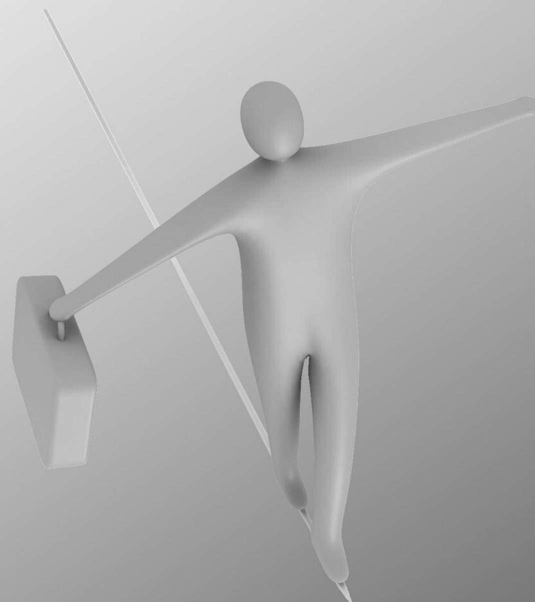
FREEDOM FROM WORRY



Are You Putting Your Business at Risk?

McGrath
Insurance Group, Inc.
FREEDOM FROM WORRY

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www.mcgrathinsurance.com

800.342.3859

Sturbridge • North Brookfield, Massachusetts

Are You Putting Your Business At Risk?

Risk is inherent in all businesses. Every day, businesses risk losing customers or having customers that don't pay their bills. Businesses risk having employees suffer from work-related accidents, and having their products cause injury or even death. Poor investments, security breaches, natural disasters and potential lawsuits are just a few of the risks that businesses face.

Of course, we accept many of these risks without thinking twice. However, there are many risks that we should pay attention to, as they can potentially have a catastrophic impact on our business.

Smart investors mitigate their risk through careful research, diversification and hedging strategies. Even gamblers mitigate risk by hedging their bets. Likewise, there is much that businesses can do to manage risk.

Just ask yourself:

- What risks are your business exposed to?
- What can you do to mitigate those risks?
- Where do you start?
- How can you determine the payoff for your efforts?

This white paper was written to help you answer these questions.

Like a smart investor, by managing risk you can reduce losses and increase profitability - assuming you take the right approach to managing risk.

The Risk Management Process

Risk management is the process of mitigating risk by using factors you can control to eliminate, avoid, reduce or transfer risk.

The International Organization for Standardization (ISO), a prestigious world-wide federation of national standards organizations, has drafted standards for risk management[1] that roughly can be summarized as follows:

- Risk identification
- Risk analysis
- Risk evaluation
- Risk treatment

It's appropriate that ISO, the organization that created quality standards that are followed by many of the best companies throughout the world, is also creating risk management standards, as there are many similarities between managing risk and improving quality.

Both are ongoing processes that can create significant benefits for a company, including increased profitability, enhanced reputation and increased market share. ISO's recognition of these standards is a sign that it's time to take risk management seriously.

Has your business ever had an audit to assess your exposure to risk? That's the essential starting point for any risk management process.

It's time to take risk management seriously.

Step One. The Risk Audit: What Is Your Business Like Today?

To manage risk, the first step for any business should be to have a well-defined snapshot of your business as it is today.

An in-depth knowledge of the risks your company is exposed to and a plan for managing those risks is essential. Otherwise, you will have no way of assessing improvements or measuring your return on investment.

To gather the data needed to assess risk, you'll need to begin with a risk audit, or risk assessment. The audit will help your business to:

- Identify risks
- Create benchmarks
- Prioritize risk management
- Make the case for an ongoing risk management program

The audit should include a risk assessment methodology that is effective, simple to use and appropriate for your business.

While internal staff at all levels should provide data and input for the audit, it is important to use an independent third party with risk management experience to ensure that the audit results are unbiased and are based on appropriate criteria. Your independent insurance agent, who is familiar with both risk management and your company, may be the best party to conduct a risk audit for your business.

Businesses can be sued for almost anything. A slip-and-fall on your property. A decision not to hire a job candidate. Virtually any action that results in an injury or damage to property.

