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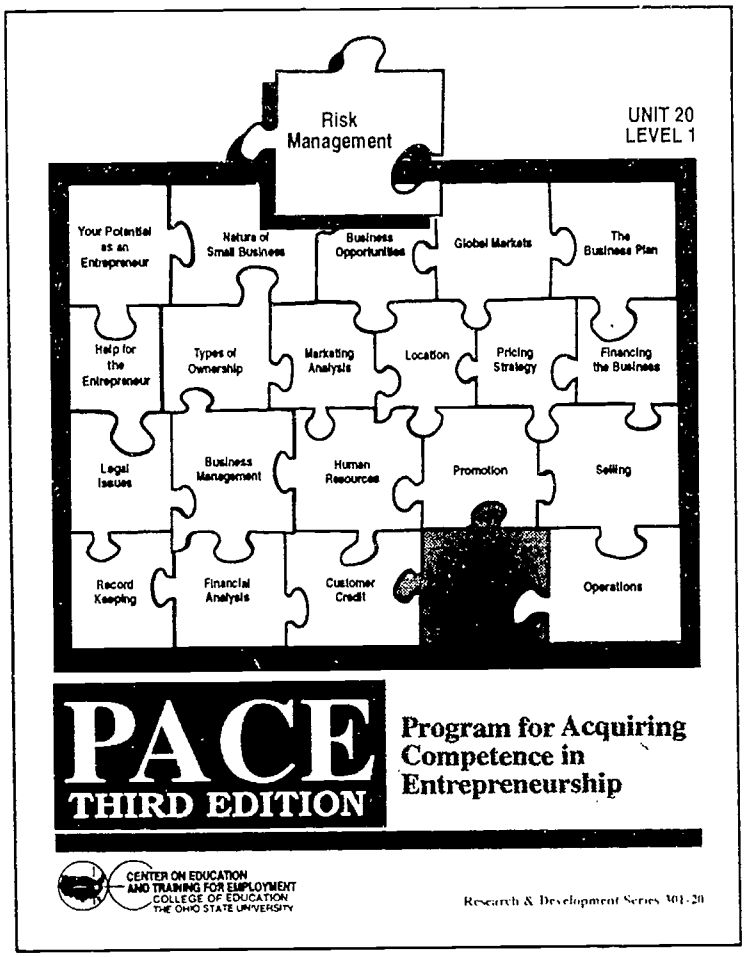
ABSTRACT

This instructor guide for a unit on risk management in the PACE (Program for Acquiring Competence in Entrepreneurship) curriculum includes the full text of the student module and lesson plans, instructional suggestions, and other teacher resources. The competencies that are incorporated into this module are at Level 1 of learning--understanding the creation and operation of a business. Included in the instructor's guide are the following: unit objectives, guidelines for using PACE, lists of teaching suggestions for each unit objective/subobjective, model assessment responses, and overview of the three levels of the PACE program. The student module includes the following: specific objectives, questions supporting the objectives, complete content in the form of answers to the questions, case studies, individual activities, group activities, discussion questions, assessment questions, and list of 10 references. Model assessment responses are provided in the instructor materials. These three objectives are addressed: discuss the importance of planning to minimize risk; define areas of risk for the entrepreneur; and explain preventive measures that can be taken by entrepreneurs. (YLB)



INSTRUCTOR GUIDE

Unit 20

Risk Management

Level 1

Objectives:

- Discuss the importance of planning to minimize risk.
- Define areas of risk for the entrepreneur.
- Explain preventive measures that can be taken by entrepreneurs.

HOW TO USE PACE

- Use the objectives as a pretest. If a student is able to meet the objectives, ask him or her to read and respond to the assessment questions in the back of the module.
- Duplicate the glossary from the *Resource Guide* to use as a handout.
- Use the teaching outlines provided in the *Instructor Guide* fo ssistance in focusing your teaching de ery. The left side of each outline page lists objectives with the corresponding headings (margin questions) from the unit. Space is provided for you to add your own suggestions. Try to increase student involvement in as many ways as possible to foster an interactive learning process.
- When your students are ready to do the *Activities*, assist them in selecting those that you feel would be the most beneficial to their growth in entrepreneurship.
- Assess your students on the unit content when they indicate they are ready. You may choose written or verbal assessments according to the situation. Model responses are provided for each module of each unit. While these are suggested responses, others may be equally valid.

