LESSON 2.4 RISK IDENTIFICATION METHODS

As you know, using the four classifications of loss exposures helps risk managers to think through the exposures, perils, and hazards relevant to different businesses. But to get a much clearer idea, risk managers use a variety of other methods for identifying potential loss exposures.

By the end of today, you will be able to describe and provide examples of ten commonly used risk-identification methods. Before we examine these methodologies, it's important that you understand that risk managers typically use several risk identification methods to develop a full understanding of each type of exposure. One method alone rarely provides the detail that is necessary for proper client protection. It's also important that you understand that there are many other methods that can be used for risk identification other than those that we will cover in this class. So let's take a look at ten commonly used risk identification methods.

If you think of these methods as a toolbox containing ten separate tools, you will realize that each of the items in the toolbox are of equal value. No single method is intrinsically better than another. Each has its place depending on the types of exposures that are of interest to the risk manager. So let's look at each of these methods individually to see when they are used – and why.

Checklists, Surveys, And Questionnaires

These methods can provide a great deal of information regarding exposures, perils, and hazards. For example, the risk manager could use an asset list to quickly identify corporate assets that are at risk. However, there is one big problem with this method. What happens if the list hasn't been updated to include the thirty million dollar manufacturing facility that the company recently purchased in another state? As you can see, it's important for the risk manager to augment information gleaned from checklists with information from other sources. This applies to all of the risk identification methods. Each have their strengths and weaknesses so risk managers always use a combination of risk identification methods to gain a more accurate understanding of the risk management considerations.

Other examples of checklists include activity or situation lists, insurance checklists, and industry lists that delineate common exposures in a specific industry. For example, an oil drilling company will have very different exposures than a hotel chain. However, there are some activities, situations, and insurance coverages that are common to most businesses. Think back to the basic loss exposure classifications. All businesses have exposures in these areas, so generic checklists can be used to provide a broad overview of the exposures faced by most businesses. This picture can then be enhanced by industry-specific checklists, as well as the use of other risk identification methods.

The office inspection checklist on the screen is only one page of a much larger checklist, but you can see that it covers risk management concerns such as ensuring that the floors are dry and clean of debris and the alarms are working properly. As you can also see, this checklist is general enough to be used in almost any office setting. Because checklists, surveys, and questionnaires are standard in nature, non-risk management personnel can use them. However, these types of documents may not identify new exposures or cover all areas of an operation. It is common for checklists to cover things like access to facilities, contracts, consumption of food or alcohol on the premises, handicapped accessibility, first aid policies and procedures, and trash/debris removal.

While checklists are generally used at the company or event level, risk management surveys and questionnaires are often conducted on a large scale to provide industry-specific information to the risk management industry. Several organizations conduct global risk surveys of risk managers and c-suite executives. The survey results are then published to provide the industry with current data that's helpful for identifying new threats. These annual surveys and reports show emerging risks, exposure areas of concern, and general trends in risk management.

For example, as new technologies are implemented, exposures can change significantly. Think of robots replacing humans in certain industries, the acceptance of cryptocurrencies at certain sporting events, or global changes in agricultural exposures related to climate change. The surveys and reports provided by these organizations can be very helpful in ensuring that new exposures are addressed in the risk identification process.

Compliance Review

This risk identification method determines an organization's compliance with regulations and laws, which may be statutory, state, or federal. Compliance reviews also examine adherence to established professional standards, including those imposed by industry and government insurance programs. For example, compliance reviews often examine the enforcement of city codes and state and federal mandates. In most cases, organizations have little or no control over reviews conducted by outside individuals, such as governmental inspectors, whose findings can generate unwanted attention. For that reason, it's much better for the organization to identify all compliance exposures and endeavor to meet the requirements for compliance to avoid negative publicity, fines, and penalties.

Procedures And Policies Review

Reviewing the implementation of current and relevant policies and procedures helps a risk manager to identify exposures throughout an organization. A review can be done internally, by external personnel, or by legal counsel. Examples of items for review include an organization's charter or articles of incorporation, mission statements, organizational charts, legal policies, board minutes and public records of meetings, employee manuals, procedure manuals, and the adequacy of risk management policies, such as those related to safety.

The primary purpose of reviewing an organization's policies and procedures is to identify areas within an organization that may not conform with the guidelines and mandates stated in these documents. It's important to understand that many organizations do not recognize the value of policy and procedure documents as a part of proactive risk management. The value of having documented processes, policies, and procedures cannot be overstated. It's by adhering to these documents that organizations secure protection for daily practices such as hiring, employee safety, cyber security, and everything else that's covered by these operational documents. Having these documents in place also ensures that key risk exposures are monitored and taken into consideration for risk assessment.

Contract Review

Careful review of contracts helps a risk manager determine an organization's obligations as well as the obligations of others to the organization. Reliance on a second party who may not conform to contract provisions might also be identified. Once the obligations are clear, compliance with contractual requirements follows. Examples of contracts include leases, hold harmless or indemnification agreements, purchase orders, sales contracts, bills of lading, warranties, advertising materials, merger and acquisition agreements, joint ventures and alliances, employment contracts, and service contracts.

The risk manager should exercise caution when relying on contractual obligations of another to the organization. If the party agreeing to the contract terms is unable to comply with them, the organization may be exposed to financial risks. For example, imagine that a tenant in a building agrees to purchase property insurance for the leased premises. If a fire breaks out in the area that is leased and the tenant has not complied with this requirement, the landlord is left with a damaged building for which she may not have purchased property insurance based on her reliance on the contract terms.