Types of Risk

To truly recognize risk within your organization, your audit should include every operation of your entire organization and should consider all types of risk. In general, business-related risks fall into seven areas[2]:

Property. Business owners risk loss of, or damage to, many types of property, including premises, office equipment, inventory, work in process, cash, patents and other assets.

Liability. Businesses can be sued for almost anything. A slip-and-fall on your property. A decision not to hire a job candidate. Virtually any action that results in an injury or damage to property.

Product Liability. Claims against manufacturers in the United States are increasing in virtually every industry. Some products may be misused by consumers, resulting in injury. More complex products, such as some drugs, may present liability issues that are not apparent until after the product is widely distributed and is being used by a large number of consumers or businesses. Even when the consumer is careless, your company may be sued for millions of dollars.

Information Technology. E-mail, instant messaging, Webinars and other forms of electronic communication expose businesses to potential viruses, identity theft and other risks. Hackers or even your own employees may have access to important proprietary files, customer lists, payroll and tax records, and even your customers' credit card numbers. Misuse of technology by employees, such as making derogatory remarks about someone in an e-mail, may also result in lawsuits against the business.

Disaster Planning. Fires and floods, hurricanes and earthquakes, ice storms and severe winds, sabotage by a disgruntled employee and even terrorist attacks may affect your business. Having a properly funded disaster plan can help the business owner get back in business quickly, before irreparable harm is done to the business.

Workers' Compensation. Not all workplace hazards are readily apparent. Safe use of machinery and protection from exposure to hazardous chemicals are critical, but employees today are also subject to not-so-obvious hazards, such as injuries caused by stress or repetitive motion injuries. Employers seeking to reduce costs also need to have a process in place for helping employees get back to work.

Motor Vehicles. Employers need to ensure that employees who are on the road and unsupervised are properly trained and have a safe driving record. Vehicles also must be well maintained with safety in mind.

Sources of Risk

In addition to recognizing types of risk, you will need to understand sources of risk. Where does risk come from? Some examples include:

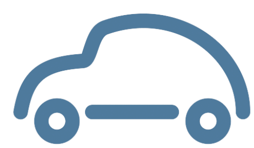
Business. A changing business environment could affect demand for your company's products or services. A competitor may locate nearby or launch a new and better product, potentially affecting your company's business prospects and putting your business at risk.

Regulatory. Complying with new regulations will make it more expensive for you to conduct business and could make it necessary to change or abandon some business practices.

Environmental. In the broadest sense, environmental risk refers to any risk from outside the company, including, for example, the geographic risk of increased competition resulting from globalization. It may also refer, of course, to the risk of property contamination or exposure to pollutants or dangerous chemicals resulting from the operation of your business.

Human. People are the greatest source of potential liability for many businesses. The actions of employees, customers and even people who are not connected with your business may result in charges of fraud, harassment, discrimination, theft and more.

Technology. Technological advances can make your product obsolete or, as in the case of the Internet, easier to promote and distribute.



Employers need to ensure that employees who are on the road and unsupervised are properly trained and have a safe driving record.

Financial. The subprime mortgage crisis, for example, has had an impact on the stock price of virtually every publicly held company and has made it more difficult for privately held businesses to borrow money.

All of these sources of risk can have a dramatic impact on your company, regardless of how well run the company may be.

Audit Criteria

Identifying types and sources of risk will provide context for an audit and help in developing audit criteria.

Criteria can be fairly simple or very complex, depending on the size of your business, the type of business you're in, your budget and the level of risk you are willling to accept.

For example, if your goal is to determine whether your business is adequately protected against losses resulting from fire, the Insurance Information Institute[3] suggests considering the following issues:

- [ ] Are employees trained in fire safety? Do they know exactly what to do if a fire starts? Is extra training given to those responsible for storage areas, housekeeping, maintenance and operations where there are open flames or flammable substances are used or stored?
- [ ] Do you have the right type, size and number of fire extinguishers? Your fire department or fire protection equipment supplier can advise you. Are the fire extinguishers serviced and tagged annually? Do you review with employees at least once a year where the fire extinguishers are and how to use them?
- [ ] If needed, have you modernized your electrical system? Faulty wiring causes a large percentage of nonresidential fires. Are electrical panels accessible, with at least three feet of clearance, and labeled? Except for temporary use (or surge protection for sensitive electronics such as computers) electrical equipment should be plugged directly into an outlet, rather than into extension cords.
- [ ] Have you situated your business in a fire-resistant building — a structure made of noncombustible materials with firewalls (self-supporting solid walls running the full width and height of the building) that create barriers to the spread of fires?
- [ ] Does your building have a fire alarm system connected to the local fire department or an alarm company?
- [ ] Does your building have a sprinkler system to douse fires? If so, is it serviced, including a main drain test, at least annually? Is your sprinkler system the right one for your kind of building and the materials used in your business? Different types of buildings and contents require different types of fire suppression systems. Your insurance carrier, alarm company or local fire department can assist you in choosing the most appropriate type of system.
- [ ] Have smoke detectors been installed, and are they regularly tested?

Do you review with employees at least once a year where the fire extinguishers are and how to use them?

- [ ] Have you posted "No Smoking" signs? Do you enforce the rule? Is there evidence of smoking?

- [ ] Do you regularly check your heating system?

As an example of a more complex risk assessment, consider the following criteria for computer-based risk assessment from the Federal Financial Institutions Examination Council (FFIEC). This example is included to demonstrate how in-depth a risk assessment can be.

Most small and mid-sized businesses have neither the resources nor the need to carry out such a detailed assessment. However, they can use their independent insurance agent to profile and identify associated risks for:

- Individual business units
- Departments
- Product lines
- Systems

FFIEC criteria for computer-based risk include:

- [ ] Identify the institution's data, application and operating systems, technology, facilities and personnel.

- [ ] Identify the business activities and processes within each of those categories.

- [ ] Include profiles of significant business units, departments and product lines or systems, and their associated business risks and control features, resulting in a document describing the structure of risk and controls throughout the institution.

- [ ] Use a measurement or scoring system that ranks and evaluates business and control risks for significant business units, departments and products.

- [ ] Include board or audit committee approval of risk assessments and annual risk-based audit plans that establish audit schedules, audit cycles, work program scope and resource allocation for each area audited.

- [ ] Implement the audit plan through planning, execution, reporting and follow-up.

- [ ] Include a process that regularly monitors risk assessment and updates it at least annually for all significant business units, departments, and products or systems[4].

The audit should also include a scoring system that enables the organization to prioritize risk mitigation. No one can completely eliminate risk, but prioritizing risk management projects will enable the company to maximize return on investment (ROI) from the start. Early success will result in organizational buy-in and ensure that risk management becomes — or continues to be — a priority.

Have you posted "No Smoking" signs? Do you enforce the rule? Is there evidence of smoking?

Risk factors used in scoring may include the following, but this is another in-depth example that is beyond the needs and resources of most businesses:

- The adequacy of internal controls
- The nature of transactions (for example, the number and dollar volumes and the complexity)
- The age of the system or application
- The nature of the operating environment (for example, changes in volume, degree of system and reporting centralization, sensitivity of resident or processed data, the impact on critical business processes, potential financial impact, planned conversions, and economic and regulatory environment)
- The physical and logical security of information, equipment and premises
- The adequacy of operating management oversight and monitoring
- Previous regulatory and audit results and management's responsiveness in addressing issues
- Human resources, including the experience of management and staff, turnover, technical competence, management's succession plan and the degree of delegation
- Senior management oversight[5]

Working with your independent agent, you can adjust these factors based on your company's needs, your goals and your budget.

Defining Benchmarks

Think of risk management as a quality improvement process. As with quality improvement, information gathered during your audit should be well documented. By using risk scores to measure current conditions, you can benchmark your level of risk, and create a means for measuring and documenting improvements.

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While the sophistication of the measurement process will depend on factors such as the size of your company and the industry you serve, criteria should be chosen carefully, as you will need to consistently use the same process from year to year if your benchmarks are to be effective.

When you schedule your initial audit, also decide on an appropriate time for a follow-up audit, which will be needed to determine risk improvements. You may, for example, set an audit cycle of every year for areas where there is a high level of risk, every two years for areas with moderate risk and every three years for areas where risk is low.