Objectives	Teaching Suggestions
1. DISCUSS THE IMPORTANCE OF PLANNING TO MINIMIZE RISK	
What is risk?	Explain the concept of risk as it relates to the small business owner. Ask the class for help in creating a list of examples that are not included in the text. Also discuss the importance of contingency or alternative planning when dealing with risk.
2. DEFINE AREAS OF RISK FOR THE ENTREPRENEUR	
What kinds of risks do entrepreneurs face?	Create a chart on the chalkboard or overhead and ask the class to offer examples of each primary type of risk faced by a small business.
3. EXPLAIN PREVENTIVE MEASURES THAT CAN BE TAKEN BY ENTREPRENEURS	
Can risks be avoided?	Introduce the concept of insurance and other preventative measures to minimize potential business losses.
What is the role of management in controlling risks?	Discuss the misconception of the entrepreneur as a high stakes gambler. Introduce the concept of assuming risk. Give examples and discuss the role of management in decision-making as it relates to risk-reduction.
What methods do entrepreneurs use to control risk?	Discuss in detail the different methods used by entrepreneurs to control risk. A local business person could be invited to speak to the class about how their particular business attempts to control risk.
How can insurance be used to control risk?	Invite one or more local insurance agents to speak to the class about the different types of insurance coverage that is offered to small business. Although it would be valuable to get more than one perspective about the importance and types of insurance for small business, it would probably be more appropriate to schedule the visits separately.

MODEL ASSESSMENT ANSWERS

1. Risk is the possibility of damage, injury, or loss. All of these risks (and more) are faced by the entrepreneur running a small business.

2. Speculative risks are created by business decisions (such as investing in the stock market) that may yield either a loss or a gain. For instance, by deciding to act invest resources with the hope of realizing a profit, the entrepreneur is speculating that a certain business conditions will exist that will allow him or her to realize a profit from the risk. Generally the higher the risk, the higher the reward.

   Pure risks are usually beyond the control of the business owner. These are risks that are automatically assumed when the decision is made to open a business. These risks include; death or injury of an employee or customer, fire, flood, hurricane.

3. Four methods used buy entrepreneurs to cope with risk are: (1) eliminating risk (risk avoidance), (2) minimizing risk (risk reduction), (3) shifting the risk (risk transfer) and, (4) absorbing the risk (risk assumption).

4. Insurance companies enter into contracts with businesses (or individuals) agreeing to pay the business for specific losses they may incur. For this protection the insured agrees to make regular payments (premiums) to the insurance company. The insurance company in turn keeps much of the money in a fund to pay for losses suffered by their clients.

5. Most pure risks are insurable, while most speculative risks are uninsurable.

6. Because of the lack of large cash reserves the concept of self-insurance is not a feasible option for most small businesses.

7. When a business purchases insurance they simply transfer the risk from a single individual or business to many individuals or businesses. Insurance is the most popular form of risk transfer.

8. The criteria for insurable risks are: (1) The risk must be a pure risk, not a fundamental risk of doing business or a speculative risk. (2) Potential loss must be measurable. (3) The likelihood of a business suffering an immediate loss must be slight. (4) There must be many businesses that are subjected to the same risk, and also willing to pay for protection against these risks. All risks that are not covered by the above criteria are generally considered uninsurable.