Insurance Policy Review

Remember the purpose of insurance is to make the client whole after a loss occurs. As the risk manager, you need to identify all operational aspects and ensure that the proper risk financing methods are in place. As insurance is a large part of risk financing, it is crucial that the risk manager examines the insurance that is in place.

Risk managers review insurance policies to identify exposures and perils arising from coverage gaps, insufficient limits, coverage limitations, and exclusions. Let's say that Julie is the new risk manager for the local family diner. She is aware of an exposure related to vats of old grease that are held in a tank on the edge of the property and emptied from time to time. Julie knows that if the vats ruptured or leaked, this could create a significant environmental liability situation, particularly because there is a creek behind the diner. However, during her insurance policy review, Julie discovers that there is very limited coverage to provide funding in the event that this were to occur. By conducting an insurance policy review, Julie was able to identify this coverage gap and procure the necessary insurance to protect the diner.

Financial Statement Analysis

Analysis of financial statements assists risk managers in the identification of exposures and the valuation of assets and possible losses. It also assists in determining an organization's financial capabilities, and with financial-based decision-making in all areas across the operation. The Income Statement, Balance Sheet, and the Statement of Cash Flows are the primary financial statements that are relevant to risk managers.

It's very important for risk managers to have a complete understanding of a company's financial health in order to properly control, finance, and administer risk. In addition to gaining a broad understanding of the company's revenues, profit margins, and cash flows, financial statement analysis will also assist with budgeting, and reveal the company's debt to income ratio. Debt is one of the biggest concerns of any organization, and it is vital for the company to know how to manage outstanding debt. For example, organizations must plan for how debt will be repaid should there be an interruption in income due to the economy, weather, or other business-related practices. Financial statement analysis may also reveal the acquisition of new equipment which will need to be added to the property schedule, or valuations being carried on the company's books that do not accurately reflect actual values.

Loss Data Analysis

It's very important for risk managers to understand a company's historical loss data information. A loss run is a report that shows losses during a specified period of time — usually grouped by year. Losses are reported and segregated by type, which allows risk managers to see if the company's losses are growing in specific areas. In other words, loss data analysis provides a historical examination of exposures and their valuation.

Let's look at an example of loss data analysis. If the loss run indicates that worker's compensation losses have increased significantly over prior years, the risk manager would want to delve deeper into the data to determine reasons for these increases. For example, injury reports could indicate that more workers are being injured on a specific piece of machinery, or there have been more vehicular accidents. The risk manager would then be in a position to make decisions on insurance programs, safety and loss control initiatives, and coverage limits. By analyzing carrier and/or third-party administrator (TPA) loss runs, internal loss runs, and incident and accident reports, risk managers are also able to make projections regarding future losses.

Expert Review

Experts provide professional advice, opinions, and direction for resolving issues associated with a given topic. There are numerous kinds of experts, including human resource consultants, accountants, loss control specialists, brokers, agents, and actuaries. Those with specialized technical skills, like robotics, or who are familiar with the production process can also be valuable to the risk identification process. Another example is human resources experts. Having your employee manual reviewed by a human resource expert helps to identify potential exposures which are not addressed in the manual. For example, a human resources expert may notice that the employee manual does not properly address the use of company vehicles outside of work hours. This could create an enormous exposure for the company that could be fixed by adding a few sentences to the employee manual.

Flowchart

Risk managers build flowcharts to graphically depict sequential steps in a process or elements in a system. The flowchart on your screen is a fairly simple flowchart that outlines an internal process for enrolling in an online class. More detailed flowcharts are useful, for example, in understanding product development processes, decision-making processes, architectural site analysis, and scheduling processes. They are also helpful in identifying bottlenecks and dependencies in a process.

Physical Inspections

Both internal and external inspectors can visit physical facilities to identify exposures to risk. Internal inspectors include risk management personnel, safety specialists, and operating personnel, while external inspectors include insurance carrier personnel, agents and brokers, professional consultants, and regulatory agency representatives. Consider a restaurant. Regular physical inspections may reveal health code and safety issues that could be corrected in order to avoid code violations, accidents, and injuries. Have you seen Kitchen Nightmares with Chef Gordon Ramsey? He always conducts a thorough inspection of the kitchens of the failing restaurants that he helps. Most of the time they have code violations which have not yet been discovered by health inspectors.

Now let's see what you've learned today. Let's see how well you did. For number one, expert review, the answer is C. Expert reviews depend upon contributions from experienced individuals in the identification of exposures. The answer for number two is A. Financial statement analysis is an examination of an organization's financial information to identify and evaluate exposures. Number three is E. The physical inspection is visits to physical sites to identify exposures to risk. Number four, Flowchart Review, is B, reviewing a graphical depiction of a process or system. Number five is G. Contract review is identification of contractual obligations and examination of contractual compliance. Number 6, Compliance Review, is H, determination of an organization's adherence to laws and regulations. The answer to number 7 is D. Checklists, surveys and questionnaires search for as many exposures, perils, and hazards as possible. Number eight is J. Insurance review is identification of exposures and perils arising from insurance coverage gaps, insufficient limits, coverage limitations, and exclusions. Loss data analysis, number nine, is F, a historical examination of exposures and their valuation. Number ten is I. Procedures and policies reviews involve the examination of current policies and procedures for the purpose of identifying exposures.

At this point, you should be able to employ a number of different methods for identifying potential loss exposures. Based on your knowledge of what the methods are, you should be able to identify which method you would use to obtain specific information.