Your insurance agent, or whoever is conducting the audit, should establish written guidelines for the use of risk assessment tools and risk factors, and review the guidelines with the company's audit committee or Board of Directors.

Remember that the ability to measure ROI will be key to the ongoing success of your risk management program. Be sure to document every dollar spent on risk management, as well as every dollar saved as a result. While savings will regularly outweigh costs, examine all costs and benefits carefully to ensure that each aspect of your risk management program is worth continuing.

In some cases, ROI can exceed $20 for every dollar spent[6]. While ROI can be difficult to measure, in general, it costs much less to manage risk than it does to pay for the results of an accident or injury that occurred because of the lack of a risk management program.

Step Two. The Risk Management Plan: What Should Your Business Be Like Tomorrow?

While the risk audit establishes the need and the criteria for a risk management program, it is not an end in itself. It provides the foundation for establishing a risk management plan, which should itself be updated regularly.

Establishing Goals

The risk management plan should be approached strategically, with a goal of achieving the best results for the available budget. As with a business plan or marketing plan, establishing clear goals is important. If you don't set goals, you can't achieve them. Potential goals may include:

- Reducing worker's compensation claims/costs by a set percent.
- Reducing the number and severity of workplace accidents by a set percent.
- Reducing downtime related to accidents or injuries by a set percent.
- Improving profitability by a certain amount by reducing operating costs.
- Enhancing employee morale by working together to make the workplace safer.

Goals should be as specific as possible, and should be ambitious, but attainable. They should also be prioritized.

Be sure to document every dollar spent on risk management, as well as every dollar saved as a result.

Identifying Action Items

Once you have established goals, what will your company do to achieve them?

Your audit presumably has identified a variety of risks - some of which you may not have realized existed. The audit should also have divided those risks into three categories:

- **Critical risks.** Any risk that involves possible losses that could result in insolvency or bankruptcy of the firm.
- **Important risks.** Any risk that does not meet the criteria for being "critical," but that would, if not addressed, require the company to borrow to continue operating or that would result in a serious impairment of earnings to address.
- **Optional risks.** Risks that can be addressed without imposing a financial strain on the company.

Of course, critical risks should be addressed first and important risks should be addressed quickly as well. Some optional risks should be addressed quickly if doing so is cost effective.

Prioritization should consider the probability of a risk, as well as the cost of mitigating the risk. A tsunami could result in insolvency of a company, but if the company is located in the United States, the probability of a tsunami would be considered an acceptable risk.

It is impossible to mitigate risk completely. At some point, the cost of mitigation outweighs the risk. For example, if you are installing equipment to reduce pollutants, the cost of removing trace measures of pollutants may be exorbitant and the potential health benefits may be negligible. The overall goal is to minimize risk, but within a sensible budget.

At what point does risk become acceptable? Assuming all regulatory requirements are met, you need to decide at what point the cost of mitigation exceeds the benefits. Also consider the opportunity costs. At some point, limited capital may provide a better return if it is invested elsewhere.

Keep in mind, though, that your business and the market in which it operates is changing continuously. Even if you've done everything you can to manage risk, keeping your risk management program in place will help your company to maintain your current programs for mitigating risk and to meet whatever new requirements result from those ongoing changes.

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Step Three. Implementation: Creating a Safer, More Profitable Business

Once you have identified risk in your business, you have four choices for risk treatment[7]:

Avoiding risk. Every business action involves some level of risk, but sometimes it can be avoided. An example of avoiding risk is calling off the acquisition of a company when the due diligence process determines that acquiring the company would create too much risk. The risk may be based on financial considerations, environmental concerns, potential product liability, the company's past experience and reputation, or many other factors.

Reducing risk. Some risks cannot be avoided, but the probability of suffering a loss relating to the risk can be reduced. Health insurers often give members discounts to join fitness clubs, for example, because they know that a person in good shape is less likely to incur significant healthcare costs for treatment of heart disease, diabetes or other major illnesses. Likewise, a hard hat, safety glasses, safety shoes and other precautions can reduce the risk of industrial accidents.

Transferring risk. You can transfer risk to a third party by outsourcing certain operations or by purchasing insurance. In the IT industry, for example, software as a service (SaaS) is a popular concept. Software companies license the use of their products, but are responsible for maintaining it and for security.