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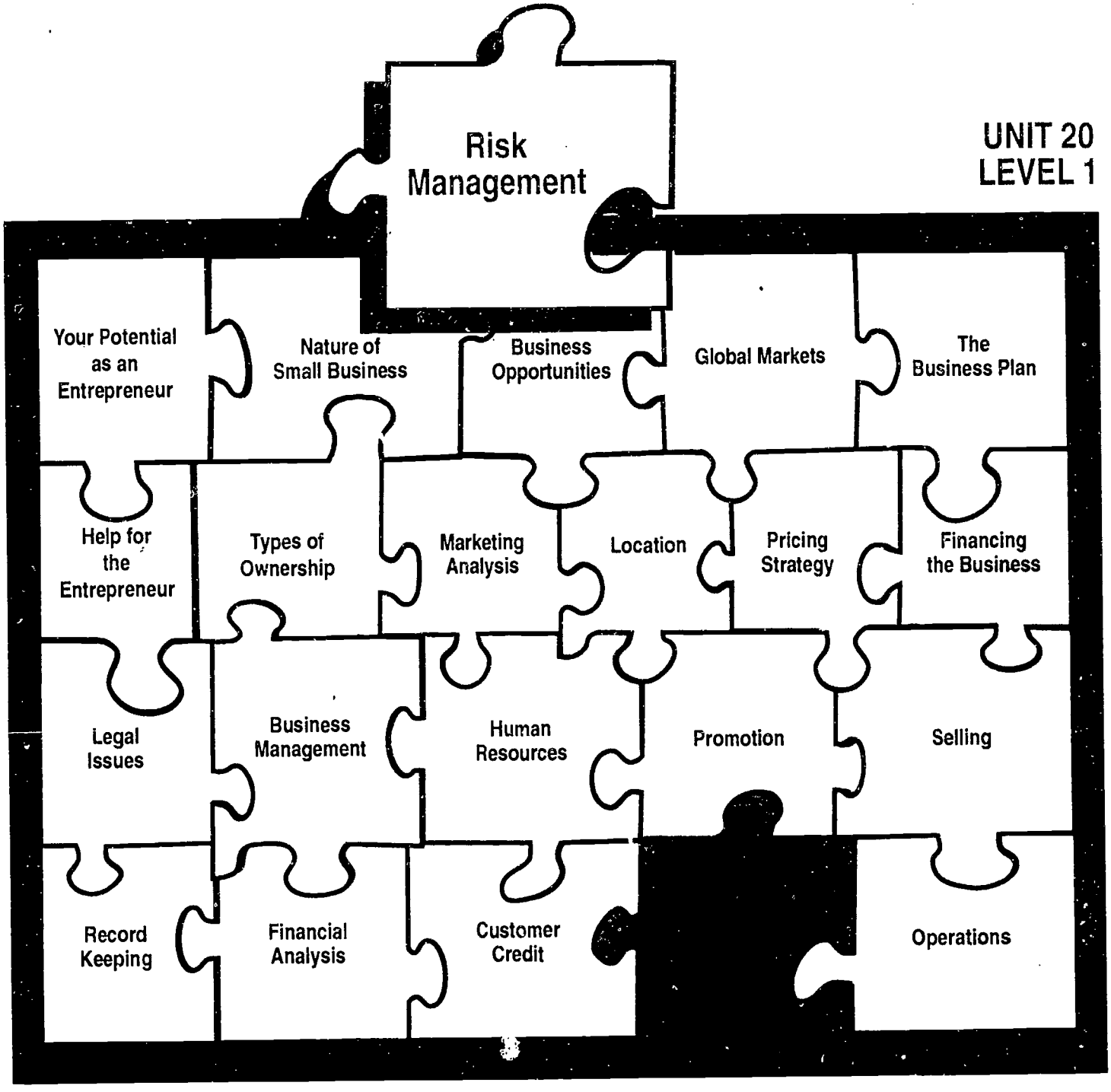


UNIT 20
LEVEL 1

PACE
THIRD EDITION

Program for Acquiring Competence in Entrepreneurship

CENTER ON EDUCATION AND TRAINING FOR EMPLOYMENT
COLLEGE OF EDUCATION
THE OHIO STATE UNIVERSITY

Research & Development Series 301-20

RISK MANAGEMENT

BEFORE YOUR BEGIN . . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read What are the Objectives for this Unit on the following page. If you think you can meet these objectives now, consult your instructor.

3. Look for these business terms as you read this unit. If you need help with meanings, ask your instructor for a copy of the PACE Glossary contained in the *Resource Guide.*

Contingency plans	Risk avoidance
Insurable risk	Risk reduction
Insurance	Risk transfer
Premium	Self insurance
Pure risk	Speculative risk
Risk	Uninsurable risk
Risk assumption	

RISK MANAGEMENT

WHAT ARE THE OBJECTIVES FOR THIS UNIT?

