

## PUBLIC ENTITY RISK MANAGEMENT (352-1)

*[The public sector includes government entities and their agencies.]*

### EO 1. EIGHT FUNDAMENTAL DIFFERENCES BETWEEN PUBLIC ENTITY ADMINISTRATION AND PRIVATE ENTITY BUSINESS MANAGEMENT:

1. **Essential functions**--Governments perform many functions that must continue (police, fire, courts, military) no matter what their cost. Private businesses may change their goals according to the dictates of the markets they serve more easily than the public sector can change its goals.
2. **Scope of exposures**--Government must provide a wider variety of services than private businesses, especially as it continues to expand its scope.
3. **Legal requirements and authority**--Government is exempt from many requirements that apply to private businesses. Government limits itself and private businesses as it chooses.
4. **Nonprofit, public service objectives**--Government seeks power, not profit. Government seeks to enhance its power in large part by doing 'good', by assuming responsibility on our behalves.
5. **Power to tax**--Government generates revenue through *[involuntary]* taxes and fees. Private entities generate revenue by selling goods and services *[in the voluntary market]*.
6. **Political scrutiny**--Government entities often opt for short-term plans and budgets because they are subject to partisan scrutiny.
7. **Special tax status**--Public entities are usually exempt from income, sales, and other taxes.
8. **Different accounting and budgeting procedures**--Public and private entities use different accounting methods in budgeting, investing, and tax accounting.

### EO 2. THE FIVE-STEP PUBLIC ENTITY RISK MANAGEMENT PROCESS:

#### I. **Identify and analyze loss exposures:**

##### A. **Determine the types of assets vulnerable to loss:**

1. **property**--both tangible (buildings, land, and personal property) *and* intangible (rights, privileges, and reputations);
2. **freedom from liability**--the legal responsibility for unintentional or unavoidable *[and intentional and avoidable]* harmful actions;
3. **net income**--revenues that exceed related expenses and that are produced by taxes, service fees, and governmental appropriations; *and*
4. **key personnel**--employees with special knowledge or skills vital to an organization's prosperity which, when lost, increase liability loss exposures, reduce income, and/or increase expenses.

##### B. **Determine the perils that might cause loss:**

1. **Natural perils**--include earthquakes, floods, and other unpreventable geological and meteorological threats. Minimize their effects before, during, and after such events.
2. **Human perils**--include deliberate actions (theft, assault, vandalism), unwitting actions, and inaction, all of which may cause an organization to suffer loss.
3. **Economic perils**--include strikes, boycotts, wars, technological changes, and consumer fickleness.
- [4. **Legal perils**--include juries excessive awards and judges' inability to properly read business contracts, including insurance policies.]*

- C. Estimate consequences of loss to limit the **frequency** and **severity** of loss. Classify loss exposures according to their potential to impair the normal functions of the public entity.

##### **Four categories of potential loss:**

1. **high-frequency/low severity**--retain and control such losses;
2. **high-frequency/high-severity**--avoid such losses;
3. **low-frequency/low-severity**--retain such losses; and
4. **low-frequency/high-severity**--transfer or insure such losses.

- D. Use these **seven methods to identify and analyze exposures**:
1. **Surveys and questionnaires**--identify an entity's property, products, assets, operations, key personnel, and other items to reveal loss exposures.
  2. **Loss histories**--identify the entity's losses and examine statistical probabilities based on its and similar entities' actual past losses.
  3. **Financial statements--include income statements** (detail profit and loss), **funds-flow statements** (report sources and uses of revenue), and **balance sheets** (list assets, liabilities, and equities). Financial statements indicate loss exposures such as property values, liabilities due to operational interruptions, and emergency cash funds.
  4. **General records and documents**--include contracts, correspondence, minutes of meetings, and memos that reveal the scope of an entity's activities and obligations.
  5. **Flow charts**--analyze procedural details and show the adverse effects of performance or production losses and disruptions on net income and revenue flow.
  6. **Personal inspections**--enable risk management professionals (**RMPs**) to directly observe and better understand an entity's operations, exposures, and liabilities.
  7. **Consultation with experts**--allows a large number of individuals (both within the organization and without) to contribute to loss exposure identification, which ensures more thorough results *and* gains support for risk management efforts.
- II. **Examine risk management treatment technique alternatives:**
- A. **Risk control techniques** minimize the frequency and severity of losses by reducing the likelihood and size of accidents and other perils causing loss.
1. **Exposure avoidance**--abandons certain activities or assets to eliminate all possibility of their related losses.
  2. **Loss prevention**--reduces loss frequency.
  3. **Loss reduction**--reduces loss severity.
  4. **Segregation of loss exposure units**--separates activities and assets. Segregation reduces loss severity but increases loss frequency. Duplicate assets and documents and store them separately.
  5. **Contractual transfer for risk control**--shifts exposures to another party. Public entities may contract with other organizations to shift responsibility for losses.
- B. **Risk financing techniques** pay for losses that occur despite any risk control techniques that have been implemented.
1. **Retention**--pays for losses with funds originating within an organization. **Informal retention** uses an entity's general funds to pay for losses. **Borrowing funds** from other entities and **levying taxes** to compensate for loss are other forms of retention. **Other risk retention options include** captive insurance companies, risk retention groups, and intergovernmental pools.
  2. **Transfer**--shifts losses and financial burdens from the **transferor** to the **transferee**. Contract law allows and governs transfer powers. Insurers act as transferees that accept the financial burden for losses suffered by insureds.
 