Likewise, insurance by definition is used for transferring risk. Your risk audit will identify gaps in your coverage where you are exposed to excessive risk or liability. Filling them will require a change to your coverage, but will not otherwise have an impact on how you do business. Your audit should also identify any areas where you are over-insured or have insurance that is unnecessary.

Retaining risk. How far should you go to mitigate risk? When the potential reward for mitigating risk no longer outweighs the cost of your effort, you've gone too far. Some risks are acceptable. The risk of an accident while driving to and from work, for example, is acceptable (except, perhaps, during a major snowstorm) and can be retained. The risk of hiring the wrong person for a particular job must also be accepted if a company expects to grow.

You can transfer risk to a third party by outsourcing certain operations or by purchasing insurance.

While a risk management plan identifies ways to avoid or reduce risk, insurance bears the burden of any risk that cannot otherwise be avoided, reduced or transferred.

Insurance Planning

More than 1,500 years ago, inhabitants of Rhodes used a form of insurance by pooling together and paying a premium to reimburse merchants whose ships were lost at sea.

Today, insurance continues to play a central role in risk management. While a risk management plan identifies ways to avoid or reduce risk, insurance bears the burden of any risk that cannot otherwise be avoided, reduced or transferred.

Implementing a risk management process can help a company control premium costs and ensure that it has only the insurance it needs - but it cannot eliminate the need for insurance.

In the process of assessing your organization's risks, you will gain a better understanding of what is covered by insurance and what is not covered. Without that understanding, your company remains at risk. You may incur a loss and think that your insurance covers the loss, only to find out that it doesn't.

Step Four. Analyzing Results: Review Your Results — And Start Again

Once you've implemented your plan, it's time to assess the results. Determine where you've met or exceeded your goals and where you fell short. And determine what you need to do next.

Risk management is never truly completed. It is an ongoing process in which continuous improvement is sought. As your business changes, it will be exposed to new risks. Changes in the business environment, growth of your customer base, acquisitions and mergers, hiring of new employees, the introduction of new products or upgrades to existing products all create new risks for your company.

The Age of Uncertainty

In today's world, protecting your business from risk is more difficult than at any time in history.

The subprime crisis has made every business aware of how vulnerable to risk it is. While no one could have anticipated the worldwide repercussions of the crisis, those businesses that were most prepared to handle risk are likely not only to survive, but to succeed.

The Internet has made even small businesses into international businesses and has created new opportunities — but it has also created new risks. Each country with which you do business has different regulations, different business practices and different codes of ethics. Companies that try to conduct business as they have in the past stand little chance of succeeding long-term. Those that adapt, however, will thrive.

With ISO's involvement, fortunately, an international standard for risk management is likely to evolve in the near future.

Companies that start the risk management process today with be better prepared for the business world of tomorrow. They may also benefit from:

- Increased profitability
- Increased productivity
- Improved morale
- Improved safety
- Less downtime
- Lower probability of lawsuits
- Less chance of regulatory action

Careful risk assessment can also help in the decision-making process. If a business action is too risky, it may not be worth taking. Conversely, no organization can completely avoid risk. The key is to manage risk, as the flip side of risk is opportunity. Without risk, there can be no reward.

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Without risk, there can be no reward.

Endnotes:

[1] International Organization for Standardization, "Committee Draft of ISO 31000 Risk Management."
[2] The Hartford, "Managing Your Risk," 2008.
[3] Insurance Information Institute (www.iii.org/smallbusiness/riskmanagement/).
[4] Federal Financial Institutions Examination Council (FFIEC), *Information Technology Examination Handbook*. (www.ffiec.gov/ffiecinfobase/booklets/audit/audit_03_risk%20ass_rb_audit.html).
[5] Ibid.
[6] Hall, Elaine M. *Risk Management Return on Investment* (John Wiley & Sons, Inc.:1999) Syst Eng 3: 1770-180.
[7] Dorfman, Mark S. *Introduction to Risk Management and Insurance* (9th Edition). (Englewood Cliffs, N.J: Prentice Hall, 2007). ISBN 0-13-224227-3.

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