Upon completion of this unit you will be able to—

- discuss the importance of planning to minimize risk,
- define areas of risk for the entrepreneur, and
- explain preventive measures that can be taken by entrepreneurs.

WHAT IS THE UNIT ABOUT?

One of the most important tasks that potential entrepreneurs must undertake is identifying and understanding the risks they face. Strategies to protect the business against the many problems or events that might slow its growth or cause it to fail should be a part of every entrepreneur's planning. Some entrepreneurs lose large amounts of money every year simply because they do not know how to protect their businesses. Without adequate risk protection, a major accident or natural catastrophe could wipe out a business or leave it seriously in debt.

The purpose of this unit is to identify the risks faced by small businesses and describe how to make plans to reduce or control those risks. Preventive measures that can be taken by entrepreneurs to control risk will also be identified.

WHAT IS A RISK?

You face risks every day. You cannot cross the street without some danger that you will be hit by a car. Getting out of bed, driving a car, walking to a friend's home, eating in a restaurant, and opening a business all involve an element of risk. *Risk* is simply the possibility of damage, injury, or loss. As much as possible, we all try to protect ourselves against losses from the risks we face. For example, we install alarms to protect our homes against burglars. We also purchase insurance to cover our home and possessions in case they are burned in a fire. Like individuals, business owners need to protect themselves against the risks they face.

Every business faces risk daily. However, most risks are relatively more important for small businesses because they are less able to absorb losses. Because of the risk of loss,

procedures and practices must be established to control risk as much as possible.

Every new business venture will face risks. It is important for entrepreneurs to recognize the potential risks they face and prepare effective strategies to deal with them. It is also useful for entrepreneurs to design *contingency plans*, or alternative courses of action. Contingency plans show potential investors that the entrepreneur is sensitive to important risks and is prepared to handle risks as they occur.

WHAT KINDS OF RISKS DO ENTREPRENEURS FACE?

Entrepreneurs risk losing some or all of the money they have invested to start and operate their business. Some of the risks that almost all businesses face involve competition, price changes, style changes, competition from new products, and changes that arise from fluctuating economic conditions.

Businesses also face risks beyond these market and economic shifts. For example, a merchandise shipment of tennis shoes may be destroyed in transit. A warehouse may burn down and large amounts of expensive inventory may be lost A delivery truck may strike a pedestrian, resulting in a lawsuit against the company. The firm's president may die unexpectedly, dramatically affecting the management of the company. Events like these threaten the security of a business. They cost money, and they may cause a business to fail. First, entrepreneurs must be able to identify all the possible risks they face. Then, entrepreneurs should decide

upon preventive measures to eliminate or lessen the impact of the risk results that may occur.

As an entrepreneur, there are two primary types of risk that you will face: *speculative risk* and *pure risk*.

Speculative risk is uncertainty as to whether an activity will result in a gain or a loss. Risks, such as building a plant that turns out to have the wrong capacity or keeping an inventory level that turns out to be too high or too low, are speculative risks.

Speculative risk is unavoidable and is inherent in the nature of the private enterprise system. Entrepreneurs must plan carefully how they will deal with speculative risk. They must manage activities such as product development, quality control, pricing, and distribution to produce a sound and profitable business. They must also juggle constantly changing market and economic factors such as changes in what buyers want, interest rates, and competitive activities. No matter how carefully managed, businesses are not immune to speculative risk.

On the other hand, *pure risk* is uncertainty as to whether some unpredictable event that can result in loss will occur. Pure risk can result only in loss, never in gain. This kind of risk consists of hazards such as a fire or a hurricane, death of key employees, or customer injuries on the premises of the business.

Pure risk exists when the possibility of loss is present, but the extent of the possible loss is unknown. For example, the consequences of a hurricane or the death of a key employee cannot be predicted with any degree of certainty. Pure risk is different from speculative risk because speculative risk carries the possibility of gain as well as loss.