**Noninsurance contractual transfers:**

    - a. **Hold harmless agreements**--are noninsurance contractual transfers for risk financing. They require the transferees to pay for losses on the transferors' behalfs.
    - b. **Indemnity agreements**--require transferees (**indemnitors**) to reimburse the transferors for payments the transferors (**indemnitees**) have already submitted.

**Contractual transfers for risk financing**

    - a. shift the financial burden of *actual* losses suffered by transferors;
    - b. offer no financial protection against losses beyond the scopes of the transfer agreements; *and*
    - c. can be prohibited by statutes, contracts, and court rulings.

III. **Select alternatives: Risk management professionals (RMPs) must predict**

- A. the frequency and severity of potential losses;
- B. the impacts selected techniques could have on frequency, severity, and predictability of foreseen losses; *and*
- C. the expense of implementing alternative techniques.

**RMPs must consider public entity** objectives, political climates, risk tolerance, service obligations, legal limits on risk control or financing methods, and budget concerns before selecting among risk management alternatives.

IV. **Implement selected methods:** RMPs must pay close attention to the technical and managerial decisions implementation demands. RMPs usually have technical decision-making powers. Managerial decision-making often involves program planning and communications and leadership skills.

V. **Monitor risk management programs:** Make sure the program achieves its intended objectives.

**Routine audits determine if**

- A. performances meets standards,
- B. substandard performances can be corrected, *and*
- C. the standards need revision.

**Results standards** measure achievement of program goals.

**Activities standards** determine how to monitor and manage activities.

Both results standards and activities standards are crucial in monitoring risk management efficacy. A city that gives defensive driving training to its bus drivers as a loss control measure is using an activity standard. A state program whose funded reserves pay for up to \$50,000 to repair fire damage to state property is using a results standard.

**Differences between public and private activities, goals, and legal environments create further differences in loss exposures and risk management decisions:**

- 1. Laws and politics influence public risk control and financing alternatives more than they do private alternatives.
- 2. The public sector's selection of risk management alternatives is affected by factors such as public interests, legal and tax requirements, budgeting, politics, and insurance market conditions more than the private sector's.
- 3. Procedural requirements and political issues have more influence on public entities' risk management implementation techniques than they have on those of private organizations.
- 4. Public entities pay more attention to specified goals and performance measures than do private entities and so have different standards and methods of evaluating their RM programs.

EO 3. **CONTRASTS BETWEEN PUBLIC AND PRIVATE RISK MANAGEMENT:**

A. **Contrasts in organizational objectives**--Private businesses seek to maximize profits.

Public entities seek to maximize the output of programs within their budgets.

Public entities' objectives reflect the interests of citizens, employees, creditors, local businesses, and other public entities that expect services or funds for services of public entities.

**Five factors influence risk management effectiveness and affect the balance of entity and public objectives:**

- 1. **Political climate**--Public entities must examine political and public interests to make 'politically correct' decisions. Private organizations focus more on profits than on politics.
- 2. **Tolerance for risk**--Public organizations must provide services for the public's benefit despite threats of loss. Private entities have fewer obligations to the public and hence greater risk tolerance but, unlike public entities, private entities can simply abandon high-risk activities and practices.
- 3. **Obligations to provide services**--Public entities must provide many services and programs that do not benefit those entities financially. Private entities have *no* obligation to provide

services detrimental to cash flow [other than, say, paying for all public entities directly through taxes and fees and indirectly through taxes on incomes and dividends].

4. **Legal requirements**--Public organizations must perform certain functions, else be sued for breach of duty. But, public entities are exempt from many tax laws and safety regulations that apply to private entities.

Private entities are exempt from many obligations of public entities.

5. **Budgetary concerns**--The struggle for funds, competition between loss control measures and services over funds, and restrictions on expenditures influence public sector decisions. Those factors affect private entity objectives and decisions less, [since private entities apply one single criterion to all objectives and decisions: Maximize return on investment.].

B. **Contrasts in organizational structure--Four key features of the public sector's bureaucracy:**

1. **Division of labor**--the division of tasks and duties among employees that creates task specialization, increases efficiency, and assigns decision-making authority. RMPs must reach each specialized subdivision to implement programs.
2. **Rules and regulations**--the written or tacit guidelines to work patterns and relationships. Public entity RMPs who communicate with staff and management understand the discrepancy between standard practice and official policy and are thus more effective risk managers. RMPs must identify concerns of all levels within public organizations and determine each level's written *and* unwritten practices to manage public risks effectively. Private entity risk management is less complex because private organizations are less bureaucratically structured and so have fewer unwritten practices.
3. **Hierarchy**--the chain of command from top managers to low-level employees. Fewer layers separate top managers from lower-level employees in private firms than in public entities. Public entity risk managers have greater difficulty implementing programs because they must deal with longer chains of command to get approval to implement programs.
4. **Span of control**--the number of people a manager supervises. (Six to eight is a common ideal span.) Setting up a system of accountability and evaluation maximizes effectiveness. Public entities perform more activities outside of the traditional, easily supervised office setting (eg, law enforcement, education, social services) than do private firms. That creates a wider span of control for public entities and an increased potential for risk. RMPs must define spans of control to reduce exposures to loss.

