dangerous risk and only perceive the downside. You have been part of the due diligence team that researched this proposal and value the ERM approach. Please explain how ERM would consider the upside of taking this risk.

Sample Answer:

Reduced carbohydrate products are not a fad, they are here to stay, and the market for them continues to grow. The new beverage could be widely well received and increase the company's revenues and overall market share by tapping into the low-carb consumer arena.

Check-In

Identify which of the ERM broad categories of risk apply to the following examples:

1. Despite wide-spread public commentary and media attention, a university decides it does not need to examine its diversity policies.

   Hazard

2. D.C. Power believes the demand for electricity will skyrocket following predictions for record temperature highs during the summer. They purchase "Congestion Contracts" to ensure delivery of power from remote locations in times of greatest demands.

   Financial

3. A well known producer of baked goods uses a single source for its flour.

   Operational

4. An automobile manufacturer wishes to create an injury-free vehicle by 2030. The car of the future will be able to steer, brake, and learn about the road ahead from a vast array of electronic sensors located around the vehicle.

   Strategic

Knowledge Check

Betsy is the owner of a small delivery service. She is wondering if ERM is right for her company. Betsy just doesn't see how all of the broad categories of risk can apply to her. She understands how hazard applies, but the others are not as clear cut. Using rising gasoline prices as an example, explain to Betsy how those prices fit within the financial and strategic categories.

Sample Answers:

Financial: Rising gas prices will directly affect her cash flow and profitability. Her costs to make deliveries will go up.

Strategic: Betsy may lose market share. She must determine if she will raise prices to cover the differential or risk being undercut by her competition who may choose to absorb those costs.

The Impact of ERM on an Organization

Check-In

1. In his will, your great-uncle gave you $10,000 with the condition that you must invest the money by purchasing $10,000 in stock from Company A or $10,000 in stock from Company B. After a little research, you determine an investment in Company A will be worthless at the end of the year, but there is a 40% chance the stock in Company B will be worthless, a 10% chance it will be worth $10,000 and a 50% chance it will be worth $20,000.

   Which investment option is riskier?

Sample Answer:

An investment in Company A will result in a guaranteed loss; there is no upside. An investment in Company B may produce a loss or a gain.

2. You pay $5 for a gift card that has a potential value of $100. To activate the gift card and claim the $100, you must correctly call the toss of a coin. If your call is incorrect, the gift card has no value. There are no second chances—you get only one call of the coin toss.

   Is there risk in accepting this offer?

Sample Answer:

Yes, there is a risk—a pure risk—that you will lose $5. And there is an upside risk that you will win $95.

Knowledge Check

Your CFO suggests she understands that TRM places risk identification and ownership with the risk manager and that ERM uses subject-matter experts and risk committees to identify organization risk. You, as risk manager, want to help her distinguish between the two approaches. What else should she know?

Sample Answers:

ERM is cross-functional, a coordinated treatment of risk across all areas of the organization. Traditional risk management (TRM) is singly functional, a specific treatment of risk within an organizational area.

ERM's perspective is that managing risk has a positive potential and a negative potential. TRM's perspective is that risk has only a downside or negative potential.

ERM is linked to strategic objectives or key business objectives. TRM is linked to cause of loss, which is prevented or reduced.

ERM is proactive and opportunistic; TRM is reactive and defensive.

The ERM Implementation Process

Knowledge Check

Will wants to convince his senior management team to consider moving to ERM. He gives everyone a book about enterprise risk management which focuses on using ERM principles to boost market share. Will feels secure in knowing that once his management team agrees, he will be ready to go. Will plans on giving all employees a copy of the book and holding book club meetings. After those meetings, everything will be in place. What do you think of Will's plan?

Sample Answer:

While Will may be successful in gaining upper management support through this unorthodox approach, he is still missing the balance of the requirements for ERM implementation: an implementation leader and dedicated cross-functional committees, a risk management assessment, a common language regarding risk, and an established framework. The book club may fulfill a small portion of the framework elements, but it is insufficient.

Knowledge Check

Laura is the commercial lines service manager in a midsized insurance agency. The owner, Daniel, has just returned from a CRM course and is interested in implementing an ERM program for the agency. Laura shares that she can't imagine there being an upside to the risks the agency faces. How should the owner respond to Laura's statement? Is Laura an obstacle to ERM implementation?