CAN RISKS BE AVOIDED?

When you start a business, you automatically assume risk; you intend to make money, but you also know that you can lose money. Not starting a business at all is the only sure way to avoid the risk. Successful entrepreneurs, however, take control over how much risk they are willing to accept and then develop plans to control the remaining risks.

Businesses face many kinds of risks, and you should realize that there is no way to avoid all of them. Sound business management procedures can minimize the losses your business may suffer from some risks, but no amount of caution and planning can eliminate risk entirely.

As an entrepreneur, you must be able to identify the risks that your business faces and take appropriate preventive measures to minimize losses. In addition, you should be aware of which losses you can protect yourself from by purchasing the appropriate business insurance. Otherwise, a lifetime of work and dreams can be lost in a few minutes.

WHAT IS THE ROLE OF MANAGEMENT IN CONTROLLING RISKS?

Risk-taking is a part of starting and operating a business. Entrepreneurs do not necessarily seek out risks; they *assume* risks.

They realize that starting a business venture entails a certain amount of risk. Some of these risks cannot be reduced significantly, but effective management decisions can be taken to offset many of them.

One of the traits that make up the entrepreneurial personality is the tendency to take risks. Some entrepreneurs may even be described as lovers of risk—gamblers who play for high stakes. However, research suggests that entrepreneurs are generally not gamblers. Successful entrepreneurs tend to be only moderate or calculated risk-takers. They do not necessarily seek out high risk ventures, but they are willing to assume a moderate amount of risk that is normal to launch and operate a new business.

Risk should not paralyze the zeal and enthusiasm of new entrepreneurs. They must be willing to take moderate risks when they believe there is a strong likelihood that they will succeed. For the entrepreneur, the brighter side of risk-taking is the possibility of success and increasing their wealth. Most dreams cannot come true unless some risks are taken.

Effective management is clearly the best way to reduce the impact of many risks, particularly speculative risks. Careful control of financing, product development activities, production, marketing, distribution, and other management concerns help ensure that the results of most speculative risks will be profits rather than result in loss or failure of the business. For example, good credit management will reduce losses from bad debts and delayed payments. Good human relations management can reduce losses from strikes or other labor problems. Many entrepreneurs control risk by keeping fixed assets to a minimum or by renting facilities rather than using personal funds to purchase land and buildings. Another way that some entrepreneurs control risk is by building a management team whose members have different but compatible skills.

You can also reduce risk through careful planning and decision-making with activities such as the following:

1. **Analyzing current and future economic and market conditions.** Information, such as unemployment rates, availability of money, and competition, must be analyzed in terms of their possible effects on a business. All businesses face certain risks due to changes in the marketplace or the economy. For example, consumers' wants and needs change. Pet rocks and hoola hoops were once "hot sellers." Firms that manufactured them were quite successful. However, with time, consumers began purchasing other new products which were arriving on the market. For example, in the apparel industry, changes in consumer demand is a risk that entrepreneurs face constantly.

   Prices may go up or down. Good managers will be aware of price trends. Carefully studying budgets and accounting records will also warn the owner against any adverse trends that are developing.

2. **Considering the consequences of alternative actions.** Entrepreneurs usually have more than one choice available to them. The consequences of each alternative should be analyzed and the one that promises the greatest return at the lowest risk selected. For example, any business can reduce the risk of loss due to accept-

ing "bad checks" by not accepting them at all. Nevertheless, business managers should also recognize that such a policy creates another risk—sales could decline.

3. **Making reasonable decisions in response to conditions as they develop and change.** Advance planning is valuable, but the entrepreneur must be flexible enough to make changes in their plans as unforeseen situations develop. The risk protection plan originally included in the business plan may need to be changed once the business opens.

Activities like these do not eliminate risk, but they aid in managing the risks that are inherent in any business venture.

WHAT METHODS DO ENTREPRENEURS USE TO CONTROL RISK?

Once entrepreneurs have identified the risks they face, they must decide what to do about them. Some risks are easier to control than others and the actions of the owner will vary with the circumstances faced by individual firms. Most owners control risk by—

1. eliminating the risk (risk avoidance),
2. minimizing the risk (risk reduction),
3. shifting the risk (risk transfer), and
4. absorbing the risk (risk assumption).