[Yes, I know a wider span of control means a shorter chain of command and vice versa, by definition.]

C. **Contrasts in financial management--**

1. **Sources of revenue**--Public entities must maintain large sums of money to meet society's needs and hence must generate funds for the public good. (Private entities have no such requirement.) **Government raises money by**
  - a. **imposing taxes** on incomes, estate transfers, and sales and on persons, corporations, trusts, and businesses and on goods and services;
  - b. **issuing bonds** to raise funds for specific purposes;
  - c. **making low-risk investments** (ie, in US Treasury bills, certificates of deposit, real estate, and stocks, but rarely in private company investments); *and*
  - d. **charging new fees** for services not previously used to produce revenues (ie, for long distance phone service, airline flights, and cable television).
2. **Budgeting**--All citizens have a right to voice opinions about public expenditures. The open nature of the budgeting process creates difficulties for RMPs who need funds for services the public deems inessential. Private sector budgeting is *not* subject to public scrutiny.
3. **Financial reporting**--Documentation of public entity activities and financial records must follow the accounting and reporting standards outlined by the **Governmental Accounting Standards Board (GASB)**. Documentation of private entity activities and financial records must follow the accounting and reporting standards outlined by the American Institute for

CPAs' (**AICPA**) Financial Accounting Standards Board, the (**FASB**).

RMPs must report losses from damage to assets, service interruptions, errors, injuries, disasters, and contracts with pools. RMPs must also provide medical benefits in compliance with GASB guidelines (or according to FASB guidelines for private firms).

D. **Contrasts in managerial accountability**--A public entity must answer to the general public.

A private entity must answer to its owners. **Public officials are judged based on if**

1. they spend budgeted money wisely *and*
2. their programs and services meet the public's expectations.

Private officials are more concerned with profit than public opinion.

Public opinion often overrides proper judgment in deciding public policy.

Public policy dramatically shifts direction from one term of office to the next (again reflecting public opinion).

Private company goals remain constant regardless of who heads the business.

RMPs must stay abreast of changes in public policy that may alter exposures to risk and loss.

E. **Contrasts in political environment**--Public entities must make public redress for their mistakes.

Private firms do not always have to do so publicly. The Public Information Act and the Freedom of Information Act give citizens and the press access to all public entity records (except personnel files). The law does *not* require private entities to make all their records available. Pressures from the public on government create internal pressures that affect policy decisions and practices.

The private sector is free to make policy decisions independent of public and political pressures.

Public risk managers seek the most efficient alternatives to avoid public accusations of misuse of funds and failure to take appropriate measures.

EO 4. **PUBLIC SECTOR EXPOSURES: Examples of the enormous scope of public entity activity and of the high-risk services government provides that create vast exposures:**

1. **Property exposures**--Buildings once intended as residences but used as offices, storage areas, and classrooms; historical buildings (city halls, libraries, museums) impossible to value or replace; and vehicles used for road work, construction, public transportation, and trash collection which require maintenance and whose operators require training all create property loss exposures.
2. **Employment-related exposures**--Trade and craftsmen, municipal workers, safety and emergency personnel, temporary personnel, and other employees who perform public sector functions create employee-related exposures.
3. **Roads and streets**--Local governments can contractually transfer risks caused by road maintenance and improvements to other organizations.
4. **Parks and recreation**--Playgrounds, parks, public golf courses, and swimming facilities carry risks of responsibility for injury and illness for public entities.
5. **Law enforcement**--Court rulings against law enforcement agencies (ie, for use of force or in cases of high-speed pursuit or high-risk detainees) create loss exposures when they limit officers' abilities to perform their duties.
6. **Special events**--Parades, circuses, fairs, and sports held on public property generate revenue but carry risks of injury and even death.
7. **Utilities**--Water, power, and sewage utilities create immense loss exposures to the public.
8. **Social services**--Responsibility for the public's welfare (ie, for the elderly, ill, and poor) creates a range of exposures. Some risks can be transferred to nonprofit organizations.
9. **Changes in legislative and regulatory requirements**--Public entities must comply with federal, state, and local regulations regardless of whether legislative changes make it more or less difficult to maintain stability, carry out programs, and provide services. Legislative and regulatory changes may involve zoning, school district staffing, tax structure, employee benefits, and safety. State governments are immune from liability under the federal **Occupational Safety and Health Act (OSHAAct)**. State and local laws regarding government employees' safety thus have priority over federal statutes.