Sample Answer:

Daniel might tell Laura that the agency's plans to expand their book of business by adding a high net worth division comes with an upside. They may be successful in acquiring new clients, their gross revenues and commissions could increase, and their reputation in the community could be bolstered.

Laura is not necessarily an obstacle; she is in need of education—one of the key components of the framework that Daniel will put in place.

Section 7 Self-Quiz

Directions: Select the correct answer.

1. ________ is/are a cross-functional view of risk affecting all areas of the entire organization.
   - [x] Enterprise risk management (ERM)
   - [ ] Traditional risk management (TRM)
   - [ ] Cross-functional committees

2. ERM is all of the following EXCEPT:
   - [ ] applied at every level of the organization
   - [ ] supportive of strategic goals and objectives
   - [x] a collage of disparate policies and approaches

3. Identify a characteristic that would fall under TRM.
   - [x] It manages downside risks.
   - [ ] It is proactive and supportive.
   - [ ] It has the potential to affect both upside and downside.

4. ________ is/are considered to be a functional, siloed view of risks affecting one or more areas of the organization and only addresses pure risk.
   - [ ] Enterprise risk management (ERM)
   - [ ] Cross-functional committees
   - [x] Traditional risk management (TRM)

5. From the list below, select the answer that is NOT an impact of ERM on the organization.
   - [ ] It protects the organization's reputation and brand.
   - [ ] It increases profitability through a reduction in costs or increase in revenue (or both).
   - [ ] It raises awareness of the importance of risk management in the organization.
   - [x] It creates a competitive edge.

6. From the following, identify the example that is NOT a requirement of ERM implementation.
   - [ ] An ERM assessment
   - [x] Documented and adequate cashflow
   - [ ] Support from the senior management team
   - [ ] An established framework

Directions: Select the correct letter to match each term with the appropriate definition.

Term	Answer	Definition
A. Financial risks	A.	Risks that are closely associated with interest rates, investments, credit, liquidity, asset market value, equity and commodity market risks, receivables, currency and foreign exchange, and cash flow
B. Operational risks	C.	Risks that are commonly addressed in traditional risk management programs, for example, property damage
C. Hazard risks	B.	Risks whose origins are centered on the day-to-day affairs of an organization; for example, talent management
D. Strategic risks	D.	Risk that originates with the decisions coming out of the executive boardroom; for example, intellectual capital

Appendix

Preparing for the Final Exam

For many learners, test preparation is stressful. Please keep in mind that the most important measure of your knowledge will be witnessed in your service to your organization. Think of a test as a tool. Use it to come to an understanding of what you know, how it affects your work, and what more you would like to know to have even greater success in the workplace.

The testing period for the Final Exam is 2 ½ hours long. The test itself is composed of 17–21 short-answer questions for a total of 200 possible points. Questions appear in the order of presentation of the topics.

Remain aware of the time as you take the test. Pace yourself and be aware that unanswered questions are considered incorrect.

Study Techniques

There are some techniques you can use to help you prepare for the end-of-course test. Apply the same techniques to each chapter in your learning guide.

1. Review the Section Goal.

2. Review each Learning Objective.

3. Change each header and subhead into a question. Then answer the question. For example,

   Header: Components of a Formal Training Plan

   Question: What are the components of a formal training plan?

4. Review each diagram, graph, and table. Interpret what you see. Ask yourself how it relates to a specific Learning Objective.

5. Check your answers to each Check-In. Correct your original answers, if necessary.

6. Check your answers to each Knowledge Check. Consider ways to improve your original answers.

7. Re-read the summary at the end of each section.

8. Check your answers to each question in the Self-Quizzes at the end of each section. Correct your original answers, if necessary.

9. Review any comments, highlights, or notes you made in each section.

10. Rewrite important ideas in your own words. Find ways to connect those ideas to your own work experiences.

11. Make flash cards to help you review important vocabulary.

Sample Test Questions

1. ABC Corporation's (ABC) board of directors is considering implementing an enterprise risk management (ERM) approach to managing risk. One of the board members has asked you, as the risk manager of ABC, to explain the concept of ERM. Please provide a definition of ERM for the board of directors.