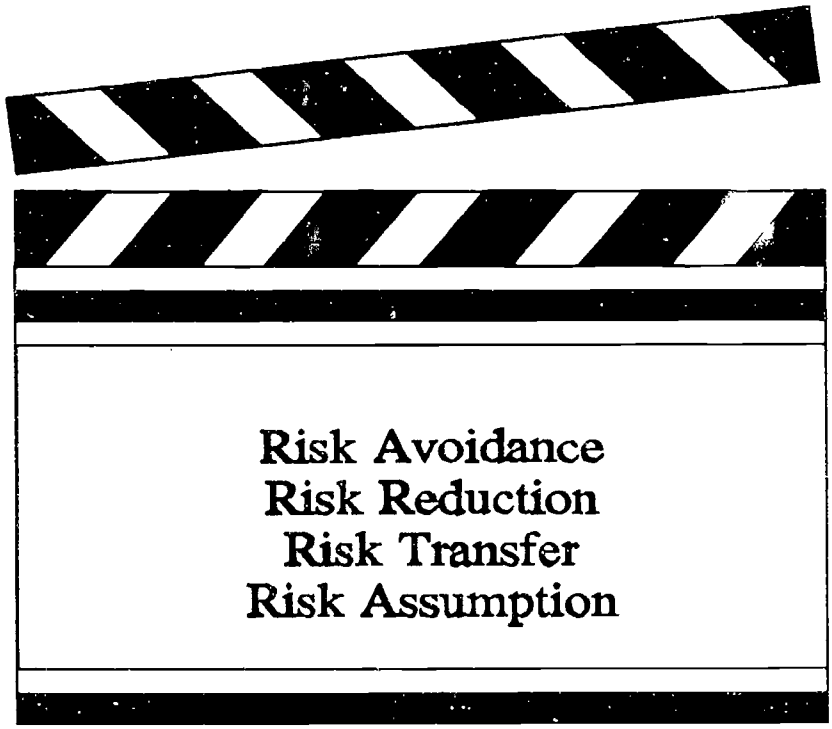
Risk avoidance is abandoning or refusing to undertake an activity in which the risk seems too costly. For instance, many small retail stores may have a policy against accepting customer checks because of the danger of receiving bad checks. Such a policy, however, may also present a risk to the business. Sales may be reduced because many customers would rather shop at a store that offers the convenience of paying by check. Avoiding one risk may, in fact, create other risks for the business. Each decision must be examined carefully to determine its impact on other aspects of the business.

Risk reduction consists of using various methods to reduce the probability that a given event will occur. Although some risks cannot be avoided, most can be appreciably reduced. The primary control technique is prevention, including the use of safety and protective techniques. For example, you might try to control losses by providing first-aid rooms at a business, providing special driver training for delivery persons, posting safety rules near equipment, or installing shoplifting prevention devices.

In other areas, the small business owner can reduce the frequency of loss in shop operations by training personnel in the safe use of machine tools. Properly installed belt guards will act to reduce the chance that an employee may be injured. Van or truck deliveries could be made safer by periodic inspection and maintenance of brakes. Entrepreneurs may reduce the risk of credit losses by carefully checking customers' credit ratings.

Other means to reduce risks and thereby control losses include the following:

- Installing fire control sprinkler systems
- Requiring all drivers in company vehicles to wear seat belts



- Allowing no more than one key company executive to travel on a single aircraft
- Training employees to detect and report shoplifting
- Teaching employees to detect counterfeit currency

Risk transfer means shifting the consequences of a risk to persons or organizations outside your business. The best known form of risk transfer is *insurance*, which is the process by which an insurance company agrees to pay an individual or organization an agreed upon sum of money for a prospective future loss. Because of the importance of insurance in controlling risks, this topic will be explored in more detail later in this unit.

