CHAPTER 2

Risk Identification

I. SUGGESTED CLASSROOM TIME: 60–75 MINUTES

II. CHAPTER OVERVIEW

Chapter 2 looks at the first and most critical step in the risk-management process. The key to risk identification is a systematic and continuous process. Firms use many means to identify exposures, and the best-managed firms engage their employees in the activity.

An important issue in exposure identification, and one that ties together pure risk exposures and ERM exposures, is the critical dependency. A critical dependency is an element of an entity's operations that has the capacity to interrupt the entire production process. An example is a manufacturer that has a single source for supply, or only foreign suppliers, of a critical input, perhaps a raw material.

So that an exposure checklist can be prepared, there is general agreement that the categories of exposures are pure risk exposures and ERM exposures. Pure risk exposures are property, liability, and human resources exposures. ERM exposures are hazard risks (essentially, the pure risk exposures), financial risks, operational risks, and strategic risks. Two later chapters will cover risk-handling techniques.

III. LECTURE OUTLINE

A. Introduction
   1. Risk identification is the most important step in the risk management process. (Remember, you can't treat an exposure you haven't identified.)
   2. Risk identification is the key to choosing correct risk-handling procedures.
   3. A key part of the task is to look for "critical dependencies."

B. Useful Methods of Risk Identification (The beginnings of a systematic process)
   1. Distinguish between internal and external exposures
      a. Location
      b. Ability to control
   2. Distinguish between pure and speculative risks

C. Direct and Indirect Losses
   1. Direct—damage, destruction, loss of use, liability claim
   2. Indirect—inability to generate income, operation of law or ordinance

D. Identification of Pure Risks
   1. Property risks
      a. Tangible property
      b. Intangible property, e.g., patents, trademarks

2. Liability risks
    a. Tort liability (covered in a later chapter; distinguished for crimes and breach of contract)
    b. Related to negligence, which has required elements
    c. Types of damages
        i. Compensatory (special [economic], general [noneconomic])
        ii. Punitive
    d. Defenses in negligence suits
        i. Contributory, or comparative, negligence
        ii. Assumption of risk
3. Human resources risks
    a. Key employee
    b. Workers' compensation
    c. Employee benefits programs

E. Enterprise Risk Management Risks
1. Hazard risks (essentially pure risks)
2. Financial risks, e.g., inflation, currency exchange
3. Operational risks, e.g., supply chains, distribution chains
4. Strategic risks, e.g., product development

IV. ANSWERS TO REVIEW QUESTIONS

1. **Explain how risk identification has changed in recent years, as well as the reasons for the change.** Risk identification has become broader and more systematic as a result of the shift from traditional corporate risk management to enterprise risk management, the search for critical dependencies, and the greater oversight by corporate boards of directors.

2. **Provide an example of an internal and external risk for a large automaker.** An internal risk for the automaker is possible damage to, or destruction of, their production facilities. An external risk is possible problems with their various parts suppliers. The Japanese tsunami of 2011 caused production delays at the U.S. plants of Japanese automakers because parts could not be shipped from Japan.

3. **Consider the losses resulting from a large fire loss to a commercial building. Provide two examples of direct losses commonly associated with a fire, as well as two examples of indirect losses.** Two direct losses related to the fire are damage to the structure and damage to the contents. Two indirect losses are the business interruption that results and the law or ordinance exposure, i.e., the possibility that in reconstruction, the building would have to be brought up to the current building code.

4. **List and briefly describe the three broad categories of hazard risks.** 1) Property risks—damage to, destruction of, or loss of use of property; 2) liability risks—damages assessed as a result of negligence; 3) human resources risks—exposures related to worker health and safety and employee benefits.

5. **Define and provide two examples of tangible and intangible property**. Tangible property includes all things with a physical presence, such as buildings and personal property. Intangible property does not have a physical presence. Examples include trademarks and patents, and in an ERM context, supply chains.

6. **Provide two examples of situations in which risk managers are concerned about damage to the property of others.** A firm might be a bailee, holding the property of others in the course of their business, e.g., a storage warehouse, or the firm might lease property, such as computers and copiers, and be required by contract to insure that property.

7. **What differentiates torts from liability for criminal acts and breach of contracts?** These are separate branches of law. Torts are civil breaches of law and relate to the concept of negligence. Crimes are defined by statutes, and breaches of contract occur only in the presence of a contract. A confounding factor is that an act, such as assault, can be both a tort and a crime.

8. **List and briefly describe the four requirements that a plaintiff must prove when suing a defendant in a negligence case.**
   1) The plaintiff must show that there is a relationship with the defendant where the defendant owed a duty to the plaintiff.
   2) The plaintiff must show that there was breach of that duty.
   3) The plaintiff must show that damages resulted from the breach of duty.
   4) The plaintiff must show that they are free from fault. (In comparative negligence states there is a consideration of "degrees of fault.")

9. **Describe the difference between compensatory and punitive damages.** Compensatory damages are meant to compensate in injured party for such things as medical costs, lost wages, property damage, and pain and suffering. Punitive damages are meant to punish, or make an example of, wrongdoers.

10. **Describe two common-law defenses that are available to a defendant in a negligence lawsuit.** The "assumption of risk" defense states that the injured plaintiff was aware of risky conditions and willingly assumed them when pursuing an activity. The "contributory negligence" defense states that a plaintiff who in any ways contributes to her injuries cannot recover.