Sample Answer:

A cross-functional view of risk affecting all levels of the organization

2. There are factors that influence an organization's risk-taking appetite; some factors are internal to the organization, and some are external. Provide two internal factors.

Sample Answers (any two):

- Organizational objectives (profitability, reputation, market share)
- Stage in the organization's life cycle OR startup, growth, maturity, decline
- Financial status (assets, income, and cash flow)
- Frequency and severity of losses
- Predictability of losses
- History/past experience of risk-taking

Glossary of Terms

auditor's opinion letter an external opinion of the fairness and accuracy of the information contained in the financial statements and the conformity to stated accounting standards

accident an unexpected and unintentional event, definite as to time and place, that results in injury or damage to a person or property

accounting a process of recording and classifying business and financial transactions and reporting them on an organization's financial statements

actual cash value the replacement cost less an allowance for depreciation or obsolescence

amortization an accounting technique used to periodically lower the book value of a loan or an intangible asset over a set period of time.

balance sheet a summary of the organization's assets, liabilities, and owner's equity as of a specific point in time

book value the historical cost, less accumulated depreciation

contract law the body of law that governs the performance of a promise. An enforceable contract must have the following four characteristics: competent parties, agreement or assent, legal consideration (exchange of values), and legal purpose.

civil law the body of law that protects the interests of individuals and includes the following sources of legal liability: torts, contracts, and statutes

claim a demand for payment or a company's moral or ethical obligation to pay damages as a result of a loss or occurrence

combination allocation method employs a blend of allocating portions of costs to operating units based on both exposures and loss experience

common law the body of law consisting of prior precedents or rulings by judges and juries in situations involving tort or contract law

common stock a share or shares of ownership in a corporation with rights to vote on management and corporate policy but not preferred over other classes of stock in regard to the payment of dividends or distribution of assets

copyright a form of protection provided to the authors of "original works of authorship" including literary, dramatic, musical, artistic, and certain other intellectual works, both published and unpublished (e.g., music)

cost of goods sold (COGS) the direct costs of producing the goods or products sold by an organization

culture a set of understandings, knowledge, beliefs, values, and habits that characterize a human group (organization) in search of a common purpose

debt ratios a measure of the organization's ability to repay its creditors over the long term and assess the organization's financial leverage

depletion the reduction in inventory and a charge against income to allocate the cost of extracting natural resources

depreciation the reduction in the value of an asset over time

economic perils perils that arise from being in business, such as acts of competitors, recessions, interest rate changes, and the like

economic risk a general class of risk; risks arising from operations, the economy, financial marketplace, or entrepreneurial activities. These include fiscal and liquidity issues, failure of financial institutions, chronic unemployment and failure of infrastructure upon which economies depend.

economic value a future stream of income assigned to the property

emerging risks a new exposure(s) to loss for which a risk treatment has not yet been implemented, or an existing exposure(s) to loss that is evolving, difficult to quantify, and may have a major financial impact on the organization

enterprise risk management (ERM) a cross-functional view of risks affecting all areas of the entire organization; ERM embraces speculative risks

expected losses the projection of the frequency or severity of losses based on loss history, probability distributions, and statistics

experience allocation method distributes the TCOR costs based on loss experience of the individual departments or operating units

exposure a situation, practice, or condition that may lead to an insured's susceptibility to adverse financial consequences or loss

exposure allocation method allocates TCOR costs based on exposure units, such as the number of vehicles or employees in each department

finance a process of managing an organization's assets, liabilities, and cash flow to maximize shareholder (or stakeholder) wealth

financial risk risks related to financial activities (speculative risk)

franchise the right or license granted to an individual or group to have access to a business's proprietary knowledge, processes, and trademarks in order to market a company's good or services in a particular area

frequency the number of losses that occur or that are expected to occur within a given period

functional replacement cost the cost to repair or replace damaged or destroyed property with materials that are functionally the equivalent of the damaged or destroyed property

hazard a factor that increases the likelihood that a loss will occur or the severity of a loss that occurs

hazard risk risks typically covered by insurance (pure risk)

historical cost the original purchase price of property

human perils perils that arise out of human behaviors, whether intentional or accidental, such as fires, trips and falls, criminal acts, or negligence

income statement a report of the organization's financial performance for a stated time period

injunction a requirement to refrain from doing an act, an enforcement of performance, or an obligation stated in contract

juridical risk a general class of risk; risks arising from a jury or judge's decision or from court or jury attitudes

leases and leasehold interests the legal right to use certain property for a limited period of time

legal risk a general class of risk; risks inherent in compliance or arising from common law and statutory liability

license the process of leasing a legally protected (trademarked or copyrighted) entity, such as a name, likeness, logo, trademark, graphic design, slogan, signature, character, etc.