Risk assumption, also known as risk absorption or risk retention, involves the planned acceptance of the risk of loss. In some instances, reducing certain risks may be too expensive. Generally, the small business owner will assume risks in which losses that occur will not produce significant financial consequences to the business. Determining the amount of loss that is significant is not a precise science. However, as a general rule, a business should absorb those losses that do not exceed one tenth of 1 percent of annual revenues for any single loss, and 1 percent of revenues for all such losses in a year.

A contractor owning a few trucks that have blue book values of just a $1,000 each might well decide that insuring the vehicles against collision damage is too expensive. The contractor feels that the business has the capacity to absorb such a loss if it occurs. On the

other hand, the risk of the trucks causing property damage or injury to other people could represent an exposure to loss of $500 000 or more. Liability losses of this size usually require insurance.

In some cases, risk assumption takes the form of *self-insurance*, whereby a business sets aside a certain amount of its own funds to meet losses. This method is usually impractical for many small firms because they do not have the large cash reserves needed to make this plan feasible.

Generally, most entrepreneurs use a combination of these methods when controlling and managing the risks that they face.

HOW CAN INSURANCE BE USED TO CONTROL RISK?

As discussed earlier, one of the primary ways that entrepreneurs can control losses from risk is to purchase insurance. Nevertheless, you should realize that insurance does not eliminate risk. Insurance simply *transfers* the cost of covering the loss from one person or business to a group of individuals or businesses.

Some risks are insurable; others are not. Most pure risks are *insurable risks*. The possibility exists of losing the results of many years of hard work due to fire, theft, or accident. These types of risks can be covered by insurance; however, most speculative risks are *uninsurable risks*. For example, there are business risks associated with the development of new products, changes in customers' preferences, or price fluctuations. None of these risks are insurable. The greatest risk facing any small business—the possibility that it will not be profitable—is also an uninsurable risk.

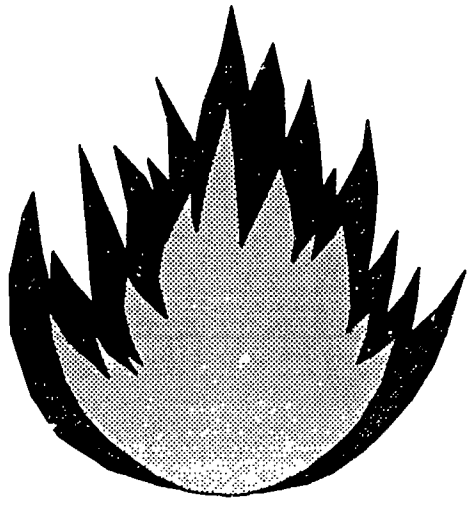
Nearly every business relies on insurance to protect itself against pure risk. Despite good management, risk reduction efforts, and the ability to accept some losses, there will always be risks that threaten a company for which insurance is usually the best answer.

Insurance can be purchased as protection against almost all pure risks. Insurance companies make contracts with businesses agreeing to pay the business for losses. The insured business makes regular payments, called *premiums*, into a pool maintained by the insurance company. The insurance company can afford to pay for losses suffered by their clients because many firms pay into the pool, but relatively few of them have to be paid for losses at any one time.

By buying insurance, a business joins many other companies to create a pool of money to pay for losses. Thus, one business's loss is spread among a great number of firms. It is hoped that the business will never have a loss. However, should a loss occur, the business insurance would help to cover it. In addition to preventing financial loss, insurance helps reduce worry, frees money for investment, and helps the firm gain credit (other businesses may not deal with an uninsured firm).

To be insurable, risks must meet the following criteria:

1. The risk must be a pure risk. It must be an accidental hazard and not a fundamental risk of doing business, such as shifting consumer demand.



2. The extent of the potential loss from risk must be measurable.

3. The likelihood of any individual business suffering an immediate loss from a given risk must be slight.

4. There must be a large number of firms subject to the risk. Many firms must contribute to the pool to provide enough money to pay for losses.

Accidental destruction of business property by fire is a good example of an insurable risk. The value of the property can be determined accurately, and an individual business is not likely to be destroyed by fire if precautions are observed. There is, however, enough risk to all businesses that large numbers of them are willing to pay premiums for protection.