11. **Describe the difference between contributory and comparative negligence.** Contributory negligence, under common law, is a "perfect" defense, i.e., if the injured plaintiff is in any way at fault, then they cannot receive damages. Comparative negligence brings a much less harsh result, in essence setting up a system of

percentage offsets that benefit the defendant but do not deny all recovery to the plaintiff.

12. **List and briefly describe the three broad categories of human resource risk found in most firms.**
    1) The key employee risk—the possibility that an employee is so valuable to the firm that his or her loss, to death or disability, would impact the firm negatively
    2) The workers' compensation risk—the worker health and safety concerns related to state workers' compensation laws
    3) The employee benefits risks—the exposures to death and disability that firms cover through group insurance for their employees.
13. **Define and briefly describe the differences between the four categories of risk found in an ERM program**.
    1) Hazard risks—the classic pure risks, i.e., property, liability, and human resources risks
    2) Financial risks—those exposures that relate to the financial system and economic conditions, e.g., currency exchange risk
    3) Operational risk—those exposures that relate to a firm's operations, e.g., supply chain risk
    4) Strategic risks—those risks that relate to a firm's strategy, e.g., product recalls and reputation risk
14. **What is price risk? In your answer, describe the difference between input costs and output costs.** Price risk involves changes in the costs of inputs or the price at which a firm can sell its products. Input costs are the costs of raw materials and other production inputs. Output costs are the prices at which a firm can sell its goods or services.
15. **Explain why failures of accounting systems can be considered a financial risk or an operational risk in two different organizations.** A failure of accounting systems might be considered a financial risk in a situation where a firm failed to account carefully for its input costs, leading to faulty pricing decisions. A failure of accounting systems might be considered an operational exposure when failure to detect business crime, e.g., embezzlement, hampered the firm's operations.

V. ANSWERS TO OBJECTIVE QUESTIONS

1. An earthquake is an example of
   a. an internal pure risk.
   b. an internal speculative risk.
   c. an external pure risk.
   d. an external speculative risk.

2. Which of the following is not an example of a direct loss resulting from a fire at Bubba's Bar-BQ, a Southern-style restaurant?
   a. $6,000 of smoke damage to the furniture and furnishings in the restaurant
   b. $18,000 in fire damage to the kitchen of the restaurant
   c. $30,000 in lost revenues resulting from a 45-day closure of the restaurant
   d. $3,000 in damaged electrical wiring caused by water used to fight the fire
   e. All of the above are direct losses from the fire.

3. Which of the following statements about intangible property is correct?
   I. Examples of intangible property include a firm's brand value and its reputation.
   II. Because it pertains to the ability of the firm to compete against its rivals, the duty to protect intangible property belongs to the corporate CEO, not the risk manager.
   a. I only
   b. II only
   c. Both I and II
   d. Neither I nor II

4. Bobby slips on an icy sidewalk when entering Skip's sporting goods store.
   Legal action is an example of which of the following?
   a. A criminal act
   b. A breach of contract
   c. A tort
   d. None of the above

5. Which of the following is not a requirement that the plaintiff must prove to the courts in a negligence case against a defendant?
   a. The defendant owed the plaintiff a legal duty.
   b. The plaintiff suffered some sort of property damage or bodily injury.
   c. The defendant failed to satisfy a legal duty that he owed to the plaintiff.
   d. The defendant committed a crime in the way that he interacted with the plaintiff.

6. If Amy wins a lawsuit from Tess for injuries suffered in an auto accident, this is an example of
   a. special damages.
   b. general damages.
   c. punitive damages.
   d. property damages.

7. Which of the following is not an example of a corporation's human resource risk?
   a. A large company's concerns about finding a person to replace its sick CEO
   b. The cost of providing workers' compensation benefits to an employer's work force
   c. Paying the medical costs incurred by customers injured by the corporation's products
   d. The cost of providing employee benefits to workers of a corporation

8. Scary Airlines, a large commercial airline, suffers a huge loss of profitability due to a 30 percent increase in the cost of jet fuel. The risk that caused this loss is an example of which of the following?
   a. A hazard risk
   b. A financial risk
   c. A strategic risk
   d. An operational risk

9. Gamer Industries suffers a 22 percent decline in quarterly revenues after a longshoreman's strike prevents the firm from shipping its new video game product to its international markets. The risk that caused this loss is an example of which of the following?
   a. A hazard risk
   b. A financial risk
   c. A strategic risk
   d. An operational risk

10. Sleeper Film Company estimates that it loses about 2 percent of its annual sales revenue as a result of counterfeiters selling bootleg copies of the movies that Sleeper produces. The risk that caused this loss is an example of which of the following?
   a. A hazard risk
   b. A financial risk
   c. A strategic risk
   d. An operational risk

VI. IDEAS FOR INSTRUCTORS AND TEACHING METHODS

1. Get articles about lawsuits from your local newspaper. Discuss with your class whether the suits contained all of the required elements of establishing negligence.

2. There have been instances when a criminal case and a civil case have been filed related to the same incident and have been resolved differently. (It is unlikely that your students will remember the O.J. Simpson case.) Discuss this proposition, perhaps dividing the class for argument: If a person is acquitted in a criminal case but found negligent in a civil case involving the same incident, is that reasonable?

3. Discuss with your class their notions about how human beings normally identify loss exposures in their own lives. Are there any who confess to "muddling through," i.e., having to suffer a few losses in order to be aware of potential exposures? (Perhaps you will consider the proposition "That which does not kill you makes you stronger—or smarter.")