liquidity ratios a measure the organization's ability to pay bills over the short term

long-term debt funds borrowed from external sources payable over time

loss a reduction in the value of assets

market value the amount a willing buyer will give to a willing seller

moral hazards arise out of defects in human character, such as the intent to cause harm by stealing someone's identity or passwords

morale hazards arise out of indifference, such as not locking your car because you know it is insured and there is nothing valuable in it

natural perils perils that arise out of nature, such as wind, lightning, flood, and earthquake

negligence the failure to exercise the degree of care which a reasonably prudent person would exercise under similar circumstances. To prove negligence, the plaintiff must show that a duty existed, that duty was breached, and damages or injury resulted from the breach

notes to the financial statement an explanation of the contents of the financial statements, rules by which the financial statements are drawn, and non-financial information that impacts the numbers

occurrence goes beyond an immediate and observable accident; instead, it is an extended situation leading to damages or injury

operational risk risks related to processes and management activities (speculative)

organizational risk culture a set of understandings, knowledge, beliefs, values, and habits toward risk that characterize a human group (organization) in search of a common purpose

patent used for an invention; the grant of a property rights to the inventor, issued by the US Patent and Trademark Office

performance enforced compliance with contractual promises

peril a cause of loss or any action or event that causes a loss

physical hazards hazards arising from physical conditions that exist naturally or those that are caused by human negligence.

physical risk a general class of risk; risks arising from property, people or information. These include natural disasters, such as earthquakes and hurricanes as well as man-made risks including nuclear accidents and climate change.

political risk a general class of risk; risks arising from changes in the law, re-interpretations or changes in governmental policy, politics and diplomacy, conflict and global governance. These also include war, terrorism, conflicts over resources, and illicit trade.

preferred stock a type of stock issued by a corporation that allows ownership privileges with respect to payment of dividends and distribution of assets greater than those of common stock owners but with no voting rights

profitability ratios calculations that measure returns on investments or expenditures

pure risk a situation or incident in which the only outcome can either be loss or no loss

reformation changing the contract to reflect the true intentions

register mark a symbol (®) that provides notice that the preceding word or symbol is a trademark or service mark that has been registered with a national trademark office

replacement cost the amount to replace a damaged or destroyed piece of property with new property of like kind and quality with no regard for depreciation

retained earnings internal funds retained from net income and not distributed to holders of common stock

risk the possibility of a positive or negative outcome arising from a given set of circumstances

risk appetite the organization's willingness to accept or tolerate risk

risk-taking ability the organization's financial capacity for assuming risk

service mark a legally registered name or designation used in the manner of a trademark to distinguish an organization's services from those of its competitors

severity the dollar amount of a given loss or the aggregate dollar amount of all losses for a given period

social risk a general class of risk; risks arising from public relations, loss of reputation, damage to brand, cultural issues, social direction, or social media. These also include risks related to social stability such as income disparity, food shortages, crumbling inner cities and risks related to public health—pandemics, chronic disease.

speculative risk the possibility of loss or no loss; also presents the chance of a gain

statement of cash flow a summary of the effects of cash on the operating, investing, and financial activities of an organization for a specific period of time

statutes enactments of legislative and administrative bodies that impose responsibility for certain actions or omissions

strategic risks risks related to an organization's strategic plan and its mission

technological risks risks arising from our growing dependence upon and use of technology, as well as those created by emerging technologies—cyberattacks, infrastructure disruption/collapse, and loss of proprietary data

tort a private or civil wrong, other than a breach of contract, for which the courts will allow an action (lawsuit) for damages

total cost of risk (TCOR) the calculation of all measured costs and expenses connected with the risk management function of an organization

trademark an unregistered mark (a symbol, word, or words) used to represent a company or product; a trademark is used to represent goods

trade secret any confidential business information which provides a competitive edge. Trade secrets include manufacturing or industrial secrets and commercial secrets