Remember, purchasing insurance is just one part of a complete protection program for your business. Sound business management practices complement such insurance coverage. Preparing to handle risks should begin with identifying the types of risk the business is likely to encounter. All businesses face risks that result from natural causes such as fires, floods, earthquakes, electrical storms, hurricanes, tornadoes, volcano eruptions or other natural phenomena. They also face risks due to changing market and economic conditions.

Risks increase the costs of owning and operating a business. Because increased costs reduce profits, entrepreneurs are always looking for ways to reduce risk. Entrepreneurs must be able to reduce and control as many risks as possible if they are to succeed in today's marketplace. Effective planning for risk management is essential.

ACTIVITIES

The following activities are designed to help you apply what you have learned in this unit.

INDIVIDUAL ACTIVITIES

A.

In our daily lives, each of us faces risks. Entrepreneurs should be able to identify all the risks they or their potential businesses face. On a sheet of paper, print these headings: "Risks I Face" and "Ways to Avoid or Reduce Risk."

In the left column, list the risks that you might face during a typical week. Include the time you spend at school, at home, at work, and in leisure activities. In the right column, list how you might be able to prevent losses from the risks or reduce the seriousness of the risks. Determine if insurance should be purchased to cover any of the risks.

B.

Entrepreneurs must decide how to deal with the risks they face. Typically, they cope with risk using risk absorption, risk reduction, risk transfer, or risk avoidance. Following is a list of typical risks that a retail store might face. Identify which of the four methods listed above would be used to most effectively deal with each risk.

1. Risk of employee tripping over boxes in storeroom
2. Risk of hurricane striking the coast where your business is located
3. Risk of accepting a "bad check"
4. Risk of new competitor, who has lower prices, opening in the same shopping center where you are located
5. Risk of electrical equipment malfunction causing a fire
6. Risk of failure of telephone system on which you rely for customer orders.

GROUP ACTIVITY

Work in teams of four to six. Each team selects a business such as a record store, video rental store, electronics store, etc.

1. Group members identify at least 10 risks faced by that business.
2. Next, group members decide how to best cope with the risks, for example, risk avoidance, risk transfer, risk absorption, or risk reduction.

CASE STUDY

Jill Kearns was in her first year of college, and was running low on money. She needed to make at least $500 to cover her expenses. She considered getting a full-time job, but realized that she did not have enough time to do her studies and keep the job. Her solution was to start a small business venture with the members of a jazz band to which she belonged. They would hold jazz concerts and sell tickets to Jill's performances.

Jill's idea for this venture came from her own and a friend's interest in jazz. As the popularity of jazz has grown, she would have seen the potential for a business venture expanding. The idea of using her interest in music to earn the money was very appealing.

Currently, the group members have $500 in the bank. In order to give a concert, Jill anticipated that they would have the following start-up expenses: an advertising cost of printing posters, rent on a concert hall, cost of printing tickets, and incidental expenses for transportation, telephone calls, etc.

By deferring as many payments as possible and obtaining credit, she found that they needed $465 to hold their first concert. Jill figured their total expenses would be about $2000. By giving two shows and multiplying the ticket price by the legal capacity of the hall, she calculated that the maximum gross receipts would be $2900. The business venture would earn a profit of $900!

DISCUSSION QUESTIONS

1. What risks are involved in this business venture?

2. How could these risks be reduced or eliminated?

3. Would you recommend the continuation of this business idea? Explain.

ASSESSMENT

Read the following questions to check your knowledge of the topics presented in this unit. When you feel prepared, ask your instructor to assess your competency on them.

1. What is risk?

2. Identify the differences between pure risks and speculative risks. Give examples of each.

3. Name four methods used by entrepreneurs to cope with risk.

4. Describe how insurance functions.

5. What is the difference between insurable and noninsurable risks?

6. Why may self-insurance be inappropriate for most small businesses?

7 Describe how businesses transfer risk through the purchase of insurance.

8. What criteria must be met for a risk to be insurable?

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PACE

Units on the above entrepreneurship topics are available at the following levels:

* Level 1 helps you understand the creation and operation of a business
* Level 2 prepares you to plan for a business in your future
* Level 3 guides you in starting and